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ANALYTICS

Supply chain due diligence

Regulatory overview and know your supplier framework

Acknowledgement

Enrico Aresu is a Director and Compliance and Financial Crime Industry Practice Lead at Moody's Analytics.

Prior to joining Moody's, he spent 15 years in the compliance and risk industry, mostly in consulting where he advised major organizations on their technology-driven compliance journeys. He focuses on the development and implementation of new technologies to build an enterprise-wide approach to risk management.

Enrico holds an MBA from POLIMI Graduate School of Management, a Master of Engineering, and a Master in Renewable Energies from the Polytechnic University of Milan.

Situation

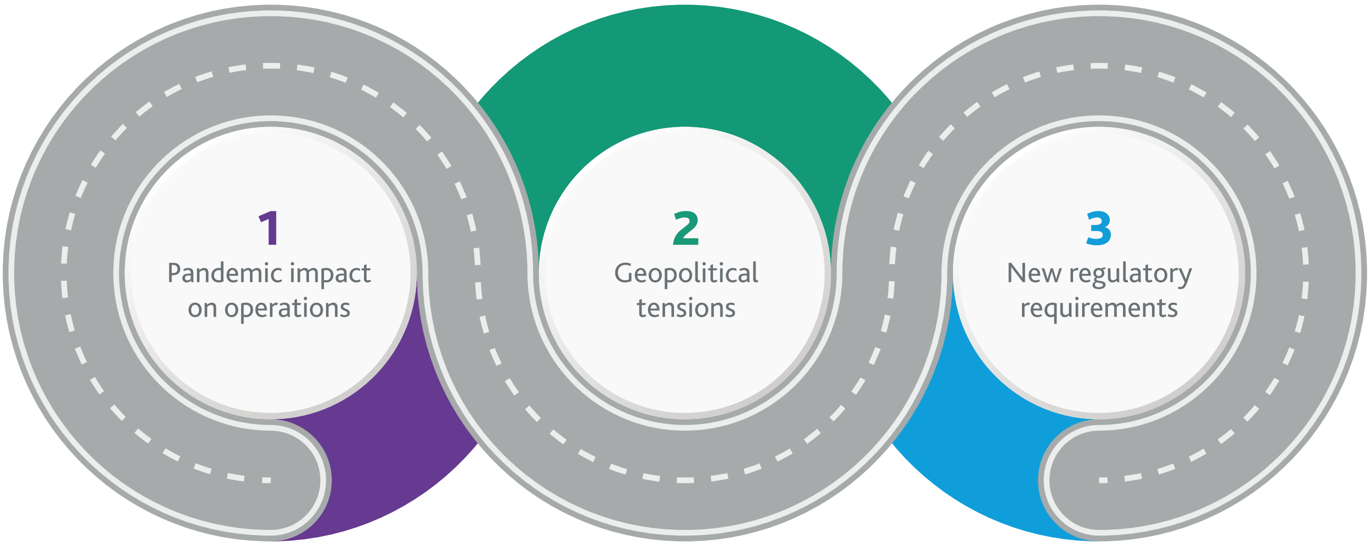
In recent years, there have been several key events that have contributed to deeply disrupting supply chain due diligence processes. Now, the way companies perceive and manage their supply chains is evolving rapidly. Expectations of internal stakeholders – senior leaders and board members – as well as external stakeholders – regulators and enforcement agencies – have also changed significantly.

The fight against human rights violations, fraud, bribery and corruption, sanctions violations, and other forms of financial and environmental crime has driven companies to change attitudes towards risk and changes to compliance standards, and that encompasses their suppliers and suppliers' suppliers.

As governments try to prevent these crimes and Environmental, Social and Governance (ESG) offenses, many countries around the world are passing modern slavery, corporate transparency, and supply chain due diligence laws and introducing new regulation. These standards are set to uproot criminal activity in legitimate business entities.

How companies apply the new laws across their organizations is key. They need to create a 360-degree view of risk across their supplier network by combining data with different risk perspectives. The compliance requirements to prevent ESG offences and to stop financial crime within business networks will only become more robust, with more scrutiny from regulators. Firms must plan and introduce best practice due diligence that is fit for the law today, and flexible enough to accommodate future change.

Accelerating factors



There were three material factors that accelerated the transformation of supply chain due diligence:

1. The Covid-19 pandemic radically impacted supplier due diligence. It pushed companies to improve knowledge about their supply chains, presenting an opportunity for a more comprehensive and holistic approach to risk management. The experience led to a balancing act between effectiveness and efficiency – firms had to work within their risk appetite while taking into consideration crucial factors that really mattered and kept production flowing.

As we all know, Covid-19 caused huge market volatility as some suppliers went out of business, demand for certain goods and services went through the roof, and other items became useless. To ensure operational resilience, businesses had to look for more suppliers and diversify networks, and new suppliers had to be onboarded quickly and at scale.

The consequences of Covid-19 are still being felt across supply chains, both in the way business continuity is managed and in terms of how supply chain risk is controlled.

Along with new opportunities, new threats emerged and different types of crime. Having a resilient, diversified supply chain is important, but so is understanding who is in that supply chain; having transparency over a supplier's ownership structure; and ensuring they have ethical, legal practices is vital to compliance.

2. Geopolitical tensions are the second area that continues to change supply chain due diligence. Over the previous three decades, firms have taken advantage of reliable, low-cost transportation, and a benign trading environment to leverage low-cost labor in different regions which enabled them to deliver a plethora of products at a reasonable cost to globally dispersed markets.

However, the US – China trade war, which began during the Trump administration, got tensions rising and the pandemic accelerated issues by exposing the depth and vulnerability of cross-border dependencies. Trade restrictions, even if temporary, have weaken trust and given countries the excuse to implement industrial policies in the name of resilience and self-sufficiency.

Then in March 2022, when Russia invaded Ukraine, many nations around the world responded by imposing swift and broad sanctions on Russian and Belarussian individuals and entities. Those subject to sanctions needed to be uncovered within supply chain networks at an unprecedented pace. This led to a change in risk monitoring, millions of new data checks each day, and a surge in demand for perpetual third-party due diligence processes - as periodic monitoring would leave businesses exposed.

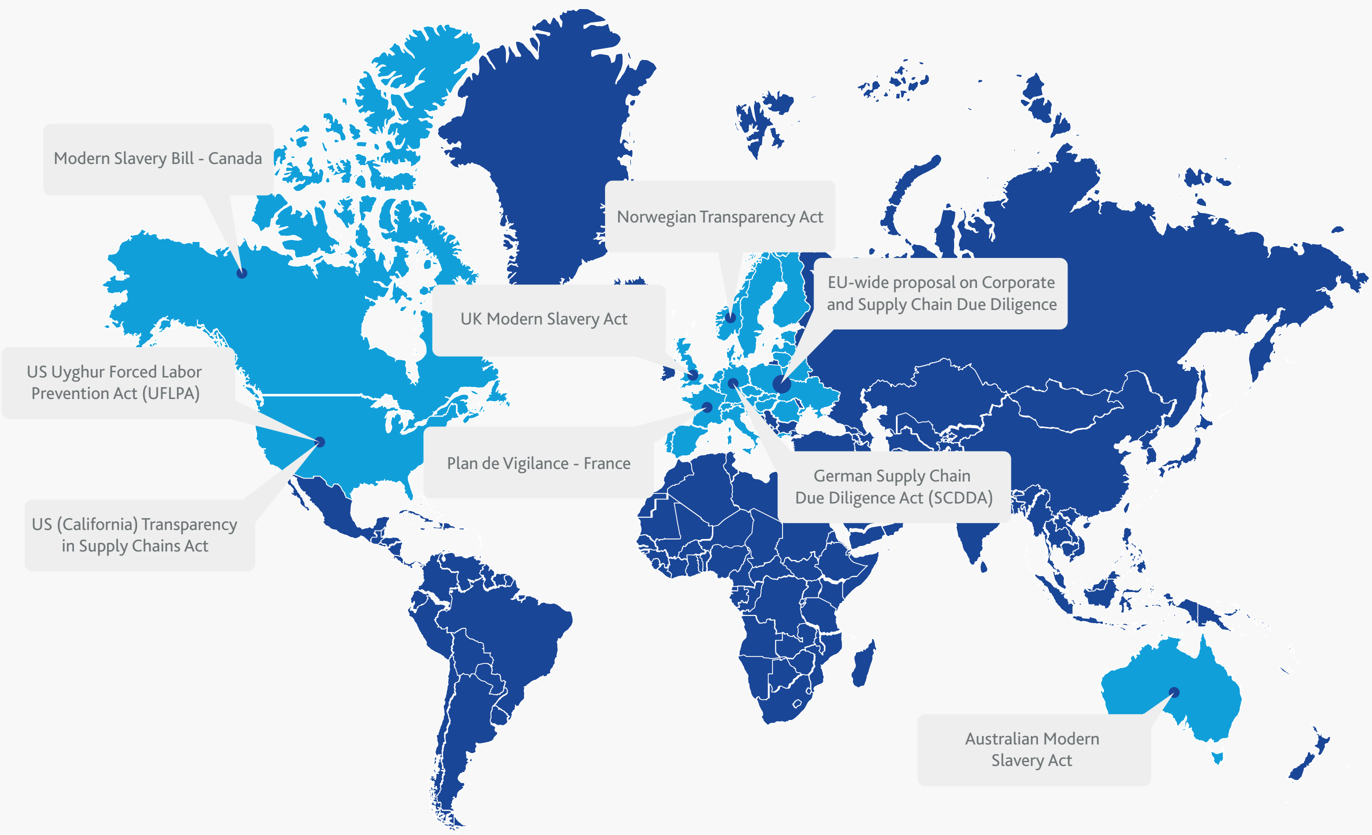
However, it's not only individuals and entities associated with Russia and Belarus that are driving this area of transformation in risk and compliance. The UK government alone has some form of sanctions imposed against circa. 24 countries. Monitoring politically exposed people (and their networks), sanctions lists, and negative news from across the world is a daily task.

3. New regulation that impacts how organizations operate and whom they can do business with, are being introduced around the world to combat financial crime and human rights violations. There is a continual wave of regulatory change hitting global firms. We have seen the corporate transparency act in the US, the modern slavery bill in Canada, the German supply chain act, and the modern slavery act in Australia to name a few.

Laws are aimed at ensuring companies understand the risks associated with direct and indirect suppliers in their networks. The regulations are also designed to create transparency around working practices to eradicate corruption and crimes such as child labor, modern slavery, and human trafficking.

Global corporate sustainability

Supply chain due diligence regulations



Events such as the Covid pandemic and Russia's invasion of Ukraine revealed how unprepared the corporate world was for a big supply chain shock, but they may, in turn, help address some of the gaps. While global triggers have tested the supply chains of many companies in many sectors for the first time, it has prompted significant expansion in the depth and breadth of internal and external supply chain audits. Companies have improved the measurability of supply chains significantly in the last two years and this trend is likely to accelerate with new reporting directives like the Corporate Sustainability Reporting Directive (CSRD) based on factors such as the EU taxonomy and the Double Materiality.

Regulatory implications

The regulatory landscape for supply chain due diligence has become increasingly complex due to operational, political, and legal pressures. Several new regulations have been implemented, and there are yet more to follow.

While this list isn't exhaustive, it gives a sample of current and new laws governing supply chain due diligence that companies need to be aware of, prepare for, and comply with.

- **In France**, companies with **more than 5,000 employees** must implement a Compliance Plan under the **Plan de Vigilance**. The law considers activities of subcontractors or suppliers as relevant to operations, and associated risks need to be understood with appropriate action or mitigation taken by obliged entities.
- **The UK** has one of the most far-reaching pieces of legislation in the world with the **UK Modern Slavery Act**. It impacts more than **12,000 companies** and their UK and international supply chains.
- **Belgium** has delivered a new legislative proposal to introduce a **duty of care and responsibility** for companies. The duty tabled is based on European standards and internationally recognized standards for corporate sustainability and protecting human rights.
- **US** adopted the **Uyghur Forced Labor Prevention Act (UFLPA)** that creates a rebuttable presumption that goods sourced from the Xinjiang Uyghur Autonomous Region (XUAR) of China are made with forced labor, meaning companies sourcing from the region must prove otherwise to enter the US market.
- **Germany** first adopted a National Action Plan for Business and Human Rights in 2016, which relied on a voluntary commitment by companies to act in a way that prevented violations. This voluntary process did not go far enough, and Germany has now introduced a **Supply Chain Act**. From January 2023, German companies with **more than 3,000 employees** must comply.

Industry leaders have been actively involved in drafting and promoting these regulations. The new laws send producers and manufacturers around the world a clear message that they must be prepared to account for operations and practices in their supply chain.

The German law is a forerunner for pushing companies to go beyond any single requirement: what they really need is a robust framework where organizations harmonize and embed a holistic set of due diligence practices according to their risk appetite and business model.

EU legislation impacting global supply chain due diligence

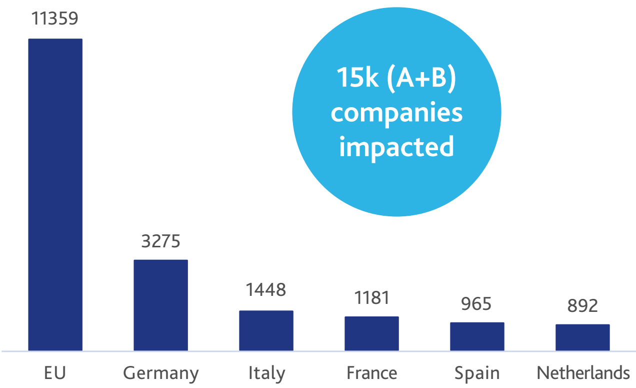
Chief among the new supply chain due diligence legislation is the European Union's (EU) proposal on Corporate and Supply Chain Due Diligence. The proposed directive imposes mandatory human rights and environmental due diligence (mHREDD) obligations on certain EU businesses, as well as some non-EU businesses that operate in the EU single market.

Companies in the EU with more than 500 employees and a net annual turnover of more than €150 million would be obliged to comply, as would companies with more than 250 employees and a net annual turnover of more than €40 million where at least half of that turnover is generated from certain "high-impact" sectors.

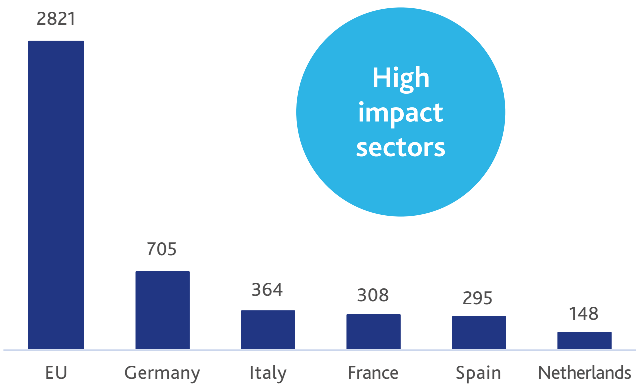
The size of the businesses impacted by the mHREDD is a game changer. Consider - the first phase of the German supply chain due diligence act targets companies with more than 3,000 employees. Here we have organizations with 250 employees that are likely to face similar compliance challenges for the first time, and who may not have the processes, practices, technology, culture, and maturity to face them with confidence.

High impact sectors include textiles, agriculture, manufacturing of food products, and extraction of natural resources such as gas and coal.

A) EU corporates with more than 500 employees and a net annual turnover in excess of €150 million (Orbis)



B) EU corporates with 250-500 employees and a net annual turnover of €40-150 million (Orbis)



Both figures (A&B) are conservative, the total number of companies affected is likely to be higher.

The due diligence obligations will also apply to companies based outside the EU provided they meet applicable turnover thresholds within the EU.

The due diligence requirements set out by the EU draw heavily on the UN Guiding Principles on Business and Human Rights (UNGPs). Essentially, businesses affected by the proposal would have to conduct due diligence to identify and then cease or mitigate the actual and potential human rights and environmental impacts of their operations, subsidiaries, and business relationships in the value chain.

Considering these legislative changes and proposals, companies operating in Europe and across the world now need to assess, alter, and improve their approach to supply chain due diligence to comply with regulation and preempt future changes in the law. This means developing and deploying a robust and transparent "know your supplier" (KYS) framework.

A robust framework

What do companies need to create a KYS due diligence framework?

What's needed is a robust and transparent framework that sets out a clear policy, assesses and uncovers risk, enables risk management and mitigation plans, facilitates a complaints process, and delivers reports to stakeholders and the authorities.

Policy	Risk assessment	Risk management	Complaints management	Reporting

- **Policy** – Companies need to develop a supply chain due diligence (DD) policy and integrate it into all corporate policies. This supply chain DD policy should be agreed with stakeholders, communicated with internal teams, integrated into working practices, and translated into any automated workflows or regulatory technology used to execute risk and compliance tasks. Companies have independent and integrated policy commitments – so the chosen format for the DD policy will typically be one where the greatest level of acceptance of its content can be achieved within the context of the entire organization.

- **Risk assessment** – Companies obliged to comply with supply chain DD regulations, such as the mHREDD, will be required to conduct periodic assessments of counterparty risk. The mHREDD for instance would require risk analysis to take place annually. It's advisable however a) for all companies to complete regular monitoring of their supplier network to assess risk, and b) to think about implementing a perpetual risk monitoring process that is event driven, rather than periodic.

- **Risk management** – Firms need to identify actual and potential risks through supply chain due diligence practices and understand the adverse impacts of those risks. They also need to prevent potentially adverse impacts through mitigation plans. And finally, firms need to have a means of ending any actual adverse impacts - i.e. they need to take action to stop something "bad" happening once it has been identified. Most companies will still be developing mechanisms to check the effectiveness of these measures.

- **Complaints** – Companies should set up a complaints procedure to identify potential violations, such as human rights violations, at the earliest possible stage. The complaints procedure should enable a firm's employees and the employees in a counterparty organization to raise issues for investigation. The person raising the compliant needs confirmation it has been received, actioned, and settled. Companies should set up multiple grievance channels for different impacted groups. It is essential to use this mechanism to improve understanding of risk.

- **Reporting** – Companies should report the outcome of their supplier DD activity in a transparent and public manner. In the case of the mHREDD and German supply chain act, this would be an annual report. Firms need to report and show they are aware of the actual and potential adverse effects of their business activities, which encompasses actions of suppliers in their network on human rights, the environment, and so on, and show they have taken appropriate action to counteract the effects. Particularly mature companies communicate transparently about their challenges, goals they haven't yet achieved, and any necessary changes. In doing so, they respond to the fact that social change takes time and can only be achieved through continuous commitment.

According to a poll carried out by Moody's Analytics, 36 percent of participants have only partially embedded ESG into their supply chain due diligence processes over the last two to three years. While the majority – 43 percent – are starting their planning. This means there is significant opportunity for improvement and implementation of best practice.

Poll

Have you embedded sustainability/ESG into your supply chain due diligence?

A) Yes, we have fully integrated these requirements into our operational due diligence	14%
B) Partially, we have improved this aspect in the last 2-3 years	36%
C) Not yet, we are starting our planning now	43%
D) No, it is not a priority	7%

Source: poll conducted by Moody's Analytics in July 2022; participants included representatives from 45 European Corporate entities.

Benefits of good KYS practices

There will inevitably be fines for violation of these supply chain and corporate transparency laws. Fines will vary by authority and according to the severity of an offense. With regards to the German supply chain act for example, companies with an annual global turnover of more than €400 million could be fined up to 2 percent of this turnover, and companies fined €175,000 or more could be excluded from public procurement for up to three years.

Executing a robust supply chain due diligence framework does more than prevent a company from being fined though. It supports the true effort behind introduction of these new laws; it helps companies fight corruption in their supplier networks that perpetuate crimes such as child labor, modern slavery, and human trafficking.

Organizations also recognize that building preventative measures and responding to risks supports business continuity and mitigates disruption to operations and to supply chains. This is the real value-add to businesses – sustaining a license to operate, business continuity, and protecting reputations.

The global priority to control and mitigate financial crime and ESG violations has led to the introduction of these laws, and it is to the advantage of corporates, their suppliers, and the world community to act with integrity to identify risks and uproot bad practices.

Takeaways

Should all elements of supply chain due diligence be implemented at the same time?

Several companies do not want to reinvent the wheel, so they are seeking to integrate these aspects of due diligence into existing risk management structures and processes, taking an approach of continuous improvement.

If you are taking this approach of making supply chain due diligence part of a process of continual improvement, here are some key factors to build in:

Framework

Firms need to deploy a robust and transparent Know Your Supplier framework and embed that into operations to comply with regulation.

Flexibility

Due to the emergence of increased regulation around Environmental and Human Rights due diligence, companies need flexibility from a process and technology to deal with today and prepare for tomorrow.

Monitoring

Organizations can't take one picture of risk and trust that it will remain the same. They must understand risk at onboarding and then continually monitor it across their network of customers, suppliers, and third-party vendors.

Governance & Compliance

Most companies do not want to measure in absolute terms the specific business value their ESG or human rights programs add. It should be considered a "must have" in terms of governance and compliance.

Responsibility & Risk

When designing their response to sustainability challenges, organizations need to differentiate between responsibility and risk. For several organizations, human rights fall under the responsibility category, meaning there is no need to justify the financial benefits of completing due diligence. It is simply something the company must do, and do well, as a matter of compliance.

Get in touch

For more information about how Moody's Analytics can support supply chain due diligence, and perpetual monitoring processes, please get in touch.

AMERICAS
+1.212.553.1653
clientservices@moodys.com

EMEA
+44.20.7772.5454
clientservices.emea@moodys.com

ASIA (Excluding Japan)
+852.3551.3077
clientservices.asia@moodys.com

JAPAN
+81.3.5408.4100
clientservices.japan@moodys.com

Moody's public ESG policy statement

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