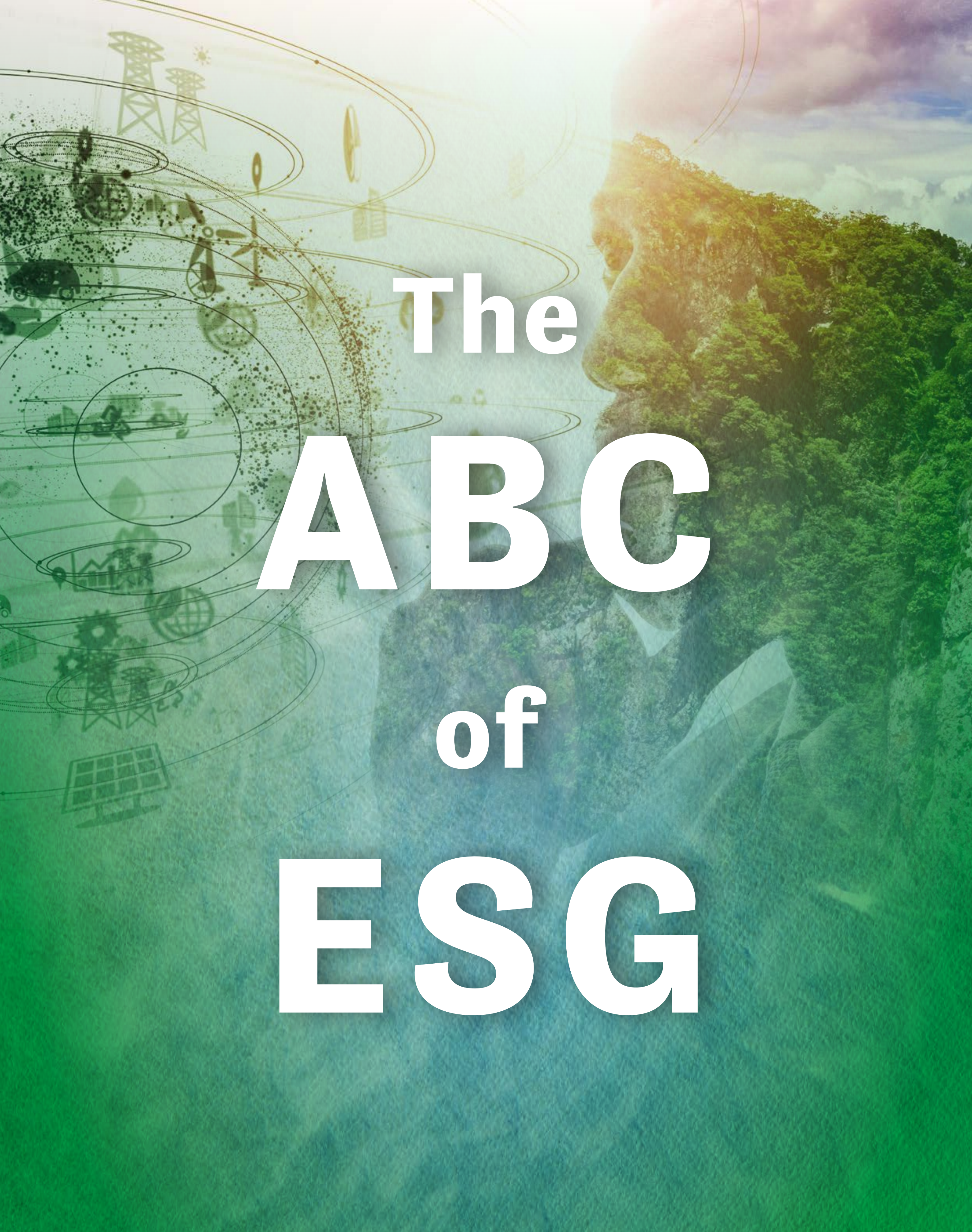

The ABC of ESG

SUPPLY MANAGEMENT INSIDER

IHS Markit™

Understanding – and managing – Environment, Social and Governance (ESG) metrics may be difficult, but it is a) possible and b) essential. The challenge for Chief Procurement Officers is to ensure they lead the process rather than getting left behind.

