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THE CASE FOR AN ENVIRONMENTAL & HUMAN RIGHTS DUE DILIGENCE OBLIGATION FOR UK BUSINESSES

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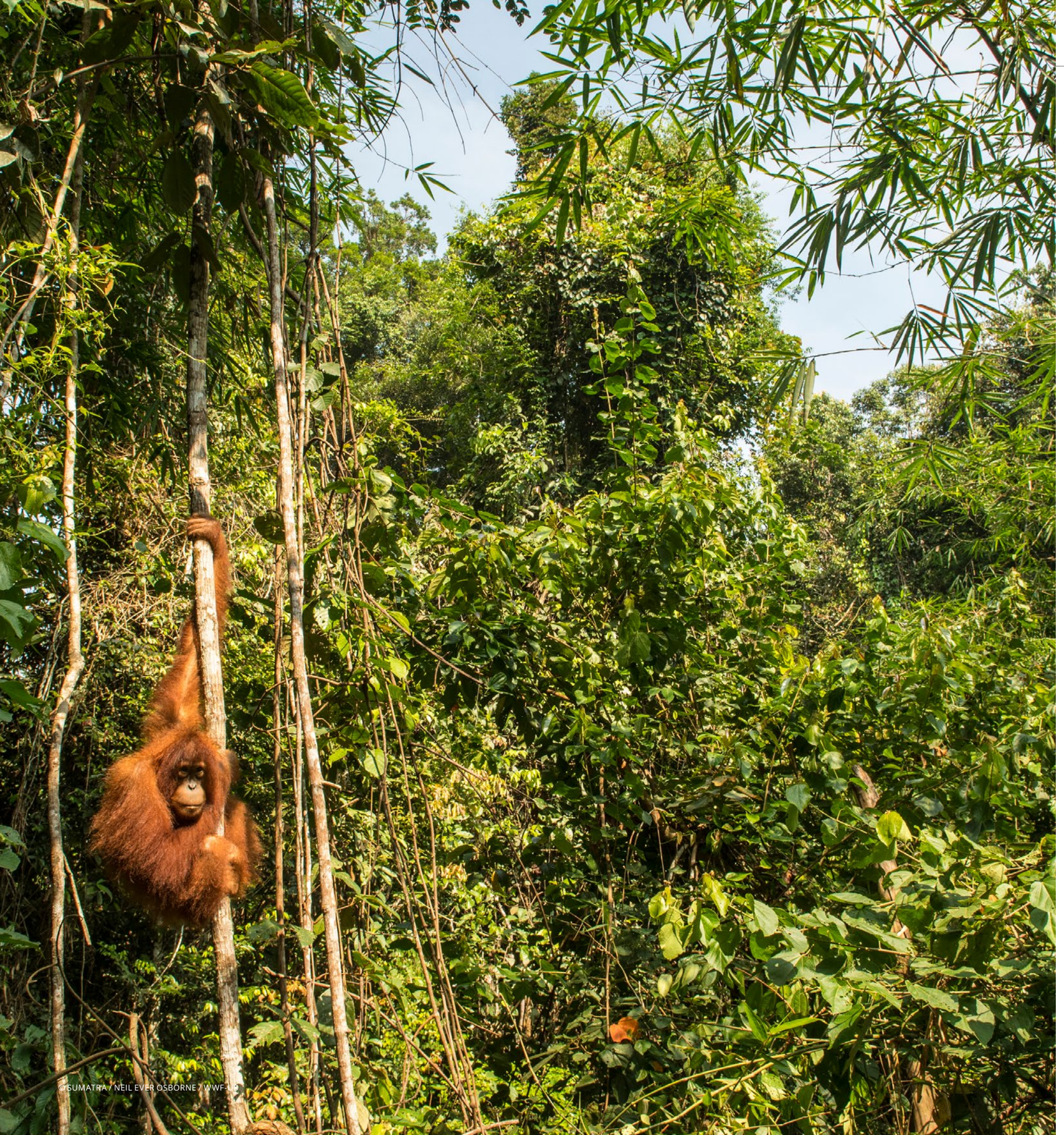

EXECUTIVE SUMMARY

This report sets out the case for an Environmental and Human Rights Due Diligence (EHRDD) obligation for UK companies. There is a significant body of work already arguing for such a policy, both domestically and at European and international levels. This report has not sought to replicate this work and has instead focuses in more detail on the benefits and practical implications for businesses.

The proposed policy is both flexible and proportionate, taking a forward-looking risk-based approach to managing environmental and human rights issues arising from the domestic and international operations and supply chains of British businesses. These issues are longstanding and serious and can be described only briefly in this report, but there is evidence that current approaches are failing in addressing problems such as deforestation and climate change. Many issues will require government intervention at a number of levels, including international agreements, regulation and prohibitions, and so EHRDD will always be one of a number of approaches used.

From considering specific issues, it is clearly shown that EHRDD practices will not only benefit society more widely by addressing market failures, but can also benefit businesses themselves. Businesses rely on a complex network of ecosystem services and social licences to operate, which may sometimes be taken for granted and leave companies exposed to unexpected risks. Some of these risks are significant to UK companies, including water availability (both domestically and internationally), climate change and extreme weather, and the reputational and operational impacts of biodiversity loss and human rights incidents. EHRDD offers businesses a coherent opportunity to map and assess risks and opportunities, as well as publicising the positive actions being taken by leading businesses. There are financial benefits for businesses that proactively manage environmental risks and the mitigation of them supports the resilience of the companies' supply chains.

We also demonstrate that an EHRDD obligation, far from penalising British businesses or damaging global trade, will position the UK at the forefront of current efforts to improve environmental and human rights performance. EHRDD is quickly becoming an expectation while doing business in many countries, and can be an efficient method of consolidating reporting obligations and providing businesses with legal certainty. Enacting this policy will meet commitments made in the 25 Year Environment Plan, as well as the recent recommendations of the Global Resource Initiative. It will also underscore the UK's commitment to the United Nations Guiding Principles on Business and Human Rights, and build on the distinction of being one of the first countries to produce a National Action Plan. We do consider that the EHRDD policy should be designed carefully to minimise the likelihood of side effects, such as divestment from particular countries, and we suggest methods for assessing and managing these possibilities.

The UK is in a unique position, as the host of the 26th Conference of the Parties to the United Nations Framework Convention on Climate Change. This policy will strengthen the UK's global presence and manage risks, particularly in imports but also in exports, and leave other countries in no doubt that Britain continues to be a relevant and responsible player on the world stage. It also represents an important step in setting the conditions for recovery and green growth in a post-COVID-19 economy.

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INTRODUCTION

As a developed country, the UK consumes significant quantities of raw and semi-processed goods, from both domestic and international sources. In some parts of the world human rights and environmental regulation is weak or rarely enforced and in some sectors, such as agriculture and food, commodities are associated with deforestation and other negative impacts. For example, palm oil, soy and beef alone were responsible for 76% worldwide of agricultural deforestation between 1990 and 2008[1]. Businesses trading in the UK and their consumers therefore run the risk of encouraging or funding unethical or unsustainable extractive and processing activities through their purchases and imports. These issues are explored in Chapter 3.

Leading businesses take these risks seriously. Investigating and taking action in their supply chains is a commitment many companies already make by means of Environmental and Human Rights Due Diligence (EHRDD), described in Chapter 4, to ensure that suppliers at all levels are aligned with the values and behaviours that consumers and the wider public expect. Any human rights abuses such as unsafe working conditions, low pay or coercion can be ended or averted, as well as unsustainable activities such as deforestation, pollution and greenhouse gas emissions. Many of these practices are illegal or in violation of international law and guidance, and the possibility of benefitting from them is a significant reputational and financial risk to companies with long and opaque supply chains.

Supply chain EHRDD also offers benefits and opportunities beyond compliance, and these are explored in Chapters 5 and 6. Mapping and understanding environmental and human rights issues in supply chains helps businesses identify opportunities to improve their resilience and efficiency. **Increasingly, investors and consumers also look favourably on companies that can disclose their environmental and human rights risks and action plans.** This can translate into better funding opportunities for these companies. For the UK as a whole, it also provides a more complete picture of the country's reliance on certain imports and their source countries and trade routes.

INCREASINGLY, INVESTORS AND CONSUMERS ALSO LOOK FAVOURABLY ON COMPANIES THAT CAN DISCLOSE THEIR ENVIRONMENTAL AND HUMAN RIGHTS RISKS

The aim of this report is to lay out the evidence base for making it mandatory for UK-based businesses to carry out EHRDD. The report focuses on the agri-food sector to give examples of current environmental and human rights impacts and how an EHRDD obligation might work, but the obligation is envisaged to cover all business sectors to a greater or lesser extent. Therefore, while some specific consideration has been given to the financial services sector in Chapter 9, further work will be needed to evaluate costs and benefits for the economy as a whole.

The recent COVID-19 pandemic and subsequent lockdown have lent a clear urgency to the need for economic stimulus, but it is also clear that a recovery must build a greener and fairer economy. In the wake of COVID-19, BP announced that the crisis had accelerated the shift to a low-carbon economy, and wrote down its assets by £14 billion[2]. At the same time Food Cardiff reported that the UK's food insecurity (people's inability to access sufficient affordable food) increased by 250% over lockdown[3]. The effects of the pandemic will only be understood when it is over, but these are clear signs of the materialisation of risks discussed in this report. It has not been possible to comprehensively assess how the recovery and an EHRDD obligation will complement each other, but **it is vital that investment in economic recovery is targeted at sectors with a positive environmental and human rights record worldwide.** Action to preserve habitats and reduce the disturbance of wildlife by humans will also practically serve to reduce the risk of pandemics of zoonotic origin[4].

[1] Brack et al, 2016 [2] www.theguardian.com/business/2020/jun/15/bp-expects-covid-19-to-have-enduring-impact-on-global-economy
[3] www.bbc.co.uk/food/articles/food_security [4] WWF, 2020

SUPPLY CHAINS AND THEIR IMPACTS TODAY

Business operations and supply chain activities today drive many negative environmental and human rights impacts, ranging from extensive deforestation to make space for cattle ranching in South America to slave labour in seafood markets in South-East Asia. **The UK's international agri-food supply chains import over £46 billion of food and drink a year[5], and draw on a footprint nearly the same size as the UK again just to produce a few key commodities such as palm oil, beef and timber.** Similarly, there are examples of both good and bad practice in the domestic agri-food industry.

Many of these impacts are inter-related. For example, unsustainable beef production can involve deforestation, which reduces the ability of the planet to absorb greenhouse gases, as well as the cattle themselves emitting additional greenhouse gases in the form of methane. Furthermore, cattle feed contains soy which itself has a significant footprint in terms of land and resource use. Mapping the web of commodities, traders and environmental and human rights impacts has been a challenge for some time, but the rise of new analytical and monitoring tools now means that enhanced supply chain due diligence is feasible. We discuss the practicalities of how businesses can implement supply chain due diligence in Chapter 8.

The agri-food supply chain contains numerous parties and relationships dispersed across the country and worldwide. As shown in Figure 1, below, the **raw inputs constitute only a small proportion of the overall £226 billion spent by UK consumers on food and drink each year, while a very significant value is added by refining, manufacturing, wholesaling, distributing, retailing and catering.** These complex networks involve businesses across the world, operating under a wide range of political and legal systems.

The resilience of these networks has been the subject of extensive study, especially following significant price increases in 2007-2008, when the Food

THE UK'S INTERNATIONAL AGRI-FOOD SUPPLY CHAINS IMPORT OVER £46 BILLION OF FOOD AND DRINK A YEAR, AND DRAW ON A FOOTPRINT NEARLY THE SAME SIZE AS THE UK AGAIN JUST TO PRODUCE A FEW KEY COMMODITIES SUCH AS PALM OIL, BEEF AND TIMBER

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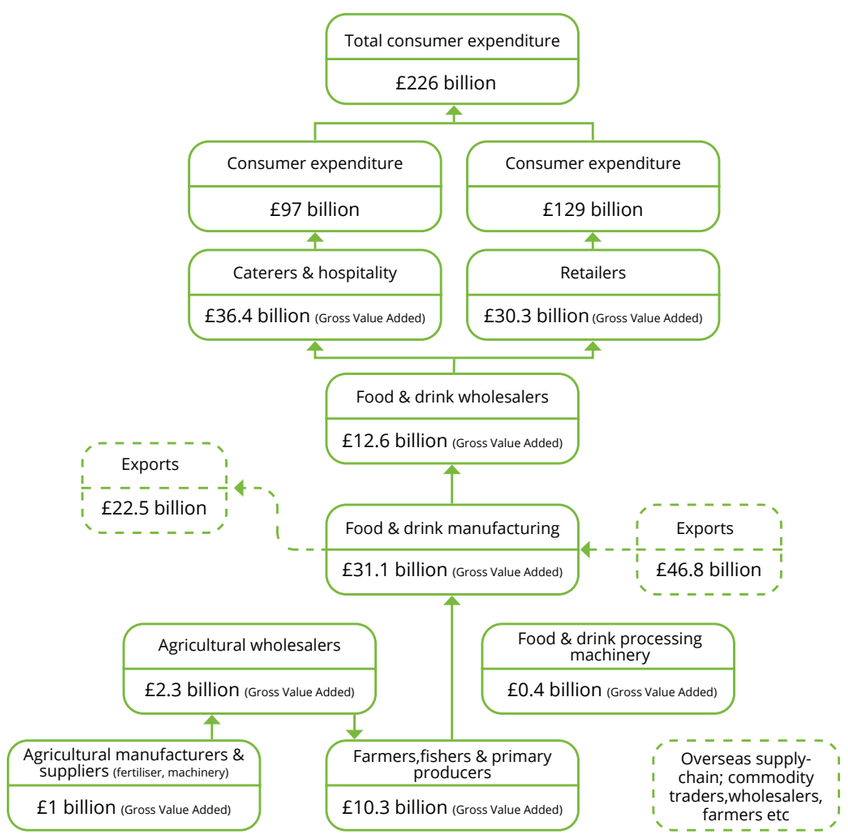

FIGURE 1: THE UK'S AGRI-FOOD VALUE CHAIN (ADAPTED FROM DEFRA, 2018)

and Agriculture Organization (FAO) Food Price Index rose over 50% over the course of a year[7]. Consumers, particularly in developing countries but also in the UK, were badly affected by these price rises. As many food products are internationally mobile (in the absence of protectionist policies), British consumers must compete in a global marketplace where there is increasing consumption of meat and dairy worldwide as populations increase in wealth and a general increase in demand for food overall as populations rise. **The combination of a larger, richer and more urban population means food production must increase by 70% by 2050[8] – if such an increase is not achieved, the UK may have to compete on a less even playing field than today.**

Changes to agri-food supply chains have in some cases led to decreased resilience. These include adoption of 'just-in-time' supply chain management[9], a reduced number of centralised production and distribution facilities and reduced financial liquidity due to lower profit margins[10]. **The sheer number of steps in a supply chain can also impede the industry's responsiveness when issues do arise, such as the 2013 horse meat scandal, which involved a chain of six firms in five European countries as well as multiple retailers across the continent[11].** Firms can take steps to reduce their vulnerability with supply chain risk management practices, such as strengthening supplier relationships with longer-term contracts and collaborative demand forecasting. This does not mitigate all risks, especially those which are systemic across the industry.
While the UK can depend on domestic production of some inputs (including over 50% of its food[12]), due to geographic, climatic and resource constraints there are many sectors where a significant proportion of raw, refined and finished

[5] Defra, 2018 [6] WWF and RSPB, 2020 [7] Bailey, 2016 [8] FAO, 2016 [9] Haywood and Peck, 2004 [10] Manning and Soon, 2016 [11] Liravi, 2016

IF BUSINESSES RELY ON CERTAIN SUPPLY CHANNELS FOR SPECIFIC OR RARE COMMODITIES, THEY MAY BE VULNERABLE TO SUPPLY CHAIN DISRUPTION

products are always likely to come from overseas. If businesses rely on certain supply channels for specific or rare commodities, they may be vulnerable to supply chain disruption. **An investigation into 'trade chokepoints' by Chatham House[13] identified three important locations (southern Brazilian ports and roads, US Gulf coast ports, and the Black Sea) through which 53% of the global trade in wheat, rice, maize and soybeans is channelled.** Some of these areas have inadequate infrastructure or are threatened by climate change or regional conflict. Supporting improved agricultural practices in these locations to mitigate environmental risks will increase supply chain resilience.

