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# Increasing Supply Chain Resilience in Asia

By Jill Baker

April 2022

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# Responsible Business Asia

## Sustainability: The Business Imperative for a Brighter Future

Jun 22-23rd, Online

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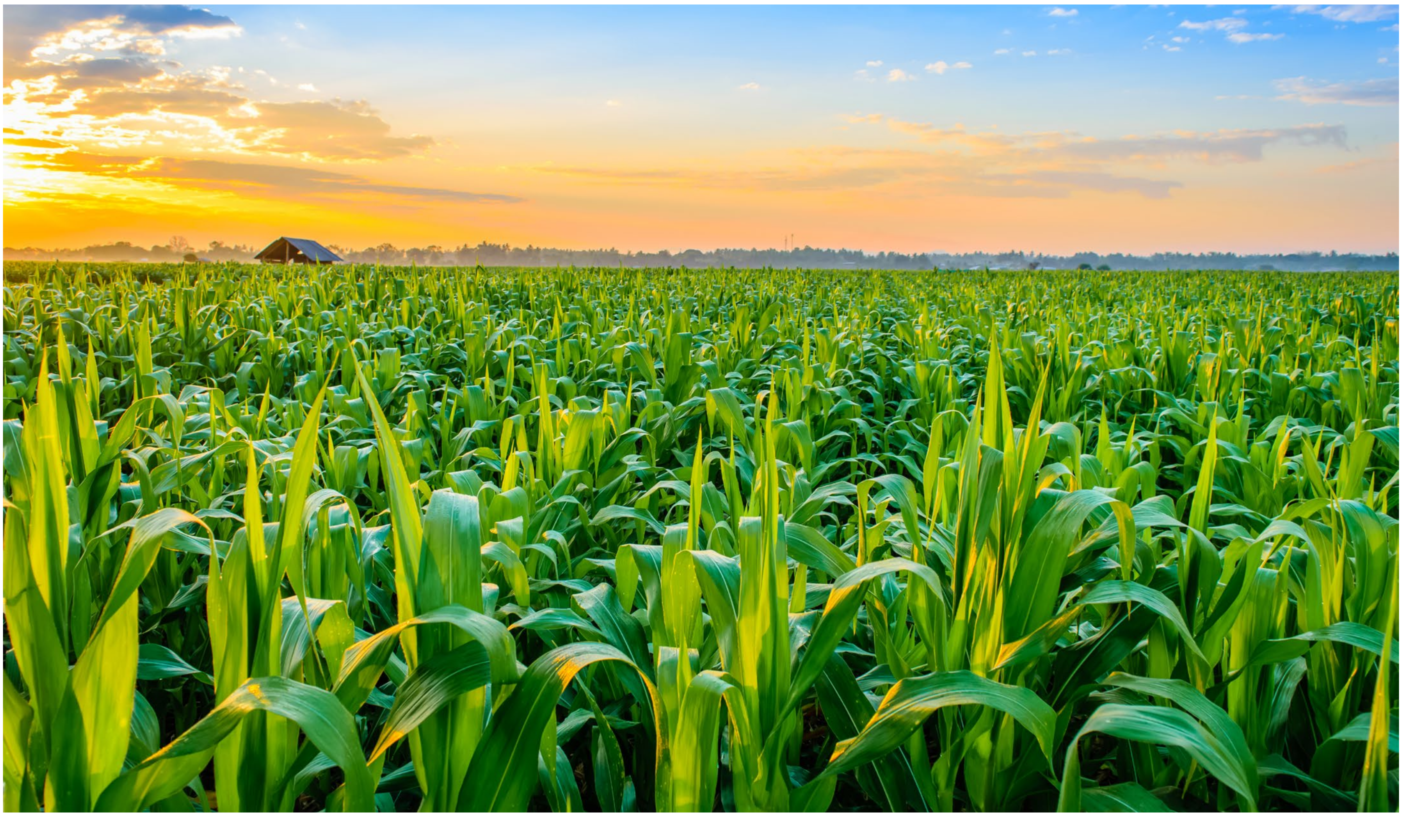