Have you made your net zero pledge yet? Ahead of the 26th United Nations Climate Change Conference (COP 26) in Glasgow this November, more than 1,500 companies globally, with a combined annual revenue exceeding £8trn, have done so. Countries accounting for some 67% of global greenhouse gas emissions, including China and the US, have made similar promises.

Definitions of net zero vary but in essence it means that companies promise that, by 2050, the activities within their value chain will have no net impact on the climate through greenhouse gas emissions. To achieve this goal, they will need to reduce emissions and balance the impact of any remaining emissions through carbon removal.

The net zero pledge has reinvigorated media coverage of climate change and placed the issue back at the top of the corporate 'to do list'. The pressure on businesses to meet ESG commitments – and to be able to prove that they are doing so – has never been greater. The risks facing companies that neglect these metrics have never been higher.

There are three major shifts which, Kevin Bourne, managing director and head of sustainable finance at IHS Markit, a leading global provider of analysis and solutions to business, says every organisation needs to be aware of: "The pandemic has taught us that globalisation and just-in-time manufacturing has created risks that we never thought we would have to deal with. There is a real concern about climate change accelerating. If it does, we could have 500 million people moving from around the equator. Regulators are saying that this is systemic risk and over the next two or three years we will increasingly see corporate loans being judged, in part, on the way businesses run their supply chain. We also now know that we do not understand our supply chains as fully as we thought, particularly in terms of country and location risk."

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The sense that the stakes have been raised – that we are, in a real sense, playing with the future of the planet – has heightened concern among regulators, investors, consumers and employees. Richard Blore, CEO and managing director of KY3P at IHS Markit, says: "Governments are taking a much more critical view of companies that indulge in 'greenwash' by, for example, making claims that either cannot be validated or are irrelevant) and promoting specific initiatives while ignoring the bigger picture. Over the past year, regulators in many sectors have renewed their focus on third-party risk management, reiterating the point that companies cannot outsource accountability."

42%

of corporate websites analysed by the European Union contained "exaggerated, false or deceptive" claims about the sustainability of their products

In January 2021, the European Commission published the results of an investigation into greenwashing on 334 websites in various business sectors, including fashion, cosmetics and household equipment. Investigators concluded that 42% of environmental claims were probably exaggerated, false or deceptive. In almost six out of 10 cases, companies had failed to provide easily accessible, verifiable evidence.