Various studies have identified and analysed the supply chain risks faced by UK businesses and consumers. The Cranfield School of Management and Dun & Bradstreet Global Supply Chain Risk Report 2019[14] found that, although the general trend was for UK businesses to be more cautious in procuring from high-risk countries, global sourcing risk had recently increased significantly in the retail sector. Food security and supply chain resilience is reviewed extensively by Lang (2020), who argues **the UK's agri-food system is unacceptably exposed in its current configuration.** It is not always disruption of physical materials that businesses are vulnerable to – in the construction sector, a Highways England study identified human capital as one of the most important and vulnerable supply chain inputs[15].

The footprint and impacts that agri-food operations and supply chains have on the world have been extensively studied and documented by sources such as WWF and RSPB's 'Risky Business' report[16] and the European Commission's report on the impact of EU consumption on deforestation[17]. This report therefore provides only a brief summary of the literature in the following pages. However, it is worth emphasising that these issues arise due to several key factors, including both market failures and private failures such as short-termism. These factors mean that **voluntary approaches are rarely wholly effective at tackling environmental and human rights issues.**

Market failures arise when private incentives are not aligned with those of society more widely, due to the existence of negative externalities (costs falling on third parties) or public goods (benefits which are non-excludable and so cannot easily be covered by property rights or charged for). Many environmental and human rights issues arise from these situations, where free riders emerge whose activities harm others (such as by emitting pollution) or over-exploit common resources (such as limited water supplies).

However, there are also private failures by organisations and individuals to take account of their reliance on the environment and society. Many businesses are not mindful of the degree to which their business models are exposed to risks until those risks materialise, or have managers who are more motivated by short-term results than long-term sustainability (an 'agency problem'), with a recent study from the UN finding that **only 4% of senior executive and non-executive appointments required sustainability experience[18].** Structured EHRDD can help companies define and build capability to map, assess and mitigate environmental and human rights risks effectively, and practical examples of this are given in Chapter 8.

[12] Defra, 2018 [13] Bailey and Wellesley, 2017
[14] www.dnb.co.uk/content/dam/english/dnb-solutions/supply-management/DNB_Q1_2019_Global_Supply_Chain_Risk_Report.pdf
[15] https://orr.gov.uk/highways-monitor/publications/highways-englands-supply chain-capability
[16] WWF and RSPB, 2017 [17] European Commission, 2013 [18] https://unglobalcompact.org/library/5745

ENVIRONMENTAL AND HUMAN RIGHTS ISSUES

CLIMATE CHANGE

A major impact of unsustainable agri-food systems today is their contribution to climate change. Research shows that agriculture as a whole is responsible for up to a third of net emissions (taking into account both direct emissions and land-use change due to agriculture[19]) while **over 80% of the carbon footprint of our diets is in meat, eggs and dairy[20]. Some food products also have an impact which is disproportionate to their scale, such as chocolate and coffee which under conventional production systems have emissions of >20kg CO2e per kg of produce[21].** While the carbon intensity of other sectors such as electricity generation has declined significantly in recent years, the effects of agriculture and associated land-use change have accelerated.

Agriculture drives emissions and climate change in multiple ways. As well as the direct emissions from cattle and other ruminants, there are significant emissions associated with fertiliser use, manure management and land-use change. For example, the use of nitrogenous fertilisers is estimated to be 1.2% of human greenhouse gas emissions each year[22], due to high energy intensity in their production as well as direct emissions from N2O soil post-application.

Climate change also affects agriculture as well as being driven by it. Changing temperatures, patterns of rain and drought, and extreme events such as floods and storms will impact agricultural businesses and supply chains in the short, medium and long
term. These impacts are explored further in Chapter 5.

DEFORESTATION, LAND CONVERSION AND BIODIVERSITY LOSS

Many imported commodities carry the risk of contributing to deforestation and biodiversity loss, particularly palm oil, soy, cattle products (beef and leather) and timber which are responsible for 3.8 million hectares of deforestation a year – 40% of forest losses[23]. For example, palm oil, which is used extensively in packaged consumer products such as biscuits, soap, chocolate, ice cream and margarine, has a deforestation footprint principally in Indonesia and Malaysia. A recent study found that **45% of palm oil plantations in South-East Asia were grown on deforested land[24].** In contrast, deforestation associated with soy is focused in South America, driven by the ability to cheaply expand agricultural land rather than using technology to increase productivity – a situation exacerbated by weak forest laws and governance.

Other commodities also have significant deforestation impacts. Conventional cocoa farming practices involve clearance of tropical forest to plant new cocoa trees (known as 'full-sun' farming), which results in a significant drop in the number of plant and animal species[25]. Some sources estimate that **70% of illegal deforestation in West Africa is due to expansion of cocoa farming[26]** – while the areas felled are not as extensive as for other commodities, they are located in some of the most sensitive ecosystems in the world.

[19] Tubiello et al, 2013 [20] Sandström et al, 2018 [21] Poore and Nemecek, 2018 [22] Wood and Cowie, 2004 [23] Henders et al, 2015 [24] Vijay et al, 2016 [25] Tondoh et al, 2015
[26] http://www.ethicalcorp.com/extreme-poverty-still-fuelling-deforestation-cocoa-west-africa

RESOURCE DEPLETION AND DEGRADATION

Vital resources such as water, soil and nutrients for fertiliser are likely to be limited in availability in coming years, while demand continues to rise as the world's population grows in size and wealth. WWAP (2015) forecasts that **freshwater demand worldwide will be 40% greater than supply by 2030,** while droughts and water shocks since 2001 have already reduced yields by the amount needed to feed 81 million people for a year[27].

Unsustainable use of water is a recurring theme in global agri-food supply chains, with agriculture being the greatest user of water globally. Increasing demand for many purposes and the limited supplies of freshwater available in much of the world **(51% of the world's population live in areas already affected by water poverty[28])** mean that water risks may manifest as geo-political tensions and displacement of people with subsequent impacts on apparently unrelated sectors and supply chains.

Other resources are already scarce and currently being used at an unsustainable rate. **One tonne of Brazilian green coffee requires 900kg of fertiliser as well as over 10 tonnes of water[29].** As well as the contribution of energy-intensive nitrogenous fertilisers to climate change, the phosphate component of most fertilisers is a non-renewable resource[30], with **almost all production from mined reserves in only five countries[31].**

Land itself, particularly high-quality agricultural land, is a finite resource which is being exploited and over-used, with desertification, erosion and soil salinisation significantly reducing land's carrying capacity. **Worldwide, soil erosion is occurring between 10 and 100 times faster than soil formation[32], with 12 million hectares damaged every year[33], despite the importance of soil as a carbon sink being highlighted by many sources[34].**

HUMAN RIGHTS ABUSES

Perhaps the most reputationally-damaging impacts are the associations some international agri-food supply chains have with human rights abuses. Some abuses arise from activities which are themselves unsustainable (such as deforestation and changes to traditional tenure patterns leaving indigenous people homeless), while others are directly harmful to individuals such as abusive employment practices and modern slavery.

51% OF THE WORLD'S POPULATION LIVE IN AREAS ALREADY AFFECTED BY WATER POVERTY

[27] Damania et al, 2017 [28] WWAP, 2018 [29] Coltro et al, 2006 [30] Reijnders, 2014 [31] Gross, 2010 [32] IPCC, 2019 [33] https://www.unccd.int/issues/land-and-human-security
[34] E.g. Lal, 2019 – although see also Schlesinger et al, 2019

Agri-food supply chains are a prevalent and important source of jobs for people across the world, for example with one in five of the population of Côte d'Ivoire being employed in the cocoa value chain[35]. However, there is widespread use of child labour[36] and low wages there, resulting in leading businesses such as Nestlé adopting proactive measures, setting strict employment policies and investing directly in-country[37].

Beef production has been linked with organised crime in Brazil associated with deforestation[38]. **The beef sector has also been identified as a hotspot of forced labour, with the International Labour Organization (ILO) reporting that over 60% of slave labourers in Brazil work in livestock farming and associated business[39].** Similar concerns are expressed by researchers and NGOs working in East Asia (particularly Thailand and Myanmar), with seafood, seeds and beans identified as commodities with a high risk of being produced using forced or child labour[40]. Numerous reports from NGOs have highlighted human rights abuses[41] associated with palm oil production in Malaysia and Indonesia, including child and slave labour[42] and abuses associated with uncertainty around land tenure, corruption, land grabs and illegal clearances[43].

EVEN THE MOST COMMITTED COMPANIES ARE NOW UNLIKELY TO MEET THEIR TARGETS OF ZERO NET-DEFORESTATION BY 2020

ARE CURRENT POLICIES AND INITIATIVES WORKING AT SOLVING THESE ISSUES?

Many of the environmental and human rights issues described briefly in this chapter are longstanding and are currently not being addressed by existing policies and initiatives. For example, significant commitments were made to ending deforestation by multinational businesses in the New York Declaration on Forests in 2014, yet deforestation has continued at an unsustainable pace, and in many regions even accelerated[44]. **Even the most committed companies are now unlikely to meet their targets of zero net-deforestation by 2020.**

Deforestation clearly affects climate change as well as other issues such as biodiversity loss and indigenous rights. Success at halting biodiversity loss has been very limited, despite its importance reflected in the Convention on Biological Diversity and the United Nations Sustainable Development Goals (SDGs)[45]. The 2019 SDG Progress Report found that deforestation and land degradation were continuing at unacceptable rates[46]. Similarly, **attempts to limit climate change to a 'safe' level of 1.5°C have also been unsuccessful so far, with current government pledges only forecast to limit temperature rises to 2.8°C[47]**, and emissions continuing to rise to record levels[48].

There has been a growth in voluntary initiatives which aim to steer behaviour through changing consumer preferences, such as eco-labelling and certification schemes. These approaches are recognised to be useful tools which can help conservation efforts but are unlikely to be sufficient on their own to deal with significant issues such as over-fishing[49]. In the food sector, consumers are concerned with other factors above sustainability, such as convenience[50] and, particularly in the UK, price[51]. **The effectiveness of some schemes is still debatable after decades in place[52] and in some cases the schemes are ineffective even when there are reasonable levels of industry participation[53].**

As existing policies and initiatives have not been as effective as hoped, new approaches must be designed to more directly involve and motivate companies and consumers to address environmental and human rights issues. EHRDD can be a powerful tool to disclose the drivers of these issues, and to ensure that they are addressed by those contributing to them. In the following chapter we describe the proposed EHRDD obligation in detail.

[35] World Bank, 2017 [36] https://www.brookings.edu/blog/education-plus-development/2019/02/13/cocoa-cote-divoire-and-childrens-education-what-you-should-know-this-valentines-day/
[37] https://www.fairlabor.org/sites/default/files/documents/reports/2017_nestle_cocoa_executive_summary_october-2018.pdf
[38] https://www.theguardian.com/environment/2020/feb/20/meat-company-faces-heat-over-cattle-laundering-in-amazon-supply-chain
[39] ILO, 2009 [40] United States Department of Labor, 2018 – https://www.dol.gov/agencies/ilab/reports/child-labor/list-of-goods [41] Rainforest Action Network – https://www.ran.org/issue/palm_oil/; Amnesty International, 2016
[42] www.amnesty.org.uk/indonesia-palm-oil-wilmar-human-rights-plantation [43] Dauvergne, 2018 [44] https://forestdeclaration.org/summary [45] Waldron et al, 2017
[46] https://www.un.org/development/desa/en/news/sustainable/sdg-progress-reports-2019.html [47] https://climateactiontracker.org/documents/698/CAT_2019-12-10_BriefingCOP25_WarmingProjectionsGlobalUpdate_Dec2019.pdf
[48] https://www.iea.org/reports/global-energy-co2-status-report-2019/emissions [49] Gulbrandsen, 2009 [50] Grunert, 2013 [51] Lang, 2020 [52] Visseren-Hamakers and Pattberg, 2013 [53] Morgans et al, 2018

WHAT IS AN ENVIRONMENT AND HUMAN RIGHTS SUPPLY CHAIN DUE DILIGENCE OBLIGATION?

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An EHRDD obligation is a flexible, proportionate, forward-looking, risk-based approach to the management of environmental and human rights issues arising from businesses' domestic and international operations and supply chains.

Implementing the proposed legislation would require British companies to:

- Assess environmental and human rights risks and impacts across their supply chains and operations
- Develop, publish and implement a plan for eliminating or mitigating those risks and impacts
- Report to government and the public on progress in implementing their plan

AN EHRDD OBLIGATION IS A FLEXIBLE, PROPORTIONATE, FORWARD-LOOKING, RISK-BASED APPROACH TO THE MANAGEMENT OF ENVIRONMENTAL AND HUMAN RIGHTS ISSUES ARISING FROM BUSINESSES' DOMESTIC AND INTERNATIONAL OPERATIONS AND SUPPLY CHAINS

The obligation could apply to all UK-registered businesses over a certain size (possibly to align with the Modern Slavery Act 2015 and comparable legislation by setting a threshold for companies based on their turnover or number of employees), and also UK-registered businesses of any size which trade in sectors designated as high-risk for causing environmental or human rights impacts (such as tropical timber).