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# Introduction

Asia, especially China's Pearl River Delta (PRD), with its vast and specialized supply chains is known as the workshop of the world. International sales of products like integrated circuits, smart phones, computers, autos and auto parts, and textiles from all of Asia make up a staggering 42 percent of global exports, a share that has risen four percent since 2016, despite threats of supply chain localization from overseas. In 2022, work stoppages due to COVID disrupted shipments of iPhones, Toyotas, and Volkswagen cars from the PRD, reminding the world that supply chains are only as strong as their weakest link. Typhoons, man-made disasters, the threat of war, tsunamis, earthquakes, and epidemic disease are but a few of the challenges Asian companies have faced since the century began. The world is running up against resource limits – especially with water and carbon—that put even simple business models at risk. Increasing supply chain resilience in Asia can help blunt the worst effects of climate change, improve biodiversity and closed loop thinking, and even help eradicate the scourge of modern slavery.

> **Increasing supply chain resilience in Asia can help blunt the worst effects of climate change**


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# Resilience Through Decarbonization

Asia accounts for half the world's greenhouse gas emissions. The region is also especially vulnerable to the effects of climate change, with millions of people in coastal and low-lying areas threatened by intensifying tsunamis, flooding and storm surge, while its increasingly crowded cities are subject to heatwaves and pollution. Supply chain transparency is generally poor, but there are powerful forces at work driving change.

Asian countries including China, Japan, and South Korea have set net zero goals for mid-century. China has a national emissions trading scheme (ETS), as does South Korea, while Singapore and Japan have a national carbon tax. These actions force companies to get in line with the decarbonization pathways and timetables set by their governments. Helping the process is a convergence of reporting standards and green taxonomies around the world. With the EU in the lead and Asia constructing its own green taxonomy, it makes sense that the two should converge. The International Sustainability Standards Board (ISSB), governed by the IFRS Foundation, is tasked with making sustainability accounting uniform across the globe. This will help companies and investors by replacing a tangle of overlapping ESG reporting options with streamlined reporting metrics that make comparability easier. Enthusiasm is high. The ISSB is supported by 38 jurisdictions, including the UK, US, and China, covering 70 percent of world GDP, according to Goldman Sachs. Many companies have already embraced Task Force on Climate-Related Financial Disclosures (TCFD) - aligned climate risk reporting. As in Europe, Hong Kong, Japan (for companies on the Prime Market), Singapore, and Malaysia have made these originally voluntary standards mandatory.