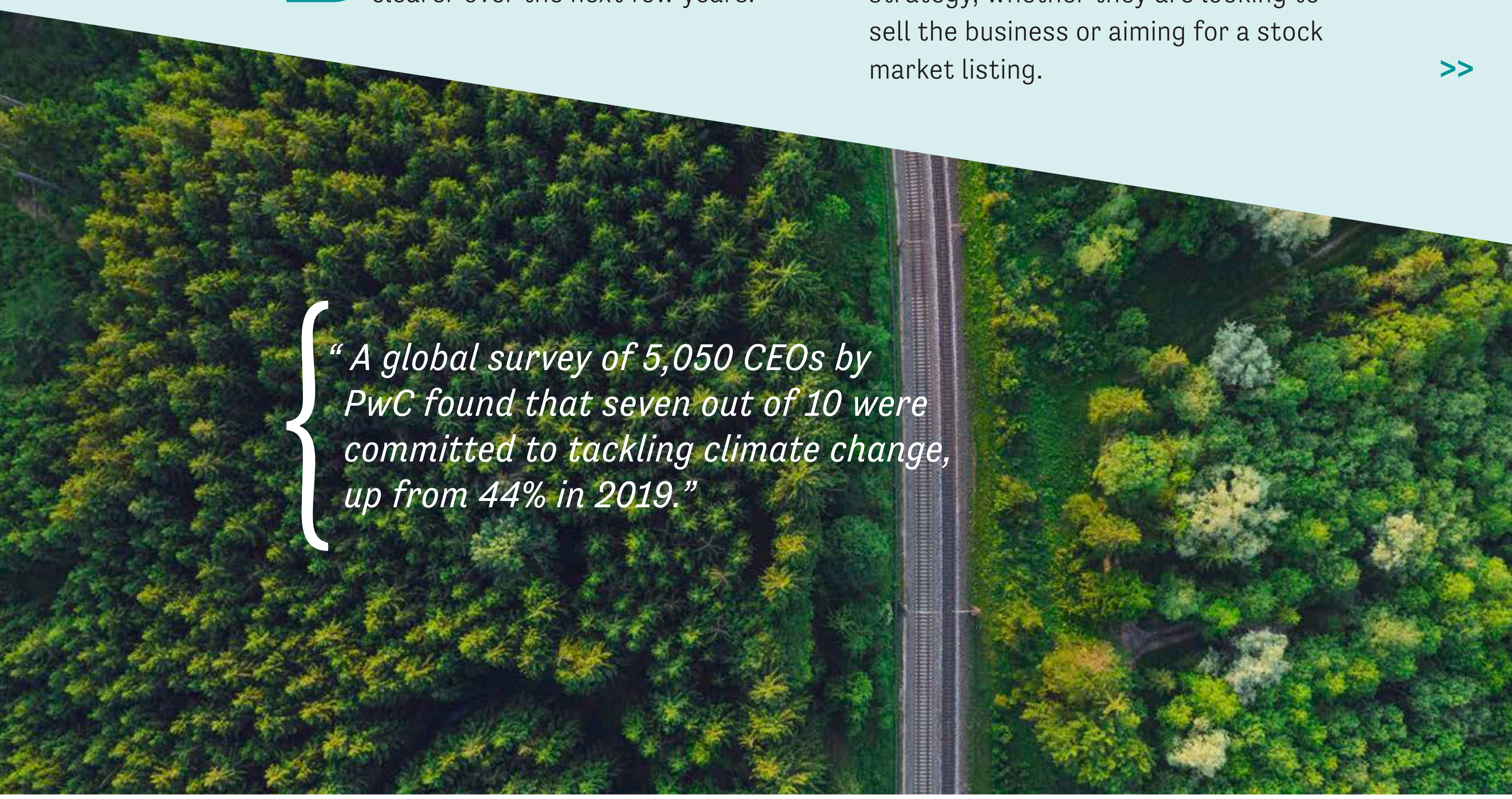
The European Commission's Sustainable Finance Disclosure Regulation (SDFR), which came into effect in March, is designed to prevent greenwashing by requiring the finance sector to report on the impact their company, services and products have on ESG. The same concern has prompted America's Securities Exchange Commission to create a task force to analyse ESG disclosures and "proactively identify ESG-related misconduct."

The penalties for companies judged to have failed to meet their ESG commitments include – but are not limited to – substantial fines, reputational damage (especially on social media) and being locked out of public sector procurement spending. In the not too distant future, in some jurisdictions, it is likely that company officers – including non-executive directors – will be held personally responsible for any malfeasance. As Blore says: “The benefit of this heightened scrutiny for chief procurement officers (CPOs) is that the return on investment in ESG has never been clearer or more compelling.”

Among the global business community, there is a growing sense that an inflection point has been reached. In March 2021, a global survey of 5,050 CEOs by PwC found that seven out of 10 were committed to tackling climate change, up from 44% in 2019. As Johnny White, climate accountability lawyer for the NGO Client Earth, told Forbes magazine recently: “There is a ‘rubber hitting the road’ moment now that is changing the practice around ESG. Sustainability is no longer a branding exercise, it is now a core requirement of business strategy.”