Accompanying the obligation to carry out due diligence would be a liability and enforcement mechanism, ensuring that any failures of a company to discharge its due diligence responsibilities can be responded to by both government and affected parties. This may not extend to the full liability envisaged by the French Devoir de Vigilance, which provides for persons with a legitimate interest (including individuals and NGOs) to litigate against French companies on the basis of breaches by any subsidiary or supplier with an established business relationship[54] – however, potential mechanisms appropriate to the UK have been explored in recent studies[55], and recent reports suggest that there is an increasing focus on liability and remedy mechanisms in international legislative developments[56].

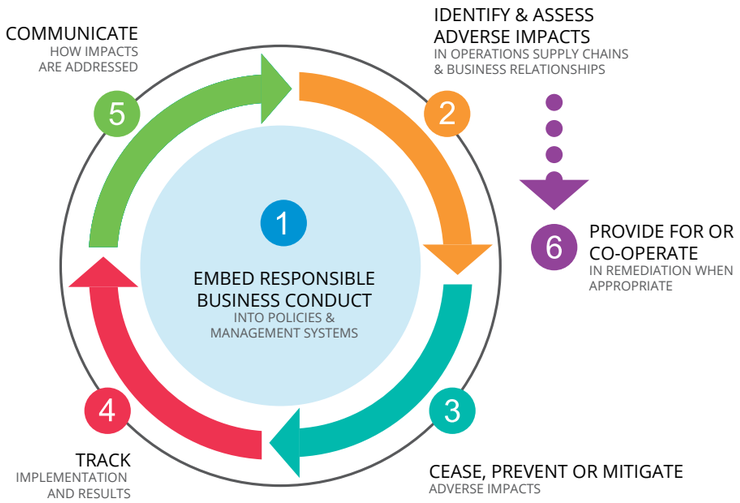
The process of due diligence is already well understood by businesses in certain contexts, such as the caution taken by a purchaser during corporate acquisitions. It has also become increasingly embedded in the business world following the publication of the Organisation for Economic Co-operation and Development (OECD)'s Due Diligence Guidance for Responsible Business Conduct in 2018[57]. The Guidance provides practical and plain-language support for businesses in implementing the OECD Guidelines for Multinational Enterprises, and seeks to reflect the United Nations Guiding Principles on Business and Human Rights[58], which state in Principle 13 the need for businesses to prevent or mitigate any adverse human rights impacts arising from their activities (including those in their value-chain). Principles 17-21 further elaborate on the need for due diligence and how it should be undertaken.

The due diligence process can be described as a cycle comprising four steps: the identification and assessment of adverse impacts; the cessation, prevention or mitigation of those impacts; tracking of those actions; and communication of success or failure. The cycle is shown in Figure 2 below, and the practical process of due diligence is described in more detail in Chapter 8.

[54] http://www.respect.international/french-corporate-duty-of-vigilance-law-english-translation/ [55] Pietropaoli et al, 2020
[56] https://gbihr.org/images/general/CC_and_GBI_briefing_-_May_2020.pdf
[57] http://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm
[58] http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf

THE EHRDD OBLIGATION WILL EXPLICITLY REQUIRE ACTION ON THE PART OF COMPANIES

FIGURE 2: THE DUE DILIGENCE PROCESS. REPRODUCED FROM OECD GUIDING PRINCIPLES, 2018

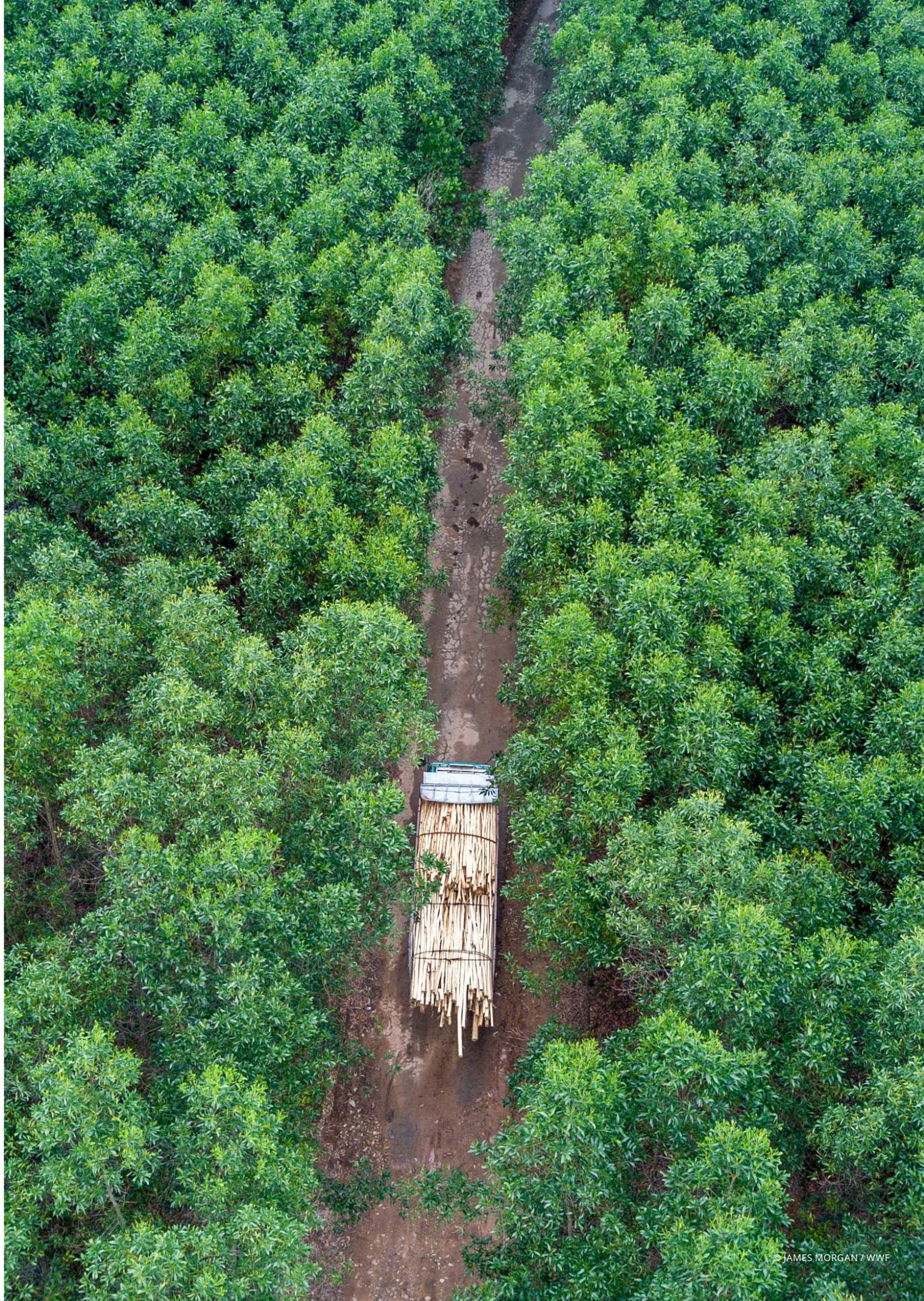


It is important to note that the EHRDD obligation will explicitly require action on the part of companies, not only to assess risks and report on them, but also to address them and report on those actions. Review of other legislation has highlighted the inadequacy of companies simply identifying supply chain risks and then reporting that no action will be taken[59], and so this option should be precluded.

Guidance would need to be published to provide support to companies in fulfilling their obligations, particularly to set expectations of which sectors and regions are considered high-risk and what good standards of environmental and human rights care look like. It is expected that this guidance will refer to the extensive literature and international agreements and conventions which already seek to define the standards of behaviour which meet the definition of environmental and human rights harm. For example, relevant benchmarks could include:

- The ILO's Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy
- The Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment of 10 December 1984
- The International Convention for the Protection of All Persons from Enforced Disappearance of 20 December 2006
- The Accountability Framework initiative for deforestation-free supply chains in agriculture and forestry[60]
- The OECD-FAO Guidance for Responsible Agricultural Supply Chains[61]

It is important that the obligation is seen to be proportionate and efficient in building on and consolidating numerous aspects of company reporting (Modern Slavery Act 2015, Non-Financial Reporting Regulations, Corporate Social Responsibility/Environment and Social Governance) which some companies currently perceive to be time-consuming and ineffective.



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POLICY CONTEXT

The UK has committed to reducing environmental and human impacts in business supply chains in both domestic and international policy. For example, the UK's 25 Year Environment Plan[62] aims to cut the greenhouse gas intensity of food and drink consumed in the UK by 20%, and also has targets for reducing food waste. The Plan contains specific commitments to:

- Work in partnership with industry to "explore the possibility of developing additional tools that support businesses to identify sustainable supply chains"
- Establish "appropriate mechanisms to screen policies and strategies for potential negative environmental effects overseas"
- Support businesses to implement zero-deforestation supply chains. This includes recognition of the need to influence and invest in "better resource governance in trading partner countries"

The UK's National Action Plan, Good Business: Implementing the UN Guiding Principles on Business and Human Rights[63] states that it "reaffirms the UK's commitment to the implementation of the United Nations Guiding Principles (UNGP) on Business and Human Rights, and acknowledges the duty of government but also sets out our expectation that UK businesses will act responsibly and in accordance with the UNGPs, wherever they operate". A progress update to the National Action Plan was published in May 2020[64], which identified certain actions the government had implemented but did not track progress against the Plan itself.

Enhanced EHRDD was recommended in the Global Resource Initiative (GRI)'s final report[65], which draws on the experience and perspectives of leaders from across business as well as government and NGOs. This states that the obligation "should require companies to analyse the presence of environmental and human rights risks and impacts within their supply chains, take action to prevent or mitigate those risks, and publicly report on actions taken and planned".

THE UK'S 25 YEAR ENVIRONMENT PLAN AIMS TO CUT THE GREENHOUSE GAS INTENSITY OF FOOD AND DRINK CONSUMED IN THE UK BY 20%

A similar conclusion was drawn by the Joint Committee on Human Rights in their 2017 report on Business and Human Rights[66], which stated:
"We recommend that the Government should bring forward legislation to impose a duty on all companies to prevent human rights abuses, as well as an offence of failure to prevent human rights abuses for all companies, including parent companies. This would require all companies to put in place effective human rights due diligence processes (as recommended by the UN Guiding Principles), both for their subsidiaries and across their whole supply chain…It should include a defence for companies where they had conducted effective human rights due diligence."

[62] https://www.gov.uk/government/publications/25-year-environment-plan [63] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/522805/Good_Business_Implementing_the_UN_Guiding_Principles_on_Business_and_Human_Rights_updated_May_2016.pdf
[64] https://www.gov.uk/government/publications/implementing-the-un-guiding-principles-on-business-and-human-rights-may-2020-update/uk-national-action-plan-on-implementing-the-un-guiding-principles-on-business-and-human-rights-progress-update-may-2020
[65] https://www.gov.uk/government/publications/global-resource-initiative-taskforce [66] https://publications.parliament.uk/pa/jt201617/jtselect/jtrights/443/443.pdf

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WHAT ARE THE BENEFITS TO BUSINESS?

As well as the clear social benefits of addressing the environmental and human rights issues described in Chapter 3, there are many direct benefits to companies who use due diligence to make more sustainable and ethical choices in their operations and purchasing decisions. These include increased confidence and certainty of legal compliance and efficiency benefits from more integrated reporting, as well as tangible examples of how EHRDD can help businesses identify and manage environmental and human rights risks to their reputation and bottom line. There is also the point, made by several businesses who already carry out EHRDD to some extent, that **a level playing field should be established to ensure that less ethical businesses do not avoid their societal obligations.**

In this chapter we explore these benefits in some detail, particularly where benefits can be expressed in terms of risks mitigated or managed. These risks may be categorised into physical, regulatory & legal, market, reputational and financial[67] although many other conceptualisation approaches exist. More information on some of these company-level benefits is also available in the European Commission study on due diligence[68].

CONFIDENCE AND CLARITY

MORE THAN 70% OF RESPONDENTS FELT THAT ADDITIONAL REGULATION WOULD BE BENEFICIAL

Confidence in government decisions and the future is a significant determinant of companies' willingness to invest. A recent survey found that many companies consider that "existing law does not provide business with sufficient legal certainty about which procedures are required to avoid legal risks for human rights abuses"[69]. **More than 70% of respondents felt that additional regulation would be beneficial by providing greater legal certainty, giving greater leverage over suppliers and providing a level playing field.** These views built on respondents' experience with the UK Bribery Act, which was felt to have effectively provided some of these benefits.

Clarity and stability of societal and governmental expectations of companies' behaviour will also help reduce the uncertainty created by numerous, incremental changes in legislation. However, a degree of flexibility will have to be maintained in any EHRDD policy to enable the regulator to issue guidance on environmental and human rights impacts as the scientific state of knowledge develops. Some commentators consider that both legal certainty and flexibility could be improved in tandem, particularly when legislators favour a programmatic approach to environmental law (relying on published plans and programmes to effect change)[70]. Reports also find that legal defensibility is perceived as being extremely important by businesses in some areas of environmental legislation[71]. This suggests that **it is important for mandatory EHRDD legislation to clearly articulate the standard of due diligence that businesses should apply in order for it to offer the prospect of a defence to any liability, as well as clearly defining the environmental and human rights harms themselves** mentioned in Chapter 4.

[67] McCraine et al, 2019 [68] Pietropaoli et a, 2020, p302 [69] Pietropaoli et al, 2020 [70] Squintani and Rijswick, 2016 [71] Watts, 1994, p238

CREATING A LEVEL PLAYING FIELD

Currently, as a largely voluntary initiative, **there are a wide range of different approaches to EHRDD by British companies.** The most responsible companies make significant efforts to assess and address possible environmental and human rights issues and may benefit to some extent from a stronger brand and better risk management, as discussed in more detail later in this chapter. However, they also incur some costs in doing so.

Other businesses do not carry out EHRDD currently or make only token efforts. Feedback from companies consulted during this project was that they would welcome a mandatory EHRDD obligation, because it would 'level the playing field' and ensure that all businesses competing in the UK marketplace were being held to the same standards.