**Supply chain transparency is generally poor, but there are powerful forces at work driving change**

# Reporting Data is the Missing Link for Supply Chains


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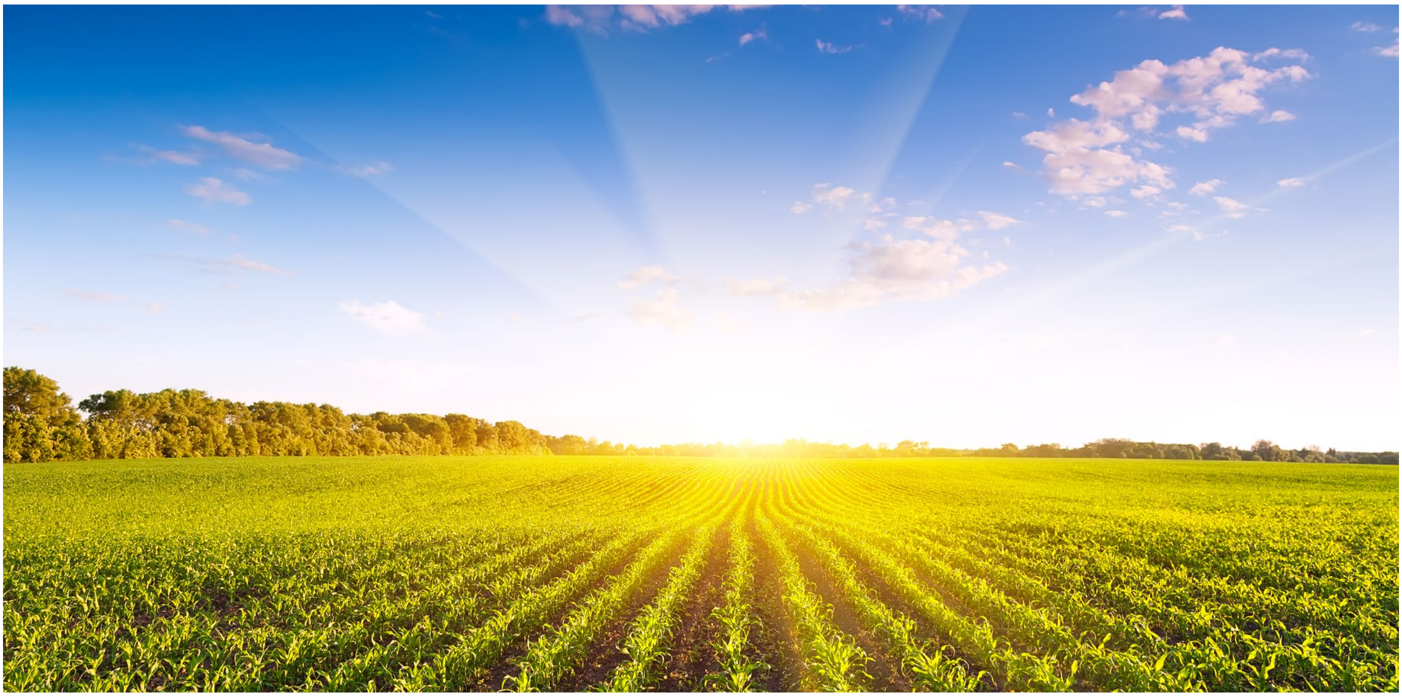
How can supply chains help meet decarbonization goals? As the old adage goes, you have to measure to manage. And supply chains are not well-measured. Their emissions are considered Scope 3 in accounting terms. While Scope 1 includes direct emissions, including those generated by company facilities and vehicles, Scope 2 is indirect, including purchased electricity, Scope 3 is also indirect, and is comprised of up and downstream emissions. It includes the company's share of suppliers' emissions, and its share of emissions created to ship its product to be sold, as well as the emissions from its product after it is sold to customers. For financial companies like banks and asset managers, Scope 3 includes their share of emissions from portfolio companies, meaning the companies they own, or lend to. Hardik Shah, ESG Practice Lead at GMO, a multi-strategy asset manager, (with $69 billion under management as of December 2021) explains that indirect greenhouse gas (GHG) emissions that occur in a company's supply chain are on average orders of magnitude larger than those from a company's operations. Not being able to measure and report them makes it practically impossible to see if a company is making sufficient progress toward reducing its overall emissions.

**"It is easier for most companies to demand better transparency related to carbon emissions from their tier one suppliers, but when it gets to the smaller tier 2 and 3 suppliers, there is much less transparency and influence, leading to poor disclosure**

GMO's co-founder, Jeremy Grantham, is a leading global advocate for climate change efforts and investment. GMO is a signatory of the Net Zero Asset Manager's initiative, a global group of asset managers committed to galvanizing the industry to support investing aligned with net zero emissions by 2050 or sooner, in line with global efforts to limit warming to 1.5 degrees Celsius. The company has integrated ESG into its investment process and governance. Shah sits on the ESG Oversight Committee, which regularly reports to GMO's board. GMO is putting out its first TCFD report this year, and one of the focus areas is calculating the portfolio emissions, which form a key part of GMO's scope 3 emissions. Shah pointed to figures from MSCI ESG Research that suggest, as of March 2020, only 18% of the constituents of the MSCI ACWI IMI index, a broad global index, reported Scope 3.

It is easier for most companies to demand better transparency related to carbon emissions from their tier one suppliers, but when it gets to the smaller tier 2 and 3 suppliers, there is much less transparency and influence, leading to poor disclosure. Shah says GMO engages through multiple collective engagement initiatives, including Climate Action 100+, which he describes as "a collection of likeminded investors, trying to engage with the top 150 odd largest GHG emitters in the world, on a range of issues including disclosure and management of their scope 3 emissions i.e. upstream and downstream supply chain emissions." Shah says GMO also supports CDP's science-based targets campaign which is "... basically urging more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and more companies to adopt of science-based climate targets that are aligned with the Paris Climate Agreement."

Formerly known as Carbon Disclosure Project, CDP is the most popular platform for corporate

sustainability reporting. In a report from CDP entitled "Engaging the Chain: Driving Speed and Scale," analysis of supply chain disclosure by over 11,000 companies on its platform revealed dual problems: lack of data from suppliers, and lack of engagement with suppliers on the part of OEMs. According to the report, CDP found that GHG emissions in a company's supply chain are, on average, 11.4 times higher than its operational emissions. "This chain of environmental risk is not just an opportunity to look beyond companies' own emissions and cascade their ambition; it is now the only way to leverage change at the scale required," the report implores.