Bourne believes the rationale for investing in ESG will become even clearer over the next few years: “The regulatory regime is going to become much tougher as global standards come together. China and Europe are looking at a joint assessment of Europe’s disclosure regime because China wants to align its new regulations with what Europe is doing. I would not be surprised if, within five to seven years, every company, public or private, is obliged to incorporate ESG into its reporting. Private companies already report financially, so why should they not report on ESG?”

He predicts that this drive will be led, in part, by private equity investors because “really good ESG is all about data discipline and historically the private equity industry has been good at that”. One of the incentives for private equity is that, without accurate, timely ESG data, it may be harder to fulfil their exit strategy, whether they are looking to sell the business or aiming for a stock market listing.



“A global survey of 5,050 CEOs by PwC found that seven out of 10 were committed to tackling climate change, up from 44% in 2019.”

77%

of companies say they have limited visibility into third-party vendors

>> Organisations cannot afford to focus all their efforts on the E in ESG – S for Sustainability in the broadest sense and G for Governance are also increasingly important. As the global economy stabilises, governments have already begun redoubling their efforts to crackdown on modern slavery, which grew significantly during the pandemic. The most striking example is Germany's new Supply Chain Act, which makes companies responsible for human rights in their supply chain. From 2024, the law will apply to all companies with 1,000 or more employees. Businesses could be fined thousands of pounds and up to 2% of their turnover.

Tougher regulation is expected in Australia, Canada, New Zealand and the UK. NGOs are also targeting certain sectors – for example tuna fishing, construction and textiles – where companies' actions do not match their public words. In the US, customs officials are increasingly likely to suspend imports of goods implicated in modern slavery – 13 such orders were issued in 2020 alone. The Canadian Senate is also discussing a bill which, for the first time ever, would make company officers and directors personally liable for non-compliance.