"WE SUPPORT APPROPRIATE LEGISLATION THAT AIMS AT ENCOURAGING COMPANIES TO ADDRESS THEIR POTENTIAL IMPACTS ON HUMAN RIGHTS AND THE ENVIRONMENT AND WOULD LEAD TO INCREASED TRANSPARENCY, COLLABORATIVE ACTION AND A LEVELLED PLAYING FIELD."
NESTLÉ[72]

There have been similar calls from the finance and investment industry, such as a statement from the Investor Alliance for Human Rights[73] which referenced the UN Guiding Principles and recognised that voluntary approaches needed to be replaced with mandatory obligations to conduct EHRDD, particularly for large companies in sensitive sectors, in order to prevent free riders. The statement was signed by **over 100 investors with US$5 trillion under management,** including Aviva, Legal & General and Aberdeen Standard Investments.

There could also be benefits from the simplification and standardisation that would result from a mandatory EHRDD regime. As **the policy could consolidate a range of different sustainability and human rights reporting initiatives into a single practical framework,** it may be more efficient for businesses to carry out than piecemeal, single-issue legislation. The conclusion of the Smarter Environmental Regulation Review[74] was that the piecemeal development of such regulation was inefficient, with around 250 separate obligations to provide information or reports existing at that time. In businesses themselves, the concept of integrated reporting (reporting which combines environmental, social and governance aspects together with conventional financial and management accounting) has been described as "a more cohesive and efficient approach to corporate reporting"[75]. While the benefit of drawing together overlapping reporting requirements has not been quantified in this report, it could be an important component of any future business case.

[72] https://www.nestle.com/ask-nestle/human-rights/answers/human-rights-environmental-due-diligence-regulation
[73] https://investorsforhumanrights.org/news/investor-case-for-mhrdd
[74] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/199869/serr-phase1-exec-summary-130516.pdf
[75] https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

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£368

£368 BILLION A YEAR, COULD BE LOST GLOBALLY DUE TO THE DECLINE OF NATURAL ASSETS, WITH THE UK SUFFERING ANNUAL DAMAGE OF AT LEAST £16 BILLION BY 2050.

RISK MANAGEMENT

There is a rich body of evidence showing the reliance of contemporary businesses and economies on the natural environment, and the importance of environmental risk as a systemic risk to the global economy[76]. Several attempts have been made to quantify the risks held by UK businesses. These quantifications are generally made at the macro-economic level.

For example, the Global Futures report by WWF identified significant risks to the global economy in the absence of concerted changes to preserve biodiversity and prevent climate change. The study estimates that **the decline of natural assets will cost the world at least £368 billion a year, with the UK suffering annual damage to its economy of at least £16 billion by 2050.** The main economic costs domestically are predicted to be increased coastal flooding and erosion (which already cost the UK £2.2 billion per year[77]), as well as declining fish stocks harming the fishing industry.

The study projected annual global costs or foregone benefits due to loss of specific ecosystem services by 2050 of:

- Coastal protection: £251 billion
- Carbon storage: £98 billion
- Water supply for agriculture: £14 billion
- Pollination from wild pollinators: £12 billion
- Forestry production: £6 billion

These risks materialise over different timescales and therefore impact society and business in different ways. Some impacts may be acute and have a serious effect in a short space of time, such as a flood destroying business premises and stock. Others may be chronic, so that current business models slowly become unviable – such as slowly dropping yields of particular crops in certain regions due to more regular heat and water stress. **The focus of many companies may be to one- to three-year planning horizons while environmental risks are generally perceived as occurring over medium to long timescales,** but some sources consider that more immediate risks have closed this gap.

"FLOODS, STORMS, CONFLICT…AND POTENTIAL LOSS OF ACCESS TO RAW MATERIALS HAVE ALREADY BEGUN TO COLLAPSE THE TIMESCALES…BRINGING THEM WITHIN CONVENTIONAL PLANNING SCHEDULES FOR BUSINESS. GREEN ET AL, 2016

Risks may propagate through supply chains, depending on the exact nature of each sector. Some studies have found that climate change is likely to reduce the resilience of supply chains in the agriculture, mining and fisheries sectors, with complex supply chains (those with more nodes) being more resilient, presumably due to having greater redundancy[78]. However other commentators consider that **lengthy supply chains are likely to be more vulnerable to risks[79], and also that relatively little attention has been paid to the quantitative risk assessment of agricultural supply chains.**

[76] World Economic Forum, 2020 [77] Foresight, 2004 [78] Lim-Camacho et al, 2017 [79] Behzadi et al, 2018

PHYSICAL RISK:

This category of risk covers the direct hazards which may impact a company's operations and assets, such as wind damage, flooding and heat stress. These are conceptually simple to understand and map, and in many cases are also covered by well-developed markets for insurance (although these markets may be stretched in the future). However, businesses may not see their exposure to these risks as being connected to poor environmental or human rights performance as they will affect both responsible and irresponsible businesses to some extent.

REPUTATIONAL RISK:

Stakeholders interviewed in the course of this project identified that reputational risk was the principal driver of environmental and human rights risk management efforts today (where brands were valuable and business models were not significantly exposed to physical, market or financial risks).

Corporate reputations often represent a significant component of the value of a company's goodwill, and the impact of scandals on high value brands can lead to an immediate fall in the share price. One example is Volkswagen's 'DieselGate' scandal, which reportedly **cost the company 50% of its share price in a matter of months[80]** (arguably a case of the market pricing in assumptions about both regulatory action and consumer response). A similar experience occurred for BP after the Deepwater Horizon oil spill, with the company's share price dropping 50% in three months in expectation of fines and litigation. Reputational and legal risks together were reported in a survey as the main reason for firms undertaking human rights due diligence[81].

Consumer responses to environmental scandals can be diverse, ranging from anger, resistance, questioning or indifference through to reaffirmations of support[82]. It may be the case that ethical and sustainability considerations motivate a relatively small segment of the consumer population. Some sources have also found that market responses to environmental and human rights incidents may be muted[83].

MANY BUSINESSES OPERATE IN INDUSTRIES WHERE REGULATORS CAN IMPOSE SERIOUS PENALTIES FOR ENVIRONMENTAL HARMS

REGULATORY AND LEGAL RISK:

Many businesses operate in industries where regulators can impose serious penalties for environmental harms. As referenced above, BP was fined over US$5 billion by the US Department of Justice for the Deepwater Horizon oil spill[84]. Similarly, Anadarko settled over US$5 billion for land contamination in 2014[85]. In the UK in 2017, Thames Water was fined £20 million for a series of water pollution incidents. Action may also be taken by third parties who have suffered harm, such as the civil action Anderson et al v Pacific Gas and Electric over groundwater contamination which was settled for $333 million, and the Exxon Valdez case where punitive damages of over $500 million were awarded[86]. Future regulation can also be a risk to businesses as once a policy direction has been established, such as the net-zero target defined through the UK's Climate Act 2008, subsequent legislation restricting related polluting activities and products becomes more likely.

MARKET RISK:

Market risks represent the chance of changing supply, demand and prices. For some companies with little market power (those who are 'price takers' or those exposed to volatile commodities) this can represent the most significant type of risk. Market risks can also be a manifestation of hazards experienced by other actors which are then translated into impacts on their customers or suppliers. For example, a flood event (a physical risk) which destroys wheat may have a significant effect on a business which purchases flour inputs frequently, but little impact on a business which has stockpiled inputs to protect it from price shocks.

[80] Kesimli, 2017 [81] McCorquodale et al, 2017 [82] Deng, 2012 [83] See Jacobs and Singhal (2017) for a discussion on the Rana Plaza disaster [84] Clark et al, 2015
[85] https://www.epa.gov/enforcement/case-summary-settlement-agreement-anadarko-fraud-case-results-billions-environmental [86] http://www.exspill.com/

ASSET STRANDING AND VALUE AT RISK

When fixed investments made by businesses become unproductive due to a changing business environment, but cannot be easily sold, scaled back or converted, they are known as stranded assets. This can be due to legislative changes which prevent certain assets being operated, market effects which make certain assets unviable (such as coal mines whose customers have switched to cleaner fuels), or physical environmental changes making those assets unproductive (such as agricultural land which becomes increasingly arid due to climate change). The assets will then be written down in value unexpectedly or converted to liabilities, and the capital expended on them is lost, or stranded.

The nature and scale of the risk here depends on the speed of environmental change and the vulnerability of the asset. Physical and natural assets in agriculture are recognised as being vulnerable to stranding[87], particularly where they are physically fixed (such as land, soil or watersheds), function-specific (such as specialised tooling) or are part of business systems that are reliant on unsustainable inputs (such as farming systems relying on high water or fertiliser inputs). Alternative uses these assets can be put to (such as arable land being converted to grazing) are not sufficient to offset potential losses. The research also identified that the agri-food sector is vulnerable due to commodity booms, which can draw in short-term surges of capital which is spent unsustainably.

Risks may be classed according to their degree of correlation with other risks and events, with those that occur in tandem with others being termed systemic risks[88]. These are potentially more difficult to insure against than idiosyncratic risks, which are uncorrelated with other risks and can be efficiently covered by insurance pools. Some sources consider that **agriculture is particularly exposed to downside risk[89] due to the alignment of systemic risks – for example, bad weather may bring multiple hazards such as flooding, soil compaction and erosion, the spread of pests and diseases and resultant poor growth.**

The analysis of rare but plausible events is regularly required in the insurance and finance industry (for example, the EU Solvency II Directive), where the downside tail of a forecast distribution is known as the Value at Risk (VaR). This is typically the loss that is assessed to have a 0.5% chance of occurring in each year, although other VaR statistics such as the 1% probability may also be used, or described alternatively as a '99th percentile' VaR. Studies have found that the scenarios involving significant climate change and capital loss also significantly increase the VaR to the global economy[90].

"UNDER THE EXTREME LOSS OF NATURAL CAPITAL SCENARIO, WE FOUND THAT THE LOSS MEASURED BY THE 0.5 PERCENT VAR COULD ALMOST DOUBLE FROM USD 6.3 TRILLION TO USD 11.2 TRILLION."
(CALDECOTT ET AL, 2013)

Mandatory EHRDD will identify instances of existing and possible future asset stranding, giving businesses and society the opportunity to adjust investment decisions. In some cases, this will lead to re-valuation of existing assets as they are recognised to be less desirable than previously assumed.

[87] Caldecott et al, 2013 [88] OECD, 2009 [89] Hardaker et al, 2014 [90] Dietz et al, 2016; Caldecott et al, 2013

CLIMATE CHANGE AND EXTREME WEATHER

Extreme weather events are a clear physical risk to UK companies, directly damaging assets, disrupting operations, and causing knock-on effects through the supply chain. **Natural disasters caused by climate change cost more than $165 billion globally in 2018, and more than 50% of that was uninsured[91].** A report by federal agencies suggests that, in the United States alone, climate-related economic damage could reach 10% of gross domestic product (GDP) by the end of the century[92]. **In the UK, the winter floods in 2015-16 were estimated to cost the country £1.6 billion, of which over £500 million was incurred by businesses not including agriculture, utilities and transport[93].**

There is some overlap between climate change and other risk categories, with different hazards acting at different geographical or temporal scales. For example, drought can be considered hydrologically as an acute extreme weather event, while ongoing aridity of particular areas combined with population growth contributing to water stress is a more chronic threat.

Attempts are being made to investigate companies' exposure to climate change and extreme weather risks, although these are sometimes combined with perceived risks of legislation restricting 'business as usual' activities. For example, a Bank of England discussion paper on the financial risks of climate change[94] proposes that as part of the usual regulatory risk modelling, **insurers and financial institutions should model and quantify their exposure to climate risks up to 2050.** The Task Force on Climate-related Financial Disclosures is also central in calling for greater investigation of companies' exposure to these risks, and disclosure to investors and the public, while a Task Force for Nature-related Financial Disclosures is also in development to provide scrutiny and focus on the challenge of biodiversity loss.

In terms of the direct physical effects on business in particular sectors, evidence is mixed. Lesk et al (2016) found that the negative effects of droughts and heatwaves on global cereal production over an extended review period (1964-2007) were apparent, but losses resulting from flooding and cold weather were much less clear. Zhao et al (2017) found consistent reductions in yield for maize, soy, rice and wheat globally for each degree of temperature rise, with almost all estimates giving reductions in yield at the country scale including in the major producers of the United States, China, Brazil and India. Studies of Mediterranean countries have shown that yields of some crops are likely to fall significantly with changing climate patterns, with some at risk of becoming completely unviable[95]. **The risks to UK businesses here could be both acute, from short-term price shocks, and chronic as long-term overseas supply chains become increasingly unviable.** In terms of domestic examples, in 2011 it was reported that the spring-time drought may have cost the UK agricultural sector £400 million in lower yields and lost sales[96]. This was later found to be one of the top 10 driest 1-2 year periods for 100 years, but particularly damaging to agriculture due to its timing and seasonality[97].

At the farm scale, practical evidence shows the impact of extreme weather on yields and farm incomes. Several studies have investigated the costs of flooding to farms, and found that while the costs of short-duration floods were low, the costs of longer-duration floods were significant in lost production and sales[98] (approaching £1,000 per hectare in 2012 economics).

In some sectors, sources identify that adaptation and mitigation efforts are only underway at particular points in the value chain[99]. However, this is to be expected where risk and influence are imbalanced and concentrated at specific points throughout the supply chain. **Some large companies perceive that they can mitigate their risk to some extent by relying on a diffuse supply chain where a few financially-distressed suppliers can be replaced by other sources.** Where climate change slowly shifts the geographies of production (making some areas more productive and others less productive), this may appear to be a rational strategy. However, where climate change impacts occur quickly or unexpectedly, or if yields are likely to fall across much of the world[100], **such a business model will not protect companies or their customers.** It is therefore sensible for companies to invest in and support improved, climate-resilient practices in their supply chain rather than assume that shifting supply locations will always be an option.

While companies are clearly exposed to climate change and extreme weather risks, their ability to influence the hazards directly by reducing emissions is limited by the global nature of the problem and the likelihood of free riders. However, enforcing due diligence and disclosure will encourage mitigation action across the board, and there is also more that could be done in terms of adaptation.

[91] Swiss Re, 2019 [92] NCA, 2018 [93] Environment Agency, 2018 [94] https://www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper
[95] Bird et al, 2016 [96] www.telegraph.co.uk/finance/economics/8557156/Drought-may-cost-UK-farmers-400m.html [97] Kendon et al, 2013 [98] Posthumus et al, 2009; Morris and Brewin, 2014
[99] For example, Fleming et al, 2014, considered that only those at the upstream end of the seafood supply chain were making adequate efforts to assess and respond to climate change risks
[100] IPCC Special Report, 2020

DEFORESTATION, BIODIVERSITY AND LAND DEGRADATION

Deforestation, biodiversity loss and land degradation are some of the most detrimental impacts to be inflicted on the environment today by business activities. Loss of forest habitat is one of the most important drivers of climate change, as well as causing the decline and extinction of significant proportions of animal and plant life[101]. **The estimated economic cost of land degradation is already more than 10% of annual global gross product[102], resulting in the emergence of stranded assets, abandonment of once-productive land and the loss of livelihoods for local communities[103].**

Some of the key risks from deforestation and land degradation to businesses appear to be legal, reputational and via market mechanisms.