L'Oréal, the cosmetics company, is featured in the CDP report as good example, one of the best on supply chain engagement demonstrating how large OEMs can be a force for change in their supply chain. A part of CDP's Supply Chain program since 2014, L'Oréal made participation mandatory for all its strategic suppliers. 75 percent of those suppliers now report their carbon emissions reductions and other data, giving L'Oréal valuable insight and data on their actions. L'Oréal, the report says, is "continuously engaging suppliers on sustainability issues and the role they can play, and runs virtual working sessions dedicated to sustainability, known as Spread the Green Vibes, with over 800 suppliers participating." Its Chief Purchasing Officer, the Chief Corporate Responsibility Officer, and the Group's Environment Director hosted two global webinars about suppliers' contribution to L'Oréal Science-Based Targets and the L'Oréal for the Future program.

CDP's reporting of suppliers' data shows they reduced

**This chain of environmental risk is not just an opportunity to look beyond companies' own emissions and cascade their ambition; it is now the only way to leverage change at the scale required**

emissions in 2020 by 231 million tonnes of CO2, while reminding practitioners that "environmental issues are interconnected, companies cannot meet their climate net-zero targets whilst generating mass deforestation in their supply chain."

The problem of missing supply chain data is receiving ever more attention. Investors, like those in the recently announced Glasgow Financial Alliance for Net Zero (GFANZ) are setting targets to align their own portfolios with net-zero. If their portfolios are proxies for the world, this would mean the world was on a safe warming trajectory of 1.5 to 2 degrees. GFANZ's members – large banks, asset managers, and insurers –control assets of $130 billion and have promised to deliver up to $100 trillion of climate-aligned funding to help economies transition to net zero over the next three decades. Their influence, through advocacy and proxy voting, can affect change. Like GMO, they advocate for better disclosure in order to bring portfolio emissions trajectories in-line with net zero. Nonetheless, and alarmingly, much as corporations are re-aligning their goals, scientists are telling us we are still not on track.

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# Modern Slavery

Another issue facing Asian supply chains is that of modern slavery. Slavery of course has been a scourge for centuries, and it's shocking that in the second decade of the 21st century it is still present. Hardik Shah says that for a sensitive issue like modern slavery, having a dialogue with companies on best practices in finding, fixing and preventing it in their operations and supply chain is one of the most effective ways to encourage constructive action. GMO is a member of Investors Against Slavery and Trafficking Asia Pacific (IASTAP), a coalition of 36 investors with AU$7.7 trillion in assets under management. By IASTAP's reckoning there are 25 million victims of modern slavery in the Asia-Pacific region, more than 70 percent of whom are women and girls, the majority of cases are forced labor, and within that, debt bondage. The investor letter signed by GMO and other investors says that the need to take real action against modern slavery is heightened by the pandemic, while noting increased risk of worker exploitation.

## Exposed to significant compliance and brand risk, which can be costly and time consuming to address

Beyond ethics, the letter states that "investing in business models and value chains that rely on underpaid workers, weak regulation or illegal activities such as forced labour and other forms of modern slavery drive unsustainable earnings." Companies are "exposed to significant compliance and brand risk, which can be costly and time-consuming to address." The letter calls for detailed risk-based mapping of supply chains, and recommends ten actions points, including consolidation of supply chains to cultivate and build stronger relations with suppliers; pricing goods in a way that a living wage can be achieved in the supply chain; setting up a process to monitor modern slavery and labor rights in the supply chain by increasing direct presence at the supplier level; and avoiding the risk of debt bondage, the most common form of forced labor, with a zero fee or "employer pays" policy that ensures no workers in the value chain are required to pay recruitment fees or other costs to secure work.

Saskia Kort-Chick, Director of ESG Research and Engagement at AllianceBernstein (AB), a global asset manager (with $765 billion under management as of October 2021), engages with portfolio companies on modern


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slavery risk as part of the firm's ESG integration strategy. The responsibility team, which Kort-Chick is part of, are the thematic experts on subjects like modern slavery, "but we collaborate closely with the fundamental and sector analysts, if we bring the two together we have a more holistic view."

Kort-Chick is co-author of "Modern Slavery Risk: The Investor's View". The report is a wealth of information and offers a five-pillar best practices framework, including developing a governance framework to align the business with the goal of reducing modern slavery risk; identifying the risk, which is often partially hidden given its covert nature; setting up an action plan; monitoring the plan's effectiveness; and planning for continuous future improvement.

Kort-Chick goes on to say, "We engage for action." As part of the five pillar best practices, AB encourages companies

## Do you understand where your suppliers are? Where did you get them from and not just your tier one, but throughout your supply chain?

to map their supply chain thoroughly, down to the raw materials. "Do you understand where your suppliers are? Where did you get them from and not just your tier one, but throughout your supply chain?" Kort-Chick asks. "What is the risk to people," she says, emphasizing the words, "in the products and services you've sourced?" The philosophy behind AB's engagement is to establish a collaborative relationship with management that helps improve their practices. And, if that doesn't work? "We have escalation paths, which can include voting against management, voting against a board, or ultimately selling or reducing a position in a certain stock," she says.

Emerging Asia, Kort-Chick says, "has a higher [slavery] risk to people." One of the report's graphics is a color-coded mapping of the prevalence of modern slavery, worldwide. India and Southeast Asia are among the highest in Asia. The report mentions fish from Thailand (Kort-Chick has done a lot of work in this area and says that roughly 80% of the labor in the Thai fishing industry is from Myanmar). Also mentioned are rubber gloves from Malaysia; and some cotton from China which has been subject to US import bans. Shipping, construction, and mining are other industries of concern.

**Potential risk telltales outlined in the report are:**

- Vulnerable populations like migrant workers, minorities, and those with linguistically diverse backgrounds.
- High risk geographies, including those with a history of abuses and limited or weak judiciaries.
- High risk products and services (including raw materials, basic services, and "sweat" shops.
- High-risk business models (including outsourcing, fraudulent recruiters, and those exposed to high seasonal demand).

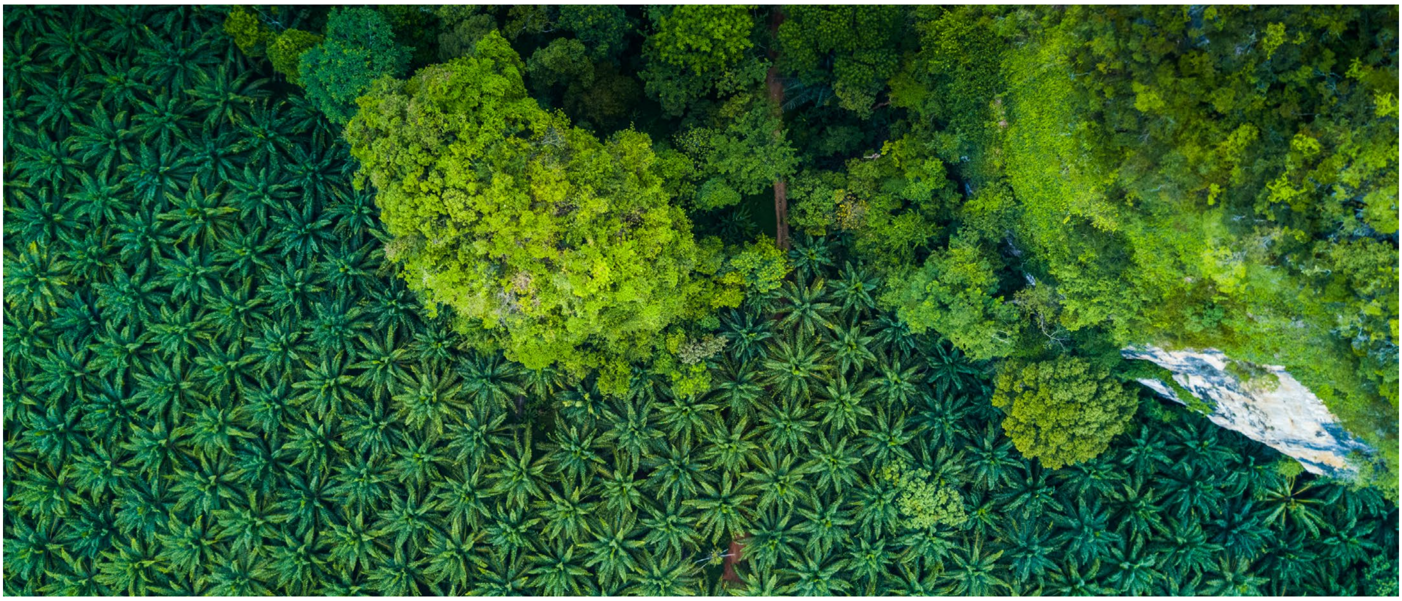
The report also discusses debt-bonded labor, which Kort-Chick says is a big problem in fishing. When compared to apparel, where consumer awareness is driving improved working conditions, Kort-Chick mentions "apps where you can check the ethical credentials of the goods you buy." Fishing is much harder to monitor. She says the workforce, some 58 million people, of whom some 48 million are located in Asia, is predominantly young, male, and migrant.

Finding a crew is often facilitated by a recruitment agency or labor organization which is sometimes legitimate, often not. "So, you're told you'll be back in six months to go and see your family which happens to be not the case. So, deceptive recruitment practices are one thing. The other one is debt bondage. Migrant workers pay to get a job overseas because they believe they can then support their family, but that debt often increases rather than decreases because they need to pay for the costs of being on the ship. They need to pay for the board, for the food, or for medical care. That again is an indicator of modern slavery that makes people very vulnerable."

COVID-19 has compounded the problem. People have not been able to go home because borders have been closed, Kort-Chick explains. "So, you've got your migrant worker from one country, shipping out on a vessel in a different country, fishing in yet another country's waters. Who do they go to to raise any issues when they are on the seas for multiple years? If you take all these factors combined, it compounds the vulnerability of an already vulnerable workforce."

AllianceBernstein collaborates with other organizations on modern slavery. "Collaboration is key when it comes to modern slavery, because it's a complex issue and no actor can do it on their own, whether it's government, corporations, or investors." AB and Themis, the Independent Anti-Slavery Commissioner, and the UK Modern Slavery Delivery Training Group are launching a toolkit aimed at the UK financial sector to offer free, virtual training around modern slavery for the financial services industry.

Ratings agencies are also starting to pay attention. Another notable addition to the dialog is a report from Sustainable Fitch, a division of Fitch Ratings. In "Modern Slavery and Labour Risk in Global Supply Chains" Nneka Chike-Obi, Director of Sustainable Fitch's ESG Research notes that although monetary penalties for modern slavery are low and in some cases non-existent, new regulations and public sentiment are driving greater accountability.




# The Palm Oil Supply Chain: Nature Positive Solutions for Biodiversity and Closed-Loop Thinking

Another example of resilience has to do with South East Asia's palm oil supply chain. About 85% of the world's palm oil is sourced from Indonesia and Malaysia. Palm oil is the most popular edible oil in the world, and the two biggest uses are in household cooking and the food industry. Western consumers are likely to find it in many foods and consumer products, from candy to shampoo. The problem is that palm oil is often cultivated at the expense of the region's biodiverse tropical rainforests, a quickly diminishing resource that acts the Earth's lungs. Illegal logging and burning of peatlands in order to clear land for palm oil plantations are the cause of rainforest deforestation and biodiversity loss.

The big palm oil consumer goods manufacturers (CGMs) like Nestle, Unilever, and Wilmar are no stranger to this controversy. In 2010, Greenpeace targeted Nestle with a brutally effective parody commercial in which a bored office worker unwraps what he thinks is a Kit-Kat bar. The words "Have a break?" flash on the screen. The oblivious office worker's horrified colleagues see that it's not a Kit-Kat, but the finger of an orangutan, which spurts blood onto the worker's keyboard and smears his face when he bites into it. The office shot fades. The words "Give the Orangutan a Break" fill the screen. Sounds of a chainsaw and a terrified orangutan in a landscape that is being deforested are followed by the words, "Stop Nestlé buying palm oil from companies that destroy the rainforests." The ad ends with the text, "Take Action with Greenpeace."

The parody ad and resultant consumer outrage spurred change in the palm oil industry and makes the point once again that food and other industries that are consumer-facing are vulnerable to consumer boycotts. Fast forwarding a decade or so, many large CGMs have made sustainability pledges specifically to do with the palm oil supply chain.

The Rimba Collective is a powerful, new "nature positive" supply chain solution designed by Lestari Capital along with the big consumer goods manufacturers (CGMs) such as Pepsi, P&G, Nestle, Unilever, Wilmar, and others. Nature positive measures aim to not only stop declines in biodiversity but reverse them. The Rimba Collective is focused on protecting and restoring forests and taking action to strengthen the rights of forest-frontier communities. Michal Zrust, Lestari's founder, explains that the project fills a need for the big CGMs that are dependent on palm oil sourced from the region and need a way to fulfill sustainability commitments. He says there's a "massive disconnect" between the level of demand for projects and "what's actually happening on the ground," pointing to what he called a "lack of scalable supply of conservation projects at scale."

The Rimba Collective aims to provide US$1 billion to protect or restore over 500,000 hectares of forest, supporting 32,000 individuals in forest communities in Southeast Asia over 30 years. It will initially focus on Indonesia, Malaysia and Papua New Guinea. In the past, Zrust explains, conservation has been supported by charitable giving through CSR grants, but never through market-based financing. The Rimba Collective uses a unique finance platform to raise, manage and disburse funds. The long funding period allows the projects the luxury of time to flourish. It is one of the largest efforts in Southeast Asia.

Rimba Collective operates within the laws of the countries all its project operates in. In some countries such as Indonesia, the carbon regulations are still in process and the Lestari Capital team are considering projects respecting that internal process where carbon trading is not yet allowed by law.

Lestari's experts source and do due diligence on projects. "The companies we are working with, they're making commitments to the science-based targets, and scope three emission reductions, they are obviously linked to their supply chains," Zrust said. The majority of projects focus on forest protection and restoration in Indonesia, but extend to peatland rewetting, women's empowerment, and emissions reductions and sequestration.

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Zrust emphasizes the Rimba Collective can do good beyond carbon. "This is a much broader market for what we're referring to as 'environmental service outcomes,' that create the equivalent of credits for biodiversity, to forests, to restoration, livelihoods."

Zrust uses an example, "We're meeting with people that hold logging concessions in the heart of intact primary forests that are totally remote. They're not economic to actually log. They are effectively stranded assets. And yet, if you tried to turn that into a carbon project, the verified carbon standard would grade it low because it's an intact landscape, it's not on peat, etc. So, the money is being pushed into these more destroyed areas, peatland areas. If you just focus on carbon and carbon credits, you miss all of this."

The structure of the Rimba Collective pools projects together into a portfolio. The verified outcomes it generates earn out to the CGMs on a pro-rata basis. This allows for a range of projects in the pool. "It increases the cost per ton of emission reduction, because you're diluting effectively, with the projects generating a range of outcomes beyond simply emission reductions, but you're improving the biodiversity impact."

Zrust, commenting in a follow-up email, noted enthusiastic buy-in from players in the palm oil value chain. "We have well over two thirds of the CGF's Forest Positive Coalition of Action members (in terms of palm oil usage) within the initiative. This is such a huge progressive change in the market and how companies seek demand, that I think it is a start of a wave."

Finally, Nextgreen Global Berhad (NGGB) a Malaysia-based investment holding company originally in the printing business, has diversified its business to manufacture renewable paper. It is also taking innovative steps to reuse and recycle oil palm wastes in a closed loop industrial park called the Green Technology Park (GTP) in Pekan, Pahang, Malaysia. Esther Teh, Head of Sustainability, said the company is setting up collection centers throughout the country which will aid in the collection of oil palm waste that can be processed into materials for the production of pulp and paper, tissue paper, animal feed, fertilizer, and more. The GTP is due to start operating this year. This is an impressive plan which, if it proves to be scalable, could be very positive in making the palm oil supply chain more sustainable.

Why do companies benefit from having transparency in their supply chains? It is a costly and difficult process. Third party verifiers and others need to do a lot of footwork to trace supply chains down to raw materials and verify that working conditions are safe. Developing meaningful engagement between OEMs and suppliers takes time. But it is ultimately worth it. Goldman Sachs, for example, is seeing Asia Pacific companies that are more sustainable trade at premiums to those which are less so. Laggards face increasingly higher hurdles from ESG accounting standards convergence, and the pressure being brought to bear by multiple stakeholders, including government regulators. And surely, it is time to agree that zero tolerance for modern slavery is a best practice for all.

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