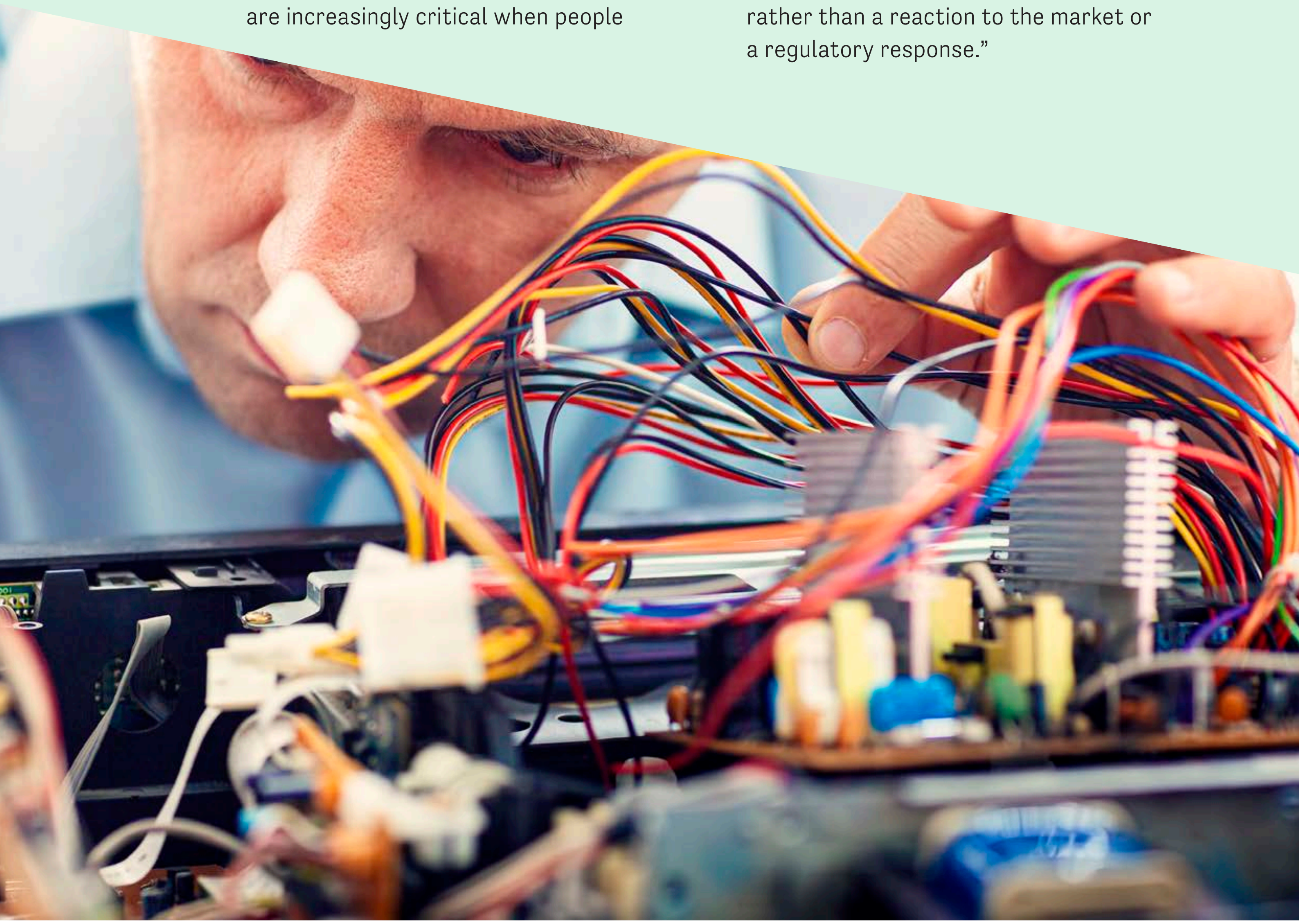
The emergence of right to repair regulations, which come into force within the European Union this March and will also take effect in the UK, shows regulators are thinking systemically about ESG – which is why companies must do the same. The EU's rules apply to certain electrical appliances (washing machines, hairdryers, refrigerators) and TVs but not, as yet, to smartphones and laptops. Even so, with the European Commission apparently favouring the kind of repair rating introduced in France, it is likely these rules will become tougher and more ambitious. >>

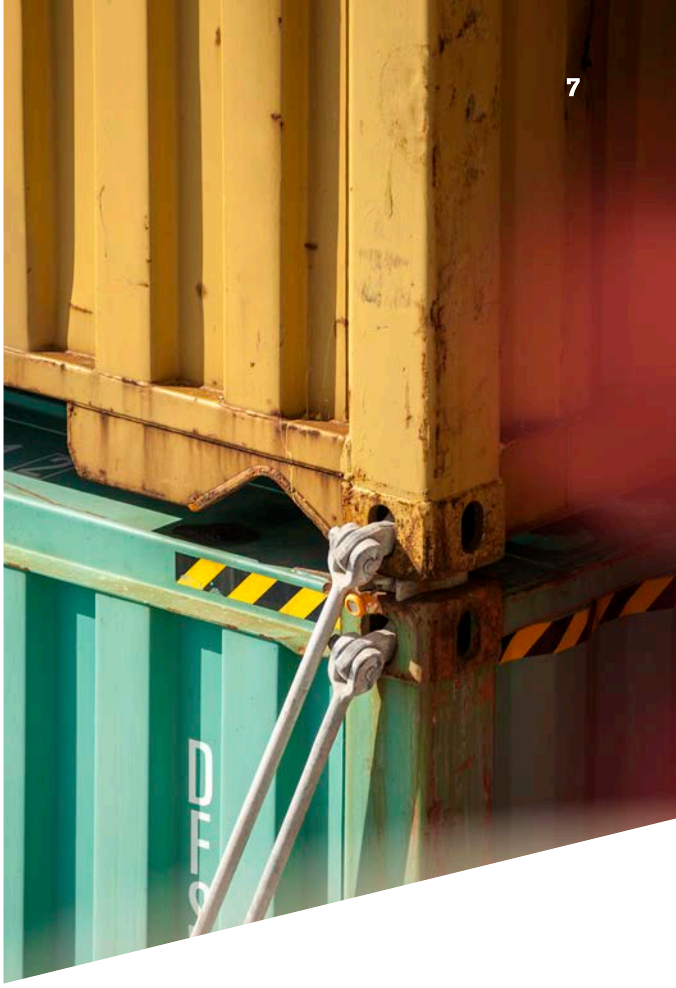
"Investing in ESG is weighted towards protecting value. Medium-to long-term, such investments could enhance company performance by creating value."