For example, the Indonesian palm oil supplier IOI was suspended from the Roundtable on Sustainable Palm Oil (RSPO) in 2016 following allegations that its subsidiary was responsible for illegal deforestation.

THE ESTIMATED ECONOMIC COST OF LAND DEGRADATION IS ALREADY MORE THAN 10% OF ANNUAL GLOBAL GROSS PRODUCT

TWENTY-SEVEN OF IOI'S KEY CUSTOMERS CANCELLED THEIR CONTRACTS, LEADING TO A DROP IN ITS MARKET VALUE OF 17% AND A DROP IN INCOME OF OVER £30 MILLION[104].

This is a combination of reputational and market risk effects – however, some risks such as loss of specific biodiversity providing critical ecosystem services can directly impact businesses' operations and bottom lines.

Pollination is one such critical ecosystem service, with insect and animal pollinators responsible for yields of a wide range of fruits, nuts and seeds[105]. Sources estimate that **overall crop production could drop by 5-8% globally in the absence of pollinators[106]**, with much more serious reductions in specific products. Some of these crops such as soft fruit, apples, almonds, cocoa and coffee are economically important and responsible for a large proportion of value addition through the supply chain. Many crops benefit from improved yields as a result of animal pollination even if not completely dependent on it[107]. **There is some evidence that pollinator-dependent crops have been less successful than other crops in the past 50 years, suggesting the effects of pollination service decline may already be being seen[108].** Certainly, 9% of bee and butterfly species in Europe are threatened and nearly a third of vertebrate pollinator species in South America are either threatened or have too little data available to be classified under the International Union for Conservation of Nature categories[109].

Changes in land-use towards intensive farming with associated pesticide use, invasive species and climate change are the main risk drivers of pollinator decline, and these triggers could cause a sudden or more gradual decline in pollinator numbers. The possibility of extinction cascades being initiated by loss of keystone species has also been explored[110] and is considered plausible. Pollinator reliance is a complicated topic, but it is believed that specialised pollinator species are the most vulnerable[111] and equally plant species with more specialised mutual relationships with pollinators could be more vulnerable to their decline[112]. Some sources suggest that neotropical rainforests contain more species with such pollinator-dependent vulnerability, while regions with more changeable weather contain plants better insured against pollinator failures[113].

[101] Brook et al, 2003 [102] IPBES, 2018 [103] www.independent.co.uk/environment/aral-sea-uzbekistan-soviet-union-agriculture-climate-change-irrigation-a8489721.html
[104] Ceres, 2017 [105] Potts et al, 2016a [106] Aizen et al, 2009 [107] For example, see Veddeler et al (2008) for a discussion of coffee yields
[108] Garibaldi et al, 2011 [109] Potts et al, 2016b [110] Kaiser-Bunbury et al, 2010 [111] Vanbergen et al, 2017 [112] Hoffman and Kwak, 2005 [113] Bond, 1994

CASE STUDY:

RISKS AND OPPORTUNITIES FOR COCOA POLLINATION

Certain crops rely primarily on animals for pollination, and may be vital to certain food sectors, regions or communities. For example, the fruit of cocoa trees (Theobroma cacao) is the key ingredient of chocolate. The trees are heavily dependent on the Ceratopogonidae family of midges for pollination (Forbes et al, 2019 – notably, a study funded in part by Mars Inc), particularly the Forcipomyia species, although ants and other hymenopterans are also important (Toledo-Hernández et al, 2017).

In the case of cacao specifically, low fruit:flower ratios (under 10%) are observed in some settings with contemporary pollination levels, due to both low levels of fertilisation and high levels of fruit failure. There is evidence that improved pollination coupled with better resource provision (water, nutrients etc) could significantly enhance yields (Groeneveld et al, 2010). The availability of pollinator services therefore appears to currently be a limiting factor and so represents both a downside risk and upside opportunity for cocoa producers and value chain participants. Should natural pollinator populations fall, yields would also be likely to decline (Gallai et al, 2009), and equally there appears to be scope for improving yields by encouraging pollinator populations alongside other sustainable management interventions (for example, see literature on 'ecological intensification' e.g. Ponisio et al, 2015 and 'climate-smart agriculture' e.g. Collette et al, 2011).

Various drivers could impact the abundance of relevant pollinators; perhaps including the use of insecticides for human health purposes. Some species of Ceratopogonid midge can be vectors for diseases such as bluetongue (De Liberato et al, 2005) and Leishmania (Dougall et al, 2011) as well as being useful pollinators.

[114] Bond, 1994
[115] Gallai et al, 2009

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The significance of pollinator service risks and opportunities to agri-food businesses will depend on factors such as:

- The vulnerability of pollinators to human and non-human factors today and in the future
- The availability and feasibility of alternative pollination approaches e.g hand pollination
- The magnitude of other risks – for example, the fruit sector is exposed to a number of environmental risks in any case which affect yield and fruit quality (frost, wind etc)

Assessments are therefore likely to be needed for each crop and region, as the factors above will vary. The use of metrics such as a vulnerability index[114] may be helpful here, although uncertainties remain about how a theoretical pollination vulnerability would translate in practice through the food chain, given the actions and interactions of multiple actors[115].

SEAFOOD

Seafood (principally fish and shellfish) is a high value component of British diets as well as its production being an important sector of the economy. Consumption at home currently stands at around 8kg per person per year, but this has been decreasing for over 10 years and is far from the peak of consumption in the 1940s of 15.6kg per person per year. There is some evidence that consumers increasingly see seafood as a luxury item and focus on perceived quality, freshness and health benefits over price[116].

The UK imports around £3.2 billion of fish and fish-derived products each year, and exports around £1.8 billion. However, 80% of domestic production is exported and 70% of domestic consumption is of imports, due to differing global consumer tastes and traditions. For example, species of Aspidochirotida sea cucumbers are considered a delicacy in some Asian markets[117] and are now under threat.

Seafood is one of the few foods typically produced through harvesting extensive wild animal populations. Consumption of particular species or geographical populations can therefore have a significant effect on biodiversity loss, both directly of those species consumed and also other species caught as bycatch or affected indirectly. Fishing practices have changed over the years, and an increasing proportion of seafood is from farmed rather than wild sources, but techniques such as bottom trawling and the use of Fish Aggregating Devices (FADs) in tuna fishing still carry a significant risk of bycatch.

Seafood is generally viewed as a relatively low greenhouse gas emitter compared to other meats, with pelagic fisheries and efficient aquaculture systems such as mussel production emitting as little as 1-3kg of CO_2e/kg of product, compared to at least 9kg CO_2/kg of beef[118]. **Some specific seafoods are less efficient, with Norway lobster trawling reportedly requiring 8lt of diesel for each 300g of edible product[119].**

However, other aspects of fishing and seafood consumption are more problematic. **Two key areas of concern are overfishing resulting in biodiversity loss and human rights issues within supply chains.** Overfishing has occurred for long enough, and at a high enough intensity, for significant, chronic effects on the abundance of many species[120], and **as of 2017 nearly 94% of fisheries were overfished or at the maximum sustainable level[121].** Negative effects are particularly evident in demersal (ocean floor) fishing, with particularly highly impacted regions including the Eastern Caribbean, North Sea and Japanese waters[122]. These impacts have a significant economic as well as environmental cost, with the World Bank estimating **annual production revenues to be US$83 billion lower than if fishing were carried out sustainably[123].**

From a human rights perspective, the seafood and fishing industries are also responsible for a number of harms. **There are multiple examples of modern slavery and exploitative employment practices in seafood supply chains, some of which have been exposed and are alleged to involve both states and multinational corporations as well as overseas producers[124].** There are also wider examples of unjust practices involving discrimination and threats against local food security and livelihoods[125].

As overfishing has the potential to irreparably damage populations[126] this carries a risk for businesses who have invested in specific regions or factors of production. For example, **the 1992 cod moratorium has been blamed for directly leading to the loss of 30,000+ jobs in Newfoundland and Labrador[127], together with a certain degree of asset stranding of fishing vessels, gear and packing plants.** For retailers, caterers and some manufacturers however, there is significant substitutability as has been seen in the switch from cod (*Gadus morhua*) to other species such as Alaska pollock, (*Gadus chalcogrammus*).

Subject matter experts consulted in the course of this report noted that while the majority (some 70%) of seafood consumption was via retailers, and many of these have improving responsible sourcing practices, there was cause for concern about the 30% of seafood consumed via catering and hospitality outlets. These businesses typically do not have such good approaches towards sustainability practices and transparency, possibly due to lower consumer brand awareness. The predominant risks for society therefore appear to be in biodiversity loss and human rights abuses, translating into reputational and market risks to businesses.

[116] Watson, 2019 [117] Purcell et al, 2014 [118] Nijdam et al, 2012 [119] Ziegler and Valentinsson, 2008 [120] Jackson et al, 2001 [121] http://www.fao.org/documents/card/en/c/ca9229en
[122] Halpern et al, 2008 [123] Arnason et al, 2017 [124] https://www.ap.org/explore/seafood-from-slaves/ [125] Teh et al, 2019 [126] FAO, 2016
[127] www.heritage.nf.ca/articles/economy/moratorium-impacts.php

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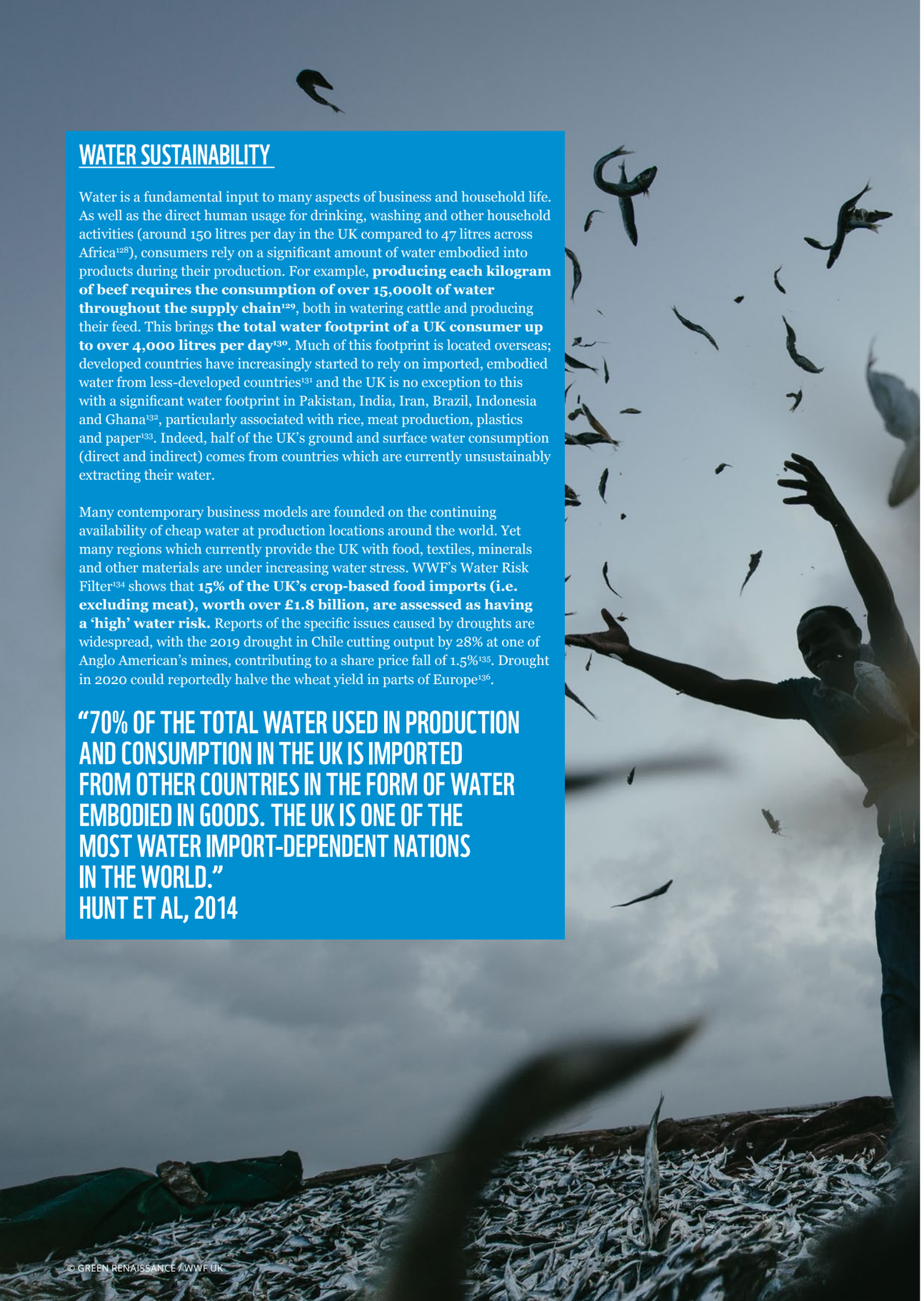
WATER SUSTAINABILITY

Water is a fundamental input to many aspects of business and household life. As well as the direct human usage for drinking, washing and other household activities (around 150 litres per day in the UK compared to 47 litres across Africa[128]), consumers rely on a significant amount of water embodied into products during their production. For example, **producing each kilogram of beef requires the consumption of over 15,000lt of water throughout the supply chain[129]**, both in watering cattle and producing their feed. This brings **the total water footprint of a UK consumer up to over 4,000 litres per day[130]**. Much of this footprint is located overseas; developed countries have increasingly started to rely on imported, embodied water from less-developed countries[131] and the UK is no exception to this with a significant water footprint in Pakistan, India, Iran, Brazil, Indonesia and Ghana[132], particularly associated with rice, meat production, plastics and paper[133]. Indeed, half of the UK's ground and surface water consumption (direct and indirect) comes from countries which are currently unsustainably extracting their water.

Many contemporary business models are founded on the continuing availability of cheap water at production locations around the world. Yet many regions which currently provide the UK with food, textiles, minerals and other materials are under increasing water stress. WWF's Water Risk Filter[134] shows that **15% of the UK's crop-based food imports (i.e. excluding meat), worth over £1.8 billion, are assessed as having a 'high' water risk.** Reports of the specific issues caused by droughts are widespread, with the 2019 drought in Chile cutting output by 28% at one of Anglo American's mines, contributing to a share price fall of 1.5%[135]. Drought in 2020 could reportedly halve the wheat yield in parts of Europe[136].

"70% OF THE TOTAL WATER USED IN PRODUCTION AND CONSUMPTION IN THE UK IS IMPORTED FROM OTHER COUNTRIES IN THE FORM OF WATER EMBODIED IN GOODS. THE UK IS ONE OF THE MOST WATER IMPORT-DEPENDENT NATIONS IN THE WORLD."
HUNT ET AL, 2014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THE CDP GLOBAL WATER REPORT FOUND THAT ONLY 38% OF RESPONDENTS HAD CONDUCTED A RISK ASSESSMENT THAT INCLUDED OPERATIONS AND SUPPLY CHAIN

There appears to be a wide variation in whether and how different businesses currently consider water risk. There are examples of detailed, quantitative risk assessments being undertaken (Dow Jones Chemicals[137]; Marks & Spencer[138]), and the CDP Global Water Report (2015) found that 65% of respondents reported that their business models held a substantive water-related risk, with nearly half of those risks lying within the next three years. A further 27% even reported having already experienced detrimental impacts in the previous financial year. However, other reviews have found that businesses have generally not yet addressed water scarcity to any significant extent[139], and the 2014 edition of **the CDP Global Water Report found that only 38% of respondents had conducted a risk assessment that included operations and supply chain.**

Perhaps due to the novelty of the concept, as well as commercial sensitivities, there are few publicly available assessments of the impacts of water risk on business costs and profitability. However, at a **macro-economic level studies have found the impact of individual droughts can range from 0.5%[140] to 1.6%[141] of regional GDP in industrialised countries,** with higher impacts still in less developed countries with a larger agricultural sector. These figures are likely to be under-estimates, as studies tend to focus on specific sectors and on direct costs only. At the firm level there is less evidence available, although stakeholders interviewed in the course of this project reported that water availability was already seen as a material risk, and that action was being taken to secure abstraction sources.

Numerous risk management and mitigation opportunities exist, from technological water efficiency, to purchasing additional abstraction rights (where they exist), to insurance and hedging strategies. Some solutions may be available in the form of improved infrastructure (reservoirs and water transfer pipelines), although these come with their own effects on biodiversity and energy consumption. While some unilateral action may be possible by businesses (acquiring new abstraction rights or purchasing insurance), in many cases improvements will only be possible with the collaboration of multiple stakeholders within a catchment. For example, efficiency improvements in farming from precision irrigation can easily be undone by increases in leakage from other users elsewhere in the catchment, or increased use of pesticides such as metaldehyde by farmers can increase the cost of water treatment for utilities and other water users. There may be opportunities for British businesses to effectively support overseas water supply chains and catchments through provision of engineering technology and expertise.

[128] UNFPA, 2002 [129] Aggidis et al, 2013 [130] https://www.watercalculator.org/footprint/water-footprints-by-country/ [131] Lenzen et al, 2013 [132] Hoekstra and Mekonnen, 2016 [133] Hunt et al, 2014
[134] https://waterriskfilter.panda.org/ [135] www.reuters.com/article/us-anglo-american-results/anglo-american-output-held-back-by-chile-drought-diamond-weakness-idUSKBN1ZM0WN
[136] https://www.bloomberg.com/news/articles/2020-05-20/100-year-drought-hits-poor-eu-region-already-reeling-from-virus [137] Reddy et al, 2015 [138] WWF and Marks & Spencer Plc, 2015
[139] Whiteman et al, 2013 [140] Martin-Ortega et al, 2012 [141] Adams et al, 2002

WHAT ARE THE IMPLICATIONS FOR INTERNATIONAL TRADE?

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As the UK exits from the EU, it finds itself in the unfamiliar position of directly negotiating new trading relationships. An EHRDD obligation could be seen as provocative in that context given that it would require businesses to look much more closely at what is happening in their supply chains and this in turn could lead to divestment from countries with which the UK has, or seeks, formal trading relationships. It is not possible to examine this issue comprehensively in this report, and further work will be required but certain key points can be made.

In negotiating new trade agreements, the UK will need to seek economic benefit without undermining its commitments to maintain high environmental standards. **Trade deals that support and enable environmentally destructive activity would fly in the face of Britain's desire to act as a world leader in promoting the global transition to resilient, reliable and sustainable commodity supply chains.** For example, agricultural expansion has been one of the primary drivers of deforestation in many areas around the world, and at the same time, global agricultural trade has been steadily increasing in part due to the rise of regional trade agreements and trade liberalisation[142].

The recently published Global Futures[143] report by WWF warns of potential risks to the world's economic prosperity if governments don't act urgently to halt nature loss. **Poorer countries would bear most of the costs, compounding the risks faced by millions in already vulnerable economies.** Eastern and Western Africa, Central Asia and parts of South America would be hit particularly hard as a result of the changes in price, trade and production levels. By identifying and reducing the UK's environmental impacts abroad (for example deforestation, carbon emissions, biodiversity loss etc), this would in turn reduce socio-economic impacts to both the UK and producer countries such as food insecurity, economic downturn, price inflation and labour rights abuses/shortages which will enable trade to continue for many more years to come.

As already noted, the UK consumes significant quantities of raw and semi-processed goods, from both domestic and international sources. The Riskier Business report by WWF and RSPB[144] shows that an area equivalent to ~88% of the size of the UK was required between 2016 and 2018 to satisfy the UK's demand for just seven agricultural and forest commodities (soy, palm oil, cocoa, beef & leather, pulp & paper, timber, and rubber) – an increase of ~15% in only three years. This demand has direct impacts in terms of climate change, biodiversity loss and deforestation. **Of the total UK land footprint overseas (21.3 Mha), 28% (or ~6 Mha) is located in risky countries, that is to say those with high deforestation and ecosystem conversion rates, poor track records on labour rights and/or a weak rule of law.**

The UK has made specific policy commitments relating to its global footprint. The 25 Year Environment Plan states (on page 125) that: **"We believe that environmental sustainability should be at the very heart of global production and trade, and we will be a passionate advocate for it. We will develop a trading framework that supports foreign and domestic policy, sustainability, environmental and development goals. In this way we will help make sure that the global environment is properly protected, and that threats of extinction are greatly reduced."**

The Plan also contains specific commitments to:

- Cut the greenhouse gas intensity of food and drink consumed in the UK by 20%
- Work in partnership with industry to "explore the possibility of developing additional tools that support businesses to identify sustainable supply chains"
- Establish "appropriate mechanisms to screen policies and strategies for potential negative environmental effects overseas"
- Support businesses to implement zero-deforestation supply chains. This includes recognition of the need to influence and invest in "better resource governance in trading partner countries"

The Foreign and Commonwealth Office has also reaffirmed

"the UK's commitment to the implementation of the United Nations Guiding Principles (UNGP) on Business and Human Rights, acknowledges the duty of government but also sets out our expectation that UK businesses will act responsibly and in accordance with the UNGPs, wherever they operate".

As noted, the UNGPs require the carrying out of human rights due diligence of the type contemplated here.

In addition, the UK's Building Stability Overseas Strategy[145] explicitly recognises the importance of trading relationships as an opportunity to actively support and positively influence other countries.

[142] "Dependencies of Food System Transformation in the Wider Economy and Society" LSE 2019, pp.27-33 http://www.lse.ac.uk/business-and-consultancy/consulting/consulting-reports/dependencies-of-food-system-transformation-in-the-wider-economy-and-society [143] https://www.wwf.org.uk/globalfutures
[144] https://www.rspb.org.uk/globalassets/downloads/documents/risky-business/risky-business-report-summary.pdf
[145] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/522805/Good_Business_Implementing_the_UN_Guiding_Principles_on_Business_and_Human_Rights_updated_May_2016.pdf

ENVIRONMENTAL CONCERNS AND WTO RULES

International trade under World Trade Organization (WTO) rules is governed by the principle of trade without discrimination. **WTO rules are meant to ensure that countries cannot discriminate between trading partners** (also known as most-favoured-nation (MFN) treatment) and that imported and locally produced goods should be treated equally (also known as the principle of national treatment).

WTO rules deal exclusively with trade-related issues and so do not explicitly promote environmental goals. Environmental concerns only emerge in so far as environmental policies have a significant impact on trade. Under the Global Agreement on Tariffs and Trade (GATT) Article XX general exceptions, countries may adopt measures intended to "protect human, animal or plant life or health" and those "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption". The hurdles that measures must pass to be permissible are high: they must not constitute "arbitrary or unjustifiable discrimination or a disguised restriction on international trade" and dispute resolution panels have tended to interpret 'arbitrary or unjustifiable' broadly[146].

ENVIRONMENTAL PROVISIONS AND FREE TRADE AGREEMENTS (FTAS)

Rather than relying exclusively on WTO rules in its trading relationships, the UK will be seeking to put in place trading agreements with a wide array of trading partners and has already 'rolled over' a number of agreements negotiated by the EU.

Environmental issues are frequently included within FTAs, alongside those on labour and human rights. A study by Morin et al[147] shows that starting in the 1990s, environmental provisions began to feature prominently in trade agreements and have increased considerably since then. This trend seems stronger in agreements between developed and developing countries. A recent OECD analysis of Regional Trade Agreements (RTAs) and the environment[148] has identified nine key types of sustainability provision.

WTO RULES DEAL EXCLUSIVELY WITH TRADE-RELATED ISSUES AND SO DO NOT EXPLICITLY PROMOTE ENVIRONMENTAL GOALS

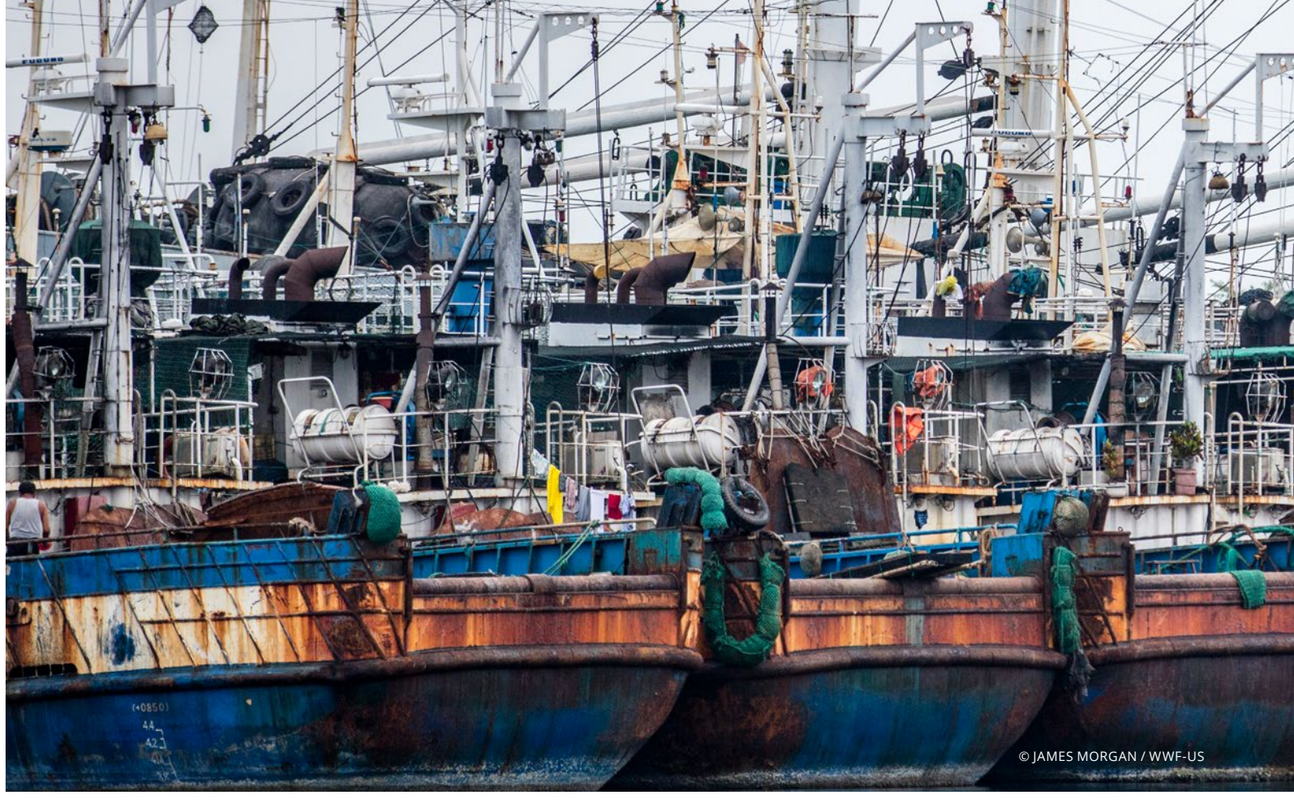
The Morin study also highlights that environmental provisions cover a large variety of environmental concerns. The most common are exceptions for the conservation of natural resources and to protect plants or animals. References to Multilateral Environmental Agreements have also become increasingly common in FTAs.

FTAs with environmental provisions are intended to encourage the maintenance of adequate levels of environmental protection. But even **where clauses on the protection of environmental, labour and human rights are included in FTAs they are consistently included in ways that are non-binding and non-enforceable.** Some consider them to be mere window dressing, aimed at diverting attention away from other parts of the agreements that continue to cause much damage to the sustainability agenda. Likewise, adequate procedures for monitoring, reporting, and review of environmental performance are often either omitted or only weakly implemented.

[146] Public Citizen (no date) 'Only One of 40 Attempts to Use the GATT Article XX/GATS Article XIV "General Exception" Has Ever Succeeded: Replicating the WTO Exception Construct Will Not Provide for an Effective TPP General Exception'. Retrieved from https://www.citizen.org/wp-content/uploads/ migration/general-exception.pdf

[147] Morin et al, 2018.

[148] See OECD "Assessing Implementation of Environmental Provisions in Regional Trade Agreements" January 2018 at https://www.oecd-ilibrary.org/environment/assessing-implementation-of-environmental-provisions-in-regional-trade-agreements_91aacfea-en The report notes a recent study by the WTO which tracked 270 RTAs notified by May 2016 and identified that 263 RTAs include at least one environmental provision either in their main text, annex or side agreements, and 177 RTAs include progressive environmental provisions that go beyond preambular statements and general exception clauses.



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AFTER MANY YEARS OF NEGOTIATION, THE EU-MERCOSUR FTA HAS BEEN CRITICISED FOR FAILING TO ADDRESS DEFORESTATION OR CLIMATE IMPACTS

FTAs can reasonably be regarded as only relatively weak instruments for achieving sustainability in supply chains, not least because they provide limited constraints to unsustainable action by a producer country. This is evident in the recent controversy regarding the EU-Mercosur FTA which is nearing completion after many years of negotiation but has been criticised for failing to address deforestation or climate impacts[149].

A recent illustration of this can be seen in the case of Indonesia, home to the world's third largest span of tropical rainforest. It is also considered very high-risk in terms of deforestation, labour rights abuses and a weak rule of law, according to the Riskier Business report. In March this year, the Indonesian Trade Ministry decided to abandon the standards[150] set by the EU's Forest Law Enforcement, Governance and Trade (FLEGT) Action Plan which currently requires Indonesian companies to obtain a licence in order to prove that their timber comes from legally and sustainably managed sources. The decision was reportedly taken to boost timber exports, due to the economic turmoil caused by the recent COVID-19 pandemic.

Notwithstanding this, the UK government, along with the governments of Denmark, France and the Netherlands, are reportedly seeking to increase their imports of Indonesian palm oil[151]. The decision has exacerbated fears that deregulation may lead to a rise in illegal deforestation as well re-incentivising the illegal timber trade.

[149] https://uk.reuters.com/article/uk-mercosur-summit/mercosur-leaders-look-to-close-eu-deal-despite-macrons-resistance-idUKKBN24303Z

[150] https://www.fern.org/news-resources/indonesias-response-to-coronavirus-threatens-to-increase-illegal-logging-2129/

[151] https://www.theguardian.com/environment/2018/mar/09/uk-defies-eu-over-indonesian-palm-oil-trade-leaked-papers-show

THE ROLE OF EHRDD

In light of the above, assuming the UK is serious about its policy commitments related to its global footprint, there is a strong case for supplementing whatever sustainability provisions might appear in the UK's FTAs with obligations on British business to play its part in encouraging sustainable practice.

To illustrate this, consider the situation in West Kalimantan Province in Indonesia, which between 2011 and 2018 lost about 2 million hectares of tree cover – equal to an area the size of Wales – due to oil palm development. Major traders importing palm oil into the UK market (AAK, ADM, Bunge and Cargill) source from a large number of mills in West Kalimantan, very few (~10%) of which are certified by the Roundtable on Sustainable Palm Oil (RSPO). Three UK banks – HSBC, Standard Chartered and Prudential – were identified as lending £613 million to palm oil client companies in Indonesia. Of this, **£161 million was lent to six companies owning mills in West Kalimantan, and amongst these mills only a very small number (one out of 12) is RSPO certified.** An EHRDD obligation would require these companies to assess the risks from these investments and determine a course of action to address those risks. A key and valuable outcome would be to see increased RSPO certification as a contribution to the UK's global footprint aims.

As noted, EHRDD is quickly becoming an expected way of doing business in many countries. Enhanced EHRDD has been recommended in the GRI's final report[152], which focuses on certain specific commodities and draws on the experience and perspectives of leaders from across business as well as government and NGOs. This states that the obligation

"the obligation should require companies to analyse the presence of environmental and human rights risks and impacts within their supply chains, take action to prevent or mitigate those risks, and publicly report on actions taken and planned".

OF THE £161 MILLION LENT TO SIX COMPANIES OWNING MILLS IN WEST KALIMANTAN, ONLY 1 IN 12 MILLS WERE RSPO CERTIFIED

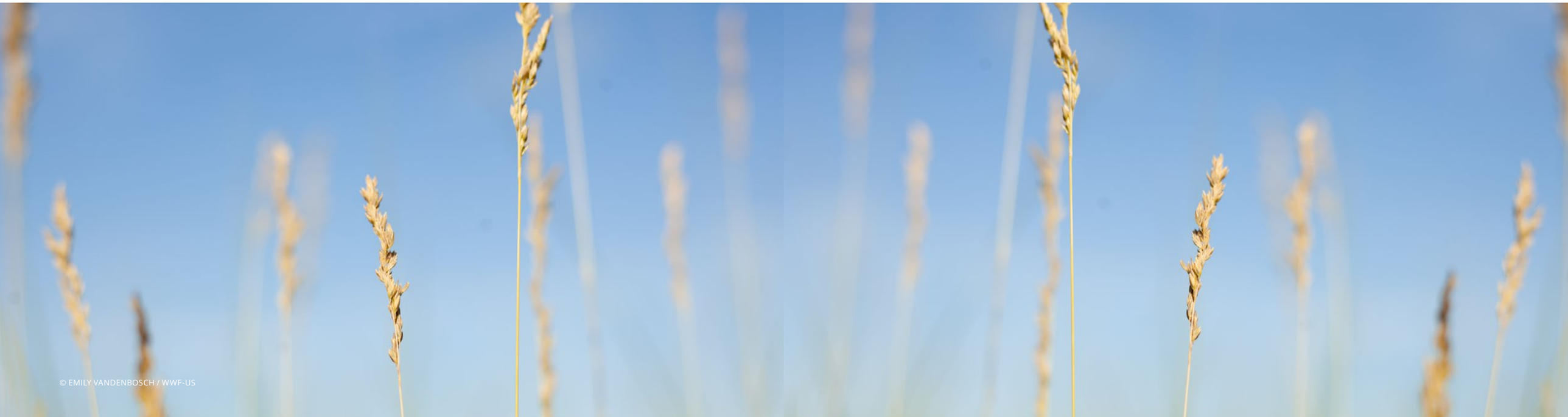
In such a scenario an EHRDD obligation would help businesses to identify high-risk producer countries (i.e. those exposed to deforestation, water or climate-related risk as well as human rights abuses/weak governance etc) and to use this information to inform both business and government remediation strategies aimed at mitigating said risks.

In doing so, this may help to:

- Maintain the flow of goods entering the UK and improve the resilience of the UK's supply chains to future pandemics/environmental impacts/market disruptions
- Support the development of stronger trading relationships with producer countries in the future
- Reduce the incentive for further deregulation within producer countries

The private sector has an important role in promoting responsible business as part of the UK's global reputation[153]. The UK is a major exporter of financial services and high-value manufacturing such as vehicles and chemicals, as well as having strong brands in food and drink, fashion and entertainment. UK goods are perceived as high-quality and trustworthy[154], advantages that should be protected by a clear understanding and management of reputational risk. For example, confidence in British goods in growth markets such as India could be damaged by any adverse local human rights issues. It is therefore possible that an effective EHRDD obligation could actually enhance and protect the reputation of British goods and services and contribute to successful export growth.

[152] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/881395/global-resource-initiative.pdf [153] Fuchs, 2005
[154] https://www.barclayscorporate.com/content/dam/barclayscorporate-com/documents/insights/trade/Made-in-Britain-Report-2018.pdf
[155] https://www.gtreview.com/magazine/volume-15issue-6/conflict-minerals-regulation-unintended-consequences-good-business
[156] Dou et al, 2018 [157] Smit et al, 2020



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AS AN EHRDD OBLIGATION IS NON-DISCRIMINATORY AND APPLIES EQUALLY TO BOTH DOMESTIC AND INTERNATIONAL SUPPLY CHAINS, IT IS UNLINKELY TO BE CHALLENGABLE UNDER WTO RULES

CONCERNS ABOUT EHRDD

Discussions around an EHRDD obligation for UK companies have highlighted the importance of the UK's international reputation being enhanced by such a policy. But two principal trade concerns have been noted. First, the possible breach of WTO rules designed to prevent discrimination against imports and second the possibility of creating a de facto 'black list' of countries where UK businesses would be reluctant to do business, with resultant harm caused to those economies[155] and the possibility of spillover effects[156] including harm to relationships currently being developed to support new trade deals. Divestment may also result in negative activities simply continuing with new customers replacing UK companies.

As to the first of these, in so far **as an EHRDD obligation is non-discriminatory and applies equally to both domestic and international supply chains and/or meets either of the two general exceptions, it is unlikely to be challengeable under WTO rules.** This appears to be the preliminary conclusion reached by the European Commission in deciding to proceed with an EHRDD obligation at EU level, as WTO rules are not considered in the most recent 2020 study[157], although it is understood that trade rule implications will be considered in more detail as part of the legislative consultation process.

As to the risk of divestment, it is not clear exactly how businesses would respond to the proposed EHRDD obligation, and to what extent there will in fact be such a risk. There are a number of reputational and business factors that would mitigate against this.

However, there appear to be no barriers to designing an EHRDD obligation that would specify that **divestment should be seen as an option of last resort only** and that would prioritise engagement and encouragement for suppliers to improve their performance instead. Guidance under an EHRDD obligation could encourage the formation of longer-term supply contracts to reduce the likelihood of divestment; or emphasise the benefits of committed change activism by businesses. Similarly, the UK could explore the option of making the benefits of FTAs or Bilateral Investment Treaties available to business on a sliding scale according to how well they are complying with EHRDD, thereby putting more onus on the action of business rather than simply leaving producer countries with the responsibility for responding.

There is already compelling evidence that the private sector can support development and bring improvements in quality of life, when combined with appropriate social policies[158] – for example, Marks & Spencer have worked with Oxfam in India as part of their 'Plan A' strategy[159], and have already **supported 890,000 people in their supply chain through employment, healthcare and training in numeracy and literacy.**

[158] Newfarmer and Sztajerowska, 2012 [159] https://corporate.marksandspencer.com/documents/plan-a/highlights-10-years-of-plan-a.pdf
[160] Caldecott et al, 2016 [161] See Mangaliso, 1999 for a view of apartheid in South Africa

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It should be noted that an EHRDD obligation does not need to exist in isolation from other policies and can be complemented by supply side policies which offer support and encouragement to developing countries to achieve the standards sought. Such supply side policies are already evident in the FLEGT Action Plan which accompanies the EU Timber Regulation and in the recommendations of the GRI. The UK government could also provide incentives for investment in the territories of certain overseas partners, mobilising capital and British innovation to augment current aid activities.

Finally, we note that some environmentally-damaging industries and their value chains, such as coal-fired power, petroleum extraction and mining, are important to the economies of some developing countries, and more detailed analysis would be needed to assess possible impacts of an EHRDD policy on those countries. There is still a high rate of investment in some of these sectors (e.g coal extraction and consumption in Indonesia and India respectively[160]), and where government is unwilling to support environmental and human rights reform, divestment may be the only meaningful policy for multinationals[161].

WHAT ARE THE COSTS?

Broadly, there are two types of cost which may arise from a mandatory EHRDD obligation. Firstly, there are the direct costs to businesses of complying with the risk assessment and reporting elements of the obligation. These activities, and the relatively modest costs associated with them, can be understood from review of comparable legislation, its impact assessments and published post-implementation evaluations.

Secondly, there are costs associated with the choices made by businesses in response to information acquired during risk assessment. Businesses will take steps in order to mitigate risks such as those described in Chapter 3. These actions and any costs are necessarily uncertain at this stage, as they depend on factors such as businesses' propensity to switch suppliers or engage in certification schemes, and consumers' propensity to respond to greater transparency by switching products. The distributional effect of these choices is also unclear – for example, to what extent any price changes might be passed onto consumers, and the extent to which there is a risk of unintended effects such as wholesale divestment from specific regions. Where possible, however, these themes are explored below.

A very comprehensive review of the costs and potential effects of comparable legislation is provided in the European Commission's study of due diligence requirements through the supply chain[162] and so only a high-level summary is given in this chapter.

In theory, it may be expected that business choices in response to supply chain risk assessment findings should be socially net-positive, as they will be aimed at eliminating or mitigating social (environmental and human rights) risks. The following analysis does not attempt to prove this theory – however, it may be a useful alternative approach to any future business case development.

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COSTS OF SUPPLY CHAIN RISK ASSESSMENT

The activities of investigating, mapping and risk assessing a company's supply chain will result in companies incurring costs, primarily in human time spent but potentially also in investment in systems and tools.

A number of past policies have considered the costs to businesses of mapping and risk assessing their supply chains and operations. Table 1 below summarises the costs identified in the respective business cases and Impact Assessments (IAs) of the EU Conflict Minerals Regulations and the UK's Modern Slavery Act 2015, as well as academic sources and the recent European Commission study on due diligence.

Table 1: Reported and estimated costs of risk assessment activities

Source	Reported or estimated costs and their specific coverage	
EU Conflict Minerals Regulations[163]	Set-up costs in first year	€13,500 (0.014% of turnover) per company
	Ongoing annual costs	€2,700 (0.011% of turnover) per company
Modern Slavery Act IA[164]	Costs assumed to be negligible due to reporting requirements already existing under the Companies Act 2006	
European Commission Due Diligence proposal[165]	Annual labour cost (note this also includes expenditure on mitigation activities in response to risk assessment, but not overheads)	€36,990 for company with turnover of €50 million €0.5 million for company with turnover of €10 billion
EU Non-Financial Reporting Directive IA[166]	Set-up and training costs	€5,000 per company
	Ongoing annual costs	€33,000-€604,000 per company depending on size and complexity
Aizawa et al, 2018	One-off human rights risk assessments in mining sector	US$30,000-150,000 per instance depending on scope and urgency

The post-implementation Assessment of Due Diligence Compliance Costs, Benefits and Related Effects of the Conflict Minerals Regulations[167] (European Commission, 2014), found that a very wide range of set-up and ongoing costs were reported for bringing companies into compliance with the Conflict Minerals Regulations. It is also apparent from Table 1 above that different literature sources present quite different costs for risk assessment activities. One interpretation of this wide range of projected and reported costs is that different businesses will start from different points. For example, those that were already largely compliant with the Conflict Minerals Regulations when they became effective, and had effective systems in place, may only have experienced small set-up and annual costs when this legislation was enacted. Those businesses that were lagging significantly behind, however, would have needed to put in place policies and systems with resultant higher costs.

[162] Smit et al, 2020, pp.290-385
[163] Impact Assessment of Conflict Minerals Regulations, European Commission, 2014, pp.290-385, retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0053
[164] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/371057/MSB_IA.pdf [165] Smit et al, 2020. p.548
[166] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013SC0127&from=EN p66

COSTS OF BUSINESS RESPONSE

Mapping and investigating supply chains will undoubtedly highlight potential issues and risks which companies will need to address, and so EHRDD is expected to drive more sustainable and responsible business activities. However, there is limited information available about exactly which management actions firms will take in response to these due diligence findings, and how those actions will be responded to by other market actors, particularly overseas. Similarly, there are uncertainties as to whether, and how, higher sustainability and social standards might change the costs of business activities, and how those costs would be borne by businesses or consumers.

Actions open to businesses include[168]:

- Join third-party certification schemes or industry roundtables
- Divest/ban
- Invest at origin
- Create internal or industry standards
- Ignore

The intention is for the EHRDD obligation to minimise the tendency for businesses to choose divestment or inaction as strategies, but even so the effectiveness of these actions will depend on specific context (commodity, country and industry structure amongst other factors). The costs of these actions are also challenging to determine accurately across a wide range of businesses and commodities. Broadly, increased costs might be due to environmentally-friendly practices being followed which involve more labour (for example while managing pests and disease), reduced short-term yields (due to reduced fertiliser inputs) and transition costs from changes in capital allocation and management (for example due to re-training). For some specific commodities, estimates of the cost differentials can be found – for example, the UK's EU Nitrates Directive transposition IA[169] considers whether the necessary changes to nitrogenous fertiliser spreading techniques, timings and intensities could increase farm costs.

However, it would be difficult to extrapolate these analyses to the wider agri-food sector. They are undoubtedly specific to the location and production methods in use in the cited studies. It would also be necessary to find such sector-specific metrics for all other sectors covered by the proposed broad EHRDD policy. It is therefore considered that a detailed assessment of the costs arising from all possible business responses may not be feasible at this stage, but specific scenarios could be presented. One such scenario is set out below as an example.

[167] https://op.europa.eu/en/publication-detail/-/publication/dced6d04-92fb-4a20-a499-4dad9974aee7 [168] Rueda, 2017 [169] http://www.legislation.gov.uk/ukia/2008/217/pdfs/ukia_20080217_en.pdf
[170] https://www.3keel.com/landscape-innovation/ [171] https://www.wrap.org.uk/content/courtauld-2025-water-ambition
[172] Oxford Economics, 2007. Report on modelling the macroeconomic impacts of achieving the UK's carbon emission reduction goal
[173] https://ec.europa.eu/environment/forests/pdf/ia_report.pdf

EXAMPLE: SCENARIO OF POSSIBLE BUSINESS RESPONSES TO BEEF SUPPLY CHAIN DUE DILIGENCE

1. Due diligence is carried out into the beef supply chain (a high impact commodity with a substantial overseas footprint, limited certification options, and an existing domestic production capability – the UK is already 70-80% self-sufficient).

2. Given the lack of certification options, existing users (food manufacturers, retailers and hospitality companies) are likely to rely on internal standards or switch to lower-impact suppliers (possibly domestic).

3. There is a lack of relevant metrics or benchmarks for firms to objectively assess the sustainability of domestic beef against (although see Poore and Nemecek (2018) and the 'livestock production' category in the EU's Sustainable Finance Taxonomy).

4. Possible effects might include a small increase in UK beef prices, although if the policy were brought in over 2+ years supply should respond. It is likely there would be a difference in cost between foreign beef and domestic, and these cost increases may be passed onto consumers. Taking into account the price elasticity for beef given in Andreyeva et al (2010), we might expect a reduction in beef consumption of slightly less than the price increase.

The experience of professionals and NGOs interviewed during the course of this project was that supply chain mapping and risk assessment was not an onerous exercise for the majority of companies, and the more significant effort came from building relationships with suppliers and sub-suppliers, and then working with them and other stakeholders to mitigate the identified risks. For example, when approaching water risks, individual companies were funding mitigations in the order of £50,000 per annum. However, as sourcing locations are common to many participants across the UK food and drink sector, where mitigation is required collective action could be taken by several businesses together (or channelled through NGOs or initiatives such as Landscape Enterprise Networks[170]. WRAP's Courtauld 2025 initiative has taken this approach with each retailer putting £5,000 -£15,000 per annum in the hotspot locations that are important sourcing regions for their business (Kenya, South Africa and UK locations including Medway, East Anglian CamEO, Wye and Usk, and Tamar[171]).

In general, the IAs reviewed, such as the Modern Slavery Act 2015, did not consider in any detail subsequent costs upon businesses as a result of risk assessment findings and changes in response to those findings. Some, such as the Climate Change Act 2008 IA[172], do consider how certain sectors might respond to enhanced environmental policies in general – for example, businesses may replace inefficient capital equipment with newer models sooner than expected. This IA also identifies that costs to firms could be substantially (c.50%) lower if policies are introduced slowly (over several years) and with warning, as this reduces the chance of capital stranding. However, only the EU Timber Regulations IA contained any clear assessment of spillover effects, based on the assumption that any reduction in production volume is matched by a proportionate decline in employment. Supporting documentation to the IA notes that any decline in production volumes as a result of stricter environmental standards is projected to be largely offset by increases in price[173].

OVERALL COST ASSESSMENT

As described in the preceding sections, the costs of risk assessment are fairly well understood while the costs to businesses of responding to findings with action are less clear. It may however be possible to model the effect of EHRDD on specific commodities, based on current levels of sustainability and human rights compliance, contemporary trade patterns, consumer demands and econometric factors.

Table 2 below sets out the projected costs of EHRDD selected by the European Commission in their 2020 study[174]. These costs were arrived at from a survey of companies who considered the likely costs of several component EHRDD activities, including impact assessments, changing of policies and reporting, and are broadly in line with the most relevant figures found from other sources in sections 7.1. and 7.2.

Company revenue	Projected annual cost of EHRDD, including overheads and outsourced activity
€50 billion	€4.70 million
€10 billion	€0.94 million
€1 billion	€93,922
€50 million	€69,356
€25 million	€34,678

23%

OF BUSINESSES COVERED ARE CURRENTLY NON-COMPLIANT WITH THE MODERN SLAVERY ACT 2015

As set out in Chapter 4, it is assumed that the number of companies covered will approximately match the Modern Slavery Act 2015 with its threshold of £36 million turnover, giving coverage of around 18,638 British companies[175]. A proportion of these businesses will already have taken action to a significant extent, while some may not act at all without enforcement (the TISC Report shows 23% of businesses covered are currently non-compliant with the Modern Slavery Act 2015).

Carrying out the initial stages of due diligence, involving the supply chain investigation, mapping, risk assessment and ongoing monitoring/reporting, should not be unduly costly, as such work is already familiar to a number of major companies such as Tesco, Marks & Spencer and Nestlé who have worked with NGOs to accomplish it. Furthermore, the European Commission's due diligence report[176] included results of a survey reporting that 37% of respondents were already carrying out EHRDD to some extent.

DISTRIBUTIONAL EFFECTS

Beyond the direct effect on companies, their costs and profitability, there may be indirect costs on consumers and companies who are not covered by the policy but who are nevertheless affected by decisions of other companies or market effects such as demand and prices. It is also possible that benefits of the policy (reduced risk of climate change, better working conditions) would be felt both in and outside the UK while the costs to UK businesses, whether passed onto consumers or not, would be mainly borne domestically.

A number of studies demonstrate that, particularly in certain markets where goods are relatively homogeneous and collusion is prohibited, costs are likely to be passed onto consumers[177] and also that retailers are quicker to pass through price increases than price decreases[178]. However, in the absence of comprehensive information on businesses' most likely actions arising from EHRDD, the effect of those actions on costs, and likely consumer response to any cost changes, it is difficult to draw broad conclusions about the precise effects of an EHRDD obligation on consumers and consumer surplus. Such analysis may be possible in future work by expanding the scenario modelling methodology outlined in section 7.2.

[174] Smit et al, 2020 [175] www.tiscreport.org [176] Smit et al, 2020 [177] Basker and Khan, 2016; Leibtag, 2009 [178] Brooker et al, 1997


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HOW WOULD SUPPLY CHAIN DUE DILIGENCE WORK?

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Feedback from both the public and private sector during this project was that adoption of an EHRDD obligation would be expedited by a clear understanding of exactly what steps businesses should take. This ensures that businesses understand what constitutes good quality due diligence and can also plan and budget for an appropriate level of effort to achieve it. Similarly, it helps legislators and policy-makers understand the current state-of-the-art, and identify any areas of opportunity which could be nurtured and encouraged.

There is a wide range of support available for businesses making their first steps in EHRDD. Many consultancies and NGOs, both established organisations and technology start-ups, are already in place and able to support companies. Their services can range from full outsourcing options providing a standardised due diligence service, to internal capability-building exercises that install and develop a dedicated in-house due diligence function, perhaps as part of existing Sustainability or Internal Audit departments. A particularly interesting theme is the emergence of technology and data analytics as a powerful tool for supply chain investigation, mapping and monitoring.

Case studies of some available tools and services and an overview of the necessary activities are presented in the following sections. However, there is extensive guidance provided by international and national sources, on due diligence as a whole and on sector-specific risk assessment. For example:

- OECD Guidelines on Due Diligence for Responsible Business Conduct and the associated Guidance, including sector-specific guidance[179] on:
    - Responsible supply chains of minerals
    - Responsible agricultural supply chains
    - Responsible garments and footwear supply chains
    - Responsible supply chains in the extractives sector
- Guidance is widely available on specific risk themes, such as WWF's report From Risk to Resilience: Does your business know its water risk?[180]
- For investments, CDC's Good Practice for Fund Managers, Environmental & Social Due Diligence[181].
- Further references are given in Chapter 9.

It is anticipated that guidance issued alongside the EHRDD obligation legislation would be likely to refer to some of these documents as good practice.

[179] http://mneguidelines.oecd.org/sectors/
[180] https://blogs.wwf.org.uk/blog/business-government/business/does-your-business-know-its-water-risk/
[181] https://assets.cdcgroup.com/wp-content/uploads/2016/07/25150839/Environmental-and-social-due-diligence.pdf

INVESTIGATION AND MAPPING

The first components of EHRDD, for all companies starting out, involve a comprehensive, targeted and proportionate operations and supply chain investigation and mapping exercise. This draws on internal and external information, such as from procurement, finance and sustainability systems, to screen for likely high-risk sectors or commodities.

Many leading companies currently carrying out due diligence will make use of NGOs and specialists to identify and prioritise risk themes for further exploration. It is also recommended that companies consider consultation and stakeholder engagement more broadly at various stages while carrying out due diligence, particularly when supply chains extend overseas and may be difficult to assess remotely. Labour organisations, NGOs working locally and community groups may all be good points of engagement and have ideas for how to carry out participation and which risks are a priority to local people.

Having prioritised areas of the supply chain or internal operations which have greatest potential to cause harm, the next step is for organisations to assess in more detail what impacts are currently being, or are at risk of being, caused by those areas. For example, Tesco identified 20 top products and ingredients with a risk of causing environmental and social harm[182]. These are items sold in significant quantities and where expert input from NGOs highlighted current issues.

Trase is a research-based supply chain transparency initiative, built on an open-access information system. It was launched in 2016 with the vision to empower markets, governments and civil society in the transition towards sustainable commodity production and consumption.

[182] https://www.tescoplc.com/sustainability-old/sourcing/top-20/

CASE STUDY:

TRASE - WWW.TRASE.EARTH

Trase has developed an entirely new approach to mapping agricultural supply chains, which combines customs, shipping, tax, logistics and other data to connect regions of production, via trading companies to countries of import, for an entire sector, such as Brazilian soy or Indonesian palm oil exports. This provides a comprehensive map of the central stages of a supply chain, connecting buyers and investors to specific production regions. By combining these high-resolution supply chain maps with new, spatially-explicit assessments of commodity-driven deforestation and other sustainability indicators, Trase is able to link markets to impacts with unprecedented detail. An Application Programming Interface has been developed which enables it to be embedded in partner platforms.

Major commodity buyers, brands and retailers, financial institutions and national governments are already using Trase data and analysis to manage risk. For example:

- The UK Roundtable on Sustainable Soya used Trase data in both its baseline and annual reports, and major retailers, especially in Europe, recognise that Trase can provide a first cut analysis to identify hotspots in their supply chains.
- A similar risk hotspot analysis was also carried out in collaboration with the Consumer Goods Forum Soy Buyers' Coalition that engaged 15 downstream companies. It involved taking Trase data alongside supplier information to develop a simple, transferable, assessment of risk that was adaptable to different types of company information. This provided the supply chain owners with a list of municipalities – and traders linked to those municipalities – that could be treated as risk hotspots for further targeted investigation and potential investment.
- Although names are withheld to protect commercial confidentiality, several banks and other financial institutions are using Trase to filter risk in their lending portfolios.
- The French government is using Trase in the development of its risk management and alert information system that will support the implementation of its 2030 Strategy to Combat Imported Deforestation.

Future plans include:

- Scaling-up coverage of more countries and commodities
- Future versions will also include live alerts for a number of key indicators
- Mainstreaming uptake and use of Trase data by making it easier for the target audience to analyse the data and access decision support tools for themselves

ACTION TOWARDS A LIGHTER FOOTPRINT

Having mapped and risk assessed their operations and supply chain, organisations must then plan and execute actions to reduce or mitigate the impacts or risks they have discovered.

There are many actions that can be appropriate depending on what is uncovered by the first due diligence stages, and decision support tools are available to organisations to help determine what is most appropriate to the situation[183]. Divestment or switching supply countries should be discouraged as the immediate response to identifying issues, as dialogue with suppliers may be able to quickly bring practices up to standard. Other actions such as participation in certification schemes or industry roundtables may also be options.

Here again, external organisations can play an important role. For example, for each of their Top 20 products and ingredients, Tesco appointed an NGO with expertise in that sector and local knowledge in the region of origin to help develop and enact sustainability and human rights policies, or else joined a relevant certification scheme or roundtable. Combining internal and external expertise with technological enablers to monitor and control the supply chain is an effective approach taken by leading organisations.

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CASE STUDY:

TECHNOLOGY IN SEAFOOD SUPPLY CHAIN TRANSPARENCY

Fishing offers several opportunities to integrate technology to enhance supply chain transparency. One such opportunity is the use of electronic monitoring, which involves monitoring systems to check where and how vessels are fishing, and which has grown already to around a thousand monitored vessels[184]. Surveillance cameras and other sensors on winches, cranes and other gear can offer an alternative to a human observer, particularly when considerations of cost-effectiveness and scalability are considered. In some cases, monitoring review can be carried out by automated, rather than human, reviewers and this machine learning is already effective for some aspects such as fish identification[185]. Once this technology has been experienced, the majority of fishermen find it effective and view electronic monitoring positively[186].

Sainsbury's supermarkets declare certain lines of tuna to be 'FAD-free', meaning that they are caught without the use of Fish Aggregating Devices (FADs). FADs are floating or tethered objects intended to attract target species of fish in order to aid capture but can also encourage non-target species to congregate and so raise the risk of bycatch. Sainsbury's is now working with the organisation OceanMind, using Artificial Intelligence to analyse vessel movements via satellite positioning, in order to monitor the vessels claiming to be involved in FAD-free fishing.

Another possibility is using blockchain, a 'distributed ledger' technology of highly secure and transparent transactions. A blockchain is a shared database which allows anyone in the network to view and verify transactions logged within it, meaning that participