Guidance on assessing and managing environmental and social risks in the supply chains of sub-projects

European Bank
for Reconstruction and Development

Introduction

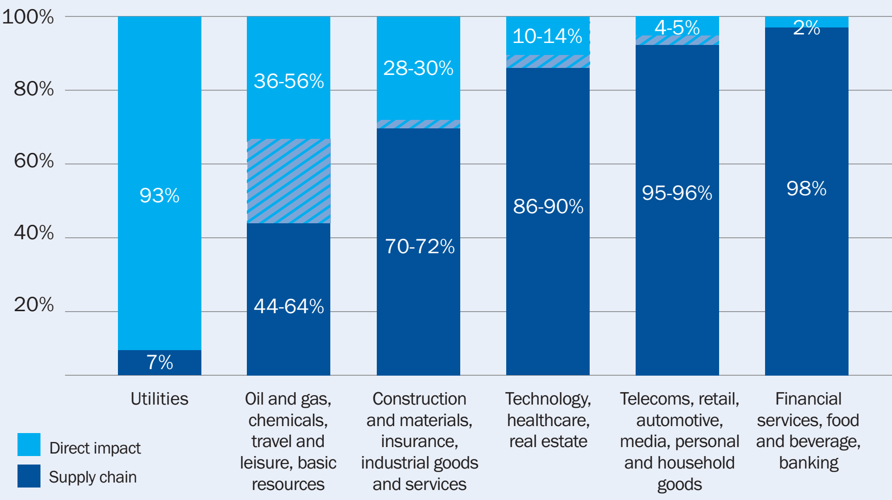
Financial intermediaries (FIs) are required to comply with Performance Requirement 9 (PR9) of the EBRD Environmental and Social Policy (ESP). These requirements include developing an environmental and social management system (ESMS), a key component of which is the risk management of sub-projects (including sub-investments in the case of equity financing).

The purpose of this guidance note is to assist EBRD FI clients in developing an approach to assessing and managing environmental and social risks in the supply chains of their sub-projects. It includes an overview of the business rationale for integrating considerations of environmental and social risks in supply chains to sub-projects, a summary of supply chains in which environmental and social risks may be heightened and practical pointers on how FIs can incorporate supply chain considerations into their existing ESMS.

Why focus on environmental and social risks in supply chains to sub-borrowers?

There is ever more emphasis on environmental and social risks in global supply chains. This increase in attention is being driven by growing evidence of human rights infringements in various phases of goods production and distribution, from reports of child labour in agriculture to adverse environmental impacts in the extractive industries. At the same time, supply-chain shocks and disruptions precipitated by conflict, weather events and the Covid-19 pandemic have created significant commercial impetus for companies to increase visibility over their supply chains.

Figure 1. Share of a sector's environmental impact located in the supply chain



Source: UNEP Finance Initiative and United Nations Global Compact (2017).

Studies have shown that across a range of sectors, most environmental and social (E&S) risk impacts are linked to supply-chain activities rather than their direct operations. Figure 1, for example, shows the share of a sector's environmental impact located in the supply chain.

This is amplified by the concurrent influence of media scrutiny, investor expectations and regulatory initiatives. There is growing momentum among governments around the world to require companies to undertake due diligence and report on sustainability in their supply chains. Such legislation typically encompasses obligations for large companies, including financial institutions and investors, to conduct due diligence to identify potential risks and impacts within their supply chains (including supply chains to their sub-investments or sub-projects), institute measures to mitigate these risks and act to address any adverse impacts that may arise. There is also an increasing expectation that financial institutions will report on these measures and outcomes.

Many initiatives use the concept of responsible business conduct (RBC), which sets out an expectation that all businesses avoid and address negative impacts of their operations, including in their supply chains, while contributing to sustainable development in the countries where they operate. See the below examples of regulations and initiatives on RBC that are particularly relevant to financial institutions.

Examples of regulations and initiatives relevant to financial institutions:

- The European Union (EU) Taxonomy Regulation[1] establishes a list of environmentally sustainable economic activities and mandates aligned with the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises,[2] the United Nations Guiding Principles on Business and Human Rights[3] and the fundamental conventions of the International Labour Organization (ILO)[4] as minimum social safeguards. Similar approaches are also being developed elsewhere, including the South Africa Green Finance Taxonomy.[5]
- The EU Sustainable Finance Disclosure Regulation (SFDR)[6] introduces transparency rules for financial institutions on the integration of sustainability risks and impacts in their processes and financial products, including reporting on adherence to internationally recognised standards for due diligence, specifically those of the OECD.
- RBC is listed among nine actions of the G20 Sustainable Finance Working Group's roadmap.[7]
- The Global Reporting Initiative (GRI) revised its universal standards[8] to align and integrate with the OECD RBC standards.
- The 2020 OECD Development Assistance Committee (DAC) Blended Finance Principles for Unlocking Commercial Finance for the SDGs[9] recognise that blended finance projects should integrate high corporate governance, environmental and social standards, as well as RBC instruments to support the development of functioning and efficient markets.
- The Equator Principles,[10] a financial industry benchmark for identifying, assessing and managing environmental and social risks in project finance, include specific expectations on human rights due diligence.

Beyond regulatory requirements, there is strong business rationale for giving serious consideration to E&S risks in sub-projects' supply chains. Where companies do not have systems in place to identify, mitigate and monitor risks in their supply chains, this not only leads to potential adverse impacts on their workforces and the communities in which they operate, but can also constrain immediate and longer-term profitability. Furthermore, if supply-chain issues are not adequately managed, this can create reputational risks, not only for the company but also for investors.

Consequently, financial institutions are increasingly incorporating assessments of sub-projects' supply-chain risks and management systems into their due diligence and monitoring processes.[11] Where gaps are identified, financial institutions can also play a role in supporting sub-borrowers to strengthen their approach to E&S risks in their supply chains.

1 See EU (2020).

2 See OECD (2023).

3 See OHCHR (2011).

4 See ILO (n.d.).

5 See National Treasury of the Republic of South Africa and International Finance Corporation (2022).

6 See European Union (2019).

7 See G20 (2021).

8 See GRI (2023).

9 See OECD DAC (2020).

10 See Equator Principles (2020).

11 See UNEP Finance Initiative and United Nations Global Compact (2017) for case-study examples of investors working to manage environmental, social and governance (ESG) risks in the supply chains of private companies and assets.

What and where are the E&S supply-chain risks?

While managing E&S risks is relevant to all companies with supply chains, FIs should focus efforts on portfolio companies where supply chains are associated with heightened E&S risks. Table 1 provides a broad view on the multifaced areas involved in supply chain management.

Table 1. Contextual view of supply chain management

Sector	Agro-food processing/commodity trading: • Child labour is a key concern in many agricultural supply chains. According to the US Department of Labor, products including cocoa, citrus fruits, cotton, cumin, hazelnuts, peanuts, pulses and sugar beets are associated with child labour in the production of goods.[12] • Other supply-chain concerns include improper or excessive use of agrochemicals, including pesticides and fertilisers, which can cause immediate and/or long-term environmental and health impacts on workers or nearby communities; poor management of water resources, which can impact the availability and quality of water resources to nearby communities; and ecological and social impacts resulting from the conversion of natural habitats, including deforestation. Renewables: • The shift to renewable energy demands significant mineral resources, each playing a role in different technologies. Battery efficiency and longevity hinge on lithium, nickel, cobalt, manganese and graphite. Rare earth elements are essential for wind turbine and electric vehicle motor magnets. Robust electricity networks require copper and aluminium, with copper pivotal to electricity-related technologies. The extraction of many of these elements is associated with significant labour risks, including child labour and forced labour. • The production of renewable energy often requires large amounts of land. This creates potential risks associated with the conversion of natural habitats or agricultural land, which could have negative impacts on communities, biodiversity and food security.
Country/geography	• In contexts where environmental and social laws and regulation are weak or not properly enforced, risks will be greater. High-risk sourcing countries include fragile and conflict-affected states.
Supply chain structure	• In general, in complex and multi-stage supply chains environmental and social risks can be more difficult to identify and manage. At the same time, the lack of traceability and associated lack of transparency can contribute to weak environmental and social standards in lower tiers of the supply chain.

How can FIs approach supply-chain E&S risk management?

The most effective way for FIs to approach E&S risks in sub-projects' supply chains is to incorporate them into their existing ESMS.

Figure 2. The E&S appraisal and monitoring process

12 See US Department of Labor (2022a).

Screening

Relevant criteria should be incorporated into pre-investment screening. As a first step, potential sub-borrowers can be screened based on known E&S risks associated with the company's operating context and supply chains. Key questions for determining risk at this stage are:

- What goods and materials are likely to be in the company's core supply chains?
- Which activities take place in the supply chains (for example, farming, manufacturing or artisanal mining)?
- From which countries (and regions of larger countries) are these goods and materials likely to be procured?
- Are any of these products/activities/country combinations associated with known E&S risks?
- Are any of these products/activities included in the EBRD E&S Exclusion List?

Case study: Taking a systematic approach to risk screening and management of supply-chain risk

In contexts where there is a known high risk of serious supply-chain issues, it is important for FIs to take a systematic approach to risk screening and management. In 2019, the EBRD developed a series of risk-screening and management tools to assist FI clients in Uzbekistan to respond to significant concerns about the use of forced labour in cotton supply chains. The tools were designed to be incorporated into an ESMS and to allow FIs to assess, manage and monitor forced labour risks throughout a transaction lifecycle. Key components include checklists to support the initial risk screening of sub-projects, guidelines on defining "risk zones" associated with the use of forced labour, suggested clauses for inclusion in contracts with sub-projects, and guidelines on how to conduct monitoring.

The ILO monitored the risk of child labour and forced labour associated with the cotton harvest in Uzbekistan through third-party monitoring (TPM), a systematic nationwide monitoring programme for the cotton harvests between 2013 and 2021. Uzbekistan made significant progress in eradicating child and forced labour between 2017 and 2021. According to TPM reports, systemic child labour was eradicated in the country in 2017, while forced labour risks declined consistently between 2017 and 2021. The 2021 ILO TPM report indicated that systemic forced labour did not occur during the 2021 cotton harvest and that 99 per cent of pickers participated in the cotton harvest voluntarily.[13] In 2022, the Cotton Campaign lifted the global boycott on cotton products from Uzbekistan,[14] and the International Labour Organisation (ILO) declared Uzbek cotton free of systemic child and forced labour. The ILO TPM project ended in 2021. Monitoring conducted by civil rights activists in 2022 indicated that some forced labour risks remained in Uzbekistan,[15] so FIs should continue to manage and monitor risks related to supply-chain risks.

Useful resources for screening:

- US Department of Labour: List of Goods Produced by Child Labour or Forced Labour: www.dol.gov/agencies/ilab/reports/child-labor/list-of-goods
- IFC Global Map of Supply Chain Risks in Agro-Commodity Production (GMAP): https://gmaptool.org/
- Business & Human Rights Resource Centre: (www.business-humanrights.org/en/)

13 See ILO (2022).

14 See Putz (2022).

15 See Uzbek Forum for Human Rights (2022).

Categorisation

Based on the information gathered during the screening stage, FIs should ensure that the E&S risk categorisation of sub-projects takes into consideration risks associated with the sub-project's core supply chain. In doing so, FIs should bear in mind that the core supply chain is likely to extend into other sectors than that of the sub-project. For example, sub-projects in the garment manufacturing sector are likely to include agricultural activities such as cotton production in their core supply chain.

See the ESMS categorisation tool for further guidance on this. Note that FIs may use their own E&S risk categorisation frameworks or those of other IFIs, as long as they are aligned with that of the EBRD and demonstrate clear and consistent methodology.

Assessment

FIs will often have large numbers of sub-projects and investments and are likely to be exposed to a wide range of environmental and social risks in supply chains through these sub-projects. They will not be in a position to address all of these risks at the same time. Risk prioritisation involves identifying which risks to address first based on their severity and likelihood:

- "Severity" refers to an assessment of the impact's scale, scope and remediability.
- "Likelihood" refers to an assessment of how likely the impact is to occur and, therefore, takes into account operating context throughout the supply chain.

The severity factor has a greater weighting than the likelihood factor. Severe impacts may include hazardous working conditions or extensive environmental degradation that threatens the livelihood and health of local communities. Sub-projects whose supply chains entail the most significant risks should be prioritised for further assessment. Where screening identifies supply-chain risks associated with a particular sub-project or activities of a sub-borrower, this should be prioritised for further assessment to understand the particular risk profile and assess the company's capacity to manage its supply-chain risks. In general, sub-borrowers (including investee companies in the case of equity financing) are better placed than FIs to identify and manage E&S risks in their specific supply chains. Therefore, the role of the FI should focus primarily on assessing the sub-borrower's capacity to manage risks, including whether they have appropriate policies and procedures in place to map supply chains, identify and assess relevant risks and put in place appropriate systems for managing them.

This involves ascertaining that the sub-borrower:

- has knowledge and visibility of its core suppliers[16]
- demonstrates knowledge and understanding of the types and severity of E&S risk in its supply chain
- has in place clear and reasonable procedures to adequately identify supply-chain risks, for example, procedures to screen potential suppliers and check working conditions at supplier premises
- has in place policies and procedures appropriate to the level of risk, for example, an effective company policy or supplier code of conduct that sets out measures to address supply-chain risks and contractual commitments in purchasing contracts
- has adequate internal management capacity to manage supply-chain risks.

Realistically, there may need to be gradated expectations for different types of sub-project, principally depending on scale. Many sub-borrowers and sub-projects are likely to be small and medium-sized enterprises (SMEs) and may have limited capacity to manage risks in their supply chains. For example, SMEs may not always have the leverage to insist that their supplier code of conduct is used by large suppliers or by suppliers for which the SME only represents a small fraction of their total business. FIs should, therefore, develop a classification system based on the risk profile of their customer base, with gradated expectations for different types of sub-borrower. As a starting point, all sub-borrowers would be expected to undertake a high-level mapping and risk assessment of child labour, forced labour and deforestation risks in their core supply chain.

Figure 3 sets out an example (for indicative purposes) of gradated expectations for sub-borrowers where there are risks of child labour, forced labour or deforestation in the supply chain.

Figure 3. Gradated expectations for sub-borrowers for supply chain management

1. High-level supply-chain mapping and risk assessment	2. Commitment, policy, resources	3. Supplier code of conduct	4. Supplier training, awareness raising, capacity building	5. Supply-chain risk prevention approach (including auditing)	6. Supply-chain remediation approach	7. Partnership with other parties to enhance leverage and address complex issues	8. Responsible disengage-ment approach

16 Core suppliers are those that supply goods and materials that are essential to the core operational functions of the project.

Mitigation

FIs may be able to provide technical guidance to sub-borrowers on how to strengthen their policies and processes for E&S risk management in supply chains, including how to increase leverage with suppliers or how to connect with relevant sectoral initiatives or training opportunities.

FIs are likely to face practical challenges in terms of the extent to which they can influence their sub-borrowers to identify and address E&S issues in their supply chains. For example, if the FI's financing is only a relatively small investment for the sub-borrower or if there are other available financing options with lower requirements, FIs may lack the requisite leverage to adequately address such issues. In such cases, FIs should seek to overcome leverage limitations and may consider the following options:

- The ability of FIs to exercise leverage is generally higher prior to contracts being signed. Where possible, FIs should seek to use contractual provisions in loan agreements to build greater leverage with sub-borrowers on supply-chain risk management issues. Specific clauses could include requiring sub-borrowers to develop a code of conduct defining key requirements for suppliers relating to E&S risks.
- Seeking long-term and stable relationships with sub-borrowers can enhance the FI's leverage. Addressing supply-chain issues is a challenging and long-term commitment which might be difficult to address within the scope of a single, short transaction.
- Where the FI has a seat on the company board, this can be a powerful opportunity to raise and follow up with company leadership on concerns regarding E&S risks in supply chains and to scrutinise risk management processes.

At this stage, it may also be helpful for FIs to look at risk exposure across their portfolio and identify whether there are any specific high-risk supply chains where the FI might have scope to engage at a sector or industry level. This could include:

- collaborating with other financial institutions to develop common approaches
- becoming involved in industry initiatives targeting specific issues.

Similarly, there can be practical limitations on the ability of sub-borrowers to effect change in the behaviour of their suppliers, related to, among other things, product characteristics, the number of suppliers, and the structure and complexity of the supply chain. Nonetheless, enterprises are expected to influence their suppliers in any way they can, such as through contractual arrangements, voting trusts and participation in industry-wide collaborative efforts with other enterprises with which they share common suppliers.

Monitoring

Monitoring and reporting systems should be put in place to track the performance of sub-borrowers in relation to their management of environmental and social risks in supply chains. These should be integrated into existing monitoring and reporting systems. Ideally, indicators used for monitoring should be adapted according to the risks that are pertinent to sub-borrowers, but generic indicators could cover:

- number of direct suppliers
- changes in supply chains of goods and materials
- results of supply-chain risk assessment
- percentage of suppliers covered by a supplier code of conduct.

Beyond monitoring for individual investments, it is also important for FIs to review their portfolio regularly in its entirety, in order to identify any emerging risks that could benefit from proactive management at a portfolio level.

Other useful resources:

OECD publications on responsible business conduct in the financial sector

United Nations Principles for Responsible Investment (PRI) on managing ESG risk in the supply chains of private companies and assets

Office of the High Commissioner for Human Rights (OHCHR) resources on the financial sector and human rights

European Sustainability Reporting Standards (ESRS)

United Nations Environment Programme (UNEP) Finance Initiative resources on supply chains

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