>> The existing rationale for investing in ESG in general (and third-party risk management in particular) is weighted towards protecting value. Yet in the medium- to long-term, such investments could enhance company performance by creating value. "We see that expectations from regulators, investors, consumers and employees are shifting. Non-financial indicators are increasingly critical when people assess the long-term sustainability of a business," says Blore.

The vast majority of the top 500 British businesses now report on climate-related risks and opportunities. In a 2019 survey by the Carbon Trust, 72% said doing so had added to their brand value, 31% that it had been financially beneficial and 21% that it had increased the company valuation.

"Companies can demonstrate ESG is something they are leading with," says Bourne. "It is a business attribute rather than a reaction to the market or a regulatory response."





So why have so many companies left it so late?

Around half of the world's GDP goes through a supply chain and many companies – and many CPOs – recognise that they cannot manage ESG properly without integrating the metrics into their supply chain. Many companies have tried to do this but, in the past, good intentions have often been frustrated by three key factors.

1. The complexity of the task

In the past, many CPOs who have sought to improve supply chain visibility but found that with traditional (sometimes manual) methods the process to be long, complex and laborious. In today's interconnected, globalised marketplace, an organisation's ESG footprint can grow exponentially in size, reach and complexity. Even medium-sized companies can have hundreds or thousands of suppliers which, in turn, will have suppliers of their own. The challenge becomes more formidable the bigger you are: there are more than 100,000 businesses in the global supply chain of Walmart, the world's largest retailer.

A few years ago, one major British retailer set out to map its entire supply chain but, after an 18-month quest, which cost more than £1m, they halted the initiative, eventually outsourcing the task to a consultancy which accomplished it in a few months. One of the obstacles the retailer resourced was bandwidth: supply chain visibility was a priority but there were many other priorities, many of which seemed more pressing.

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The result is that many organisations have settled for a partial solution with periodic, random or targeted checks on their supply chain. By their very nature, these investigations cannot give a complete picture and if they instil a false sense of complacency may do as much harm as good. Equally, validating and monitoring suppliers only when they are being onboarded, while better than nothing, will not significantly mitigate risk over the long term. Such approaches may explain why, according to IHS Markit's research, more than three out of four

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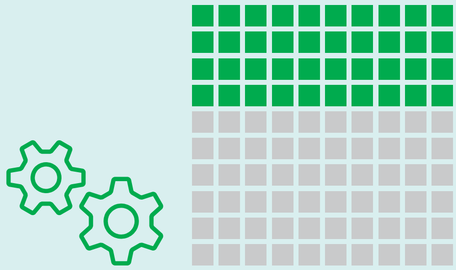

40%

of supply chain disruptions are caused by suppliers in tier 2 or the tiers below

>> companies say they have limited visibility into their third-party vendors.

The effectiveness of such efforts also depends on the degree of trust between customer and supplier. Some suppliers are reluctant to reveal the identity of their suppliers for fear of conceding a competitive advantage. Others fear that the customer's request for visibility has an ulterior motive, such as reducing costs or cutting out suppliers.

"The best approach to ESG is to tackle it in layers," says Bourne. "If you try to do everything at once, you may not succeed. Managers need to focus on getting the foundations right, which is about technology, process and data." CPOs also need to start by being realistic about the data they need to collect and ensure that this is consistent across the system to ensure that meaningful comparisons can be made.

2. Making the case for investment

In the past, inconsistent, imperfectly implemented, and badly integrated legacy IT systems have made it hard to actively and accurately monitor ESG. Internal stakeholders with long, and possibly inaccurate, memories of past IT investments may be sceptical about the efficacy of further spending. Yet in the past five years, the size of the investment required – and the time taken to implement new systems – have both reduced significantly. "Embedding ESG into supplier risk management and vendor risk assessment processes, so that the data can be looked at alongside cyber security, data privacy and compliance,

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70%

of global CEOs say they are committed to tackling climate change

>> is much less time consuming and expensive than it was," says Blore. "The technology has developed so much now that you can start to reap the rewards in weeks and months, not years as in the past."

Historically, many companies' de facto approach to ESG could be summed up as 'What you don't know can't hurt you.' Making supply chains ESG-compliant has not traditionally been a sexy topic – boardrooms are much more likely to get excited by mergers and acquisitions, new product launches, or marketing campaigns – but the risks and rewards outlined earlier should focus minds – as indeed should the disruption experienced during the pandemic.

In the 2021 *IHS Markit Supply Chain Insights Global Survey,* nearly two-thirds of global supply chain leaders said they needed better technology, platforms and data to meet their cost optimisation goals. This bolsters the case for also investing in ESG because, as Blore says: "In this highly-regulated environment, companies that focus on immediate cost savings over careful due diligence could save the organisation a few million pounds only to incur hundreds of millions of pounds in fines and penalties."

3. Making the case for procurement

You cannot eliminate risk, but you can identify it, mitigate it and control it. To do that, companies need to recognise that ESG cannot be the sole responsibility of the CPO. At a very basic level, it doesn't matter what policies and processes are put in place if business users ignore them. "In the past, many CPOs have felt they were not taken sufficiently seriously, were not given a seat at the top table, not consulted about strategy and engaged too late in the process," says Blore. "This is their opportunity to change that. As risk factors proliferate and regulatory oversight increases, procurement is not just about commercial value, it is about protecting the organisation's reputation, resilience, competitive position and market share. The challenge for CPOs is to lead this process, or get left behind."

Towards a newer world

"Every CEO should understand the operating footprint of their business," says Bourne, "and make ESG a transparent element in their message to suppliers, investors, regulators, employees and the media." Making pledges on ESG without knowing how you are currently performing is akin to plucking a profit forecast out of the air and leaves CEOs open to accusations of 'greenwash'.

Fortunately, supply chain leaders have a historic opportunity to change things. "After years of focusing primarily on cost management, few procurement professionals have the visibility into their supply chain they need to identify and neutralise risk," says Blore. "But with new tools, analytics, data, frameworks and technologies, they can identify where they are vulnerable, strengthen the entire procurement process from sourcing and contracting to managing risk and supplier relations and, through vigilance and diligence, protect the supply chain."

Investing in Third-Party Risk Management Solution (KY3P), and an ESG data management system is, Bourne says, a critical component for companies which want to make a step change in their management of ESG: "It is easy to build a system that collects and analyses data. The bigger challenge is to build a system that, by enabling reporting and monitoring, uses the data to solve problems for the business."

Because regulators are thinking systemically about ESG commitments – as evidenced by the right to repair rules – supply chain leaders need to do the same. That means not confronting one particular risk but a complex network of risks which will probably interact with each other in unexpected ways. To develop a holistic understanding of the health, resilience and sustainability of their supply chains, companies need a golden source for all supplier data, multi-source ratings to calculate risks accurately and inclusively, frameworks to standardise best-practice procurement,

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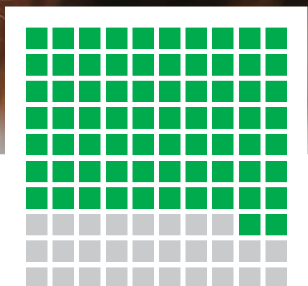
At the moment, companies that underachieve on ESG can take refuge in the absence of globally accepted key performance indicators. That wriggle room will not last. The European Union is already trying to address this and, partly by dint of being first, will have an enormous influence on regulations elsewhere.



72%

of large UK companies said that disclosing their carbon footprint had increased the value of their brand

and end-to-end visibility so they get timely warnings of emerging risks.

Visibility in supply chains is not an end in itself but past experience shows that transparency often leads to action. The fact that the Task Force on Climate-Related Financial Disclosure (TCFD) has replaced its original goal – keeping the global temperature rise well below 2°C by 2100 – with a target of keeping warming down to 1.5°C with net-zero global emissions by 2050 – indicates the growing sense of urgency surrounding this issue and the relatively short time allowed for companies to make this transition.

COVID-19 – and the production and distribution of vaccines – has put supply chains in the spotlight in a way they have seldom been in peacetime. Several surveys have suggested that the public has become more critical of – and less trusting in – large institutions, particularly in the private sector, a trend that had begun before the pandemic started. With so much at stake socially, ethically, environmentally and financially, consumers, investors and regulators are in an unforgiving mood.

If the world's supply chain leaders are to sleep at night, they need to know that their company's fine words on ESG are being translated into good deeds and, furthermore, that they can prove that is the case. If they can do that, they can turn trust into a competitive advantage, shape corporate strategy and, last but not least, help to save the planet. It will, as Bill Gates told *Harvard Business Review* this spring, "be the most amazing thing humankind has ever done". Yet, as Blore and Bourne both emphasise, the "amazing thing" will only happen if CPOs start work on it now.

How technology can help manage third-party risk

How does a CPO know if a supplier in any tier of their network is endangering their reputation by engaging in the kind of activities that infuriate regulators, alienate consumers and undermine their ESG commitments?

All too often, the answer, at the moment, is they don't. Or at least, not soon enough to control the damage and mitigate responsibility when the regulators step in. Most procurement leaders do, at least, recognise the problem.

"With IHS Markit's KY3P vendor risk management service, companies can detect whether a supplier has committed a financial crime and assess for risks."

Earlier this year, risk management and sustainability were identified by Supply Management and the Chartered Institute of Procurement and Supply (CIPS) as two of the greatest challenges facing the profession. Four out of the top five concerns about risk were connected to ESG: breaches of data protection rules; bribery and corruption; the financial stability of suppliers; and issues that may cause reputational damage. The three top sustainability concerns were ethical sourcing; bribery and corruption; and human rights.The issues at stake here are more complex than the Gordian knot and, alas, less likely to be solved by a brilliant stroke of lateral thinking. That said, there are ways that CPOs can help protect themselves and their organisation. With IHS Markit's KY3P vendor risk management service, companies can detect whether a supplier has committed a financial crime, such as bribery, money laundering, breaching sanctions and export controls, and accurately, comprehensively and efficiently assess suppliers for financial risks, cyber vulnerabilities and negative news stories in the media and on social media.

Artificial Intelligence (AI) is already being widely used in banking to detect fraud on the basis of a set of pre-defined rules and will be an increasingly powerful aid for managing third-party risk across all sectors. "If you look at all the aspects of ESG you need to manage, the scale of the task becomes clear," says Blore. "You have to factor in the impact of head office, overseas businesses, supply chain, joint ventures and other business partners, even the source of your capital. You can't do that entirely through technology – you need leadership, commitment and discipline – but you certainly can't do it without technology."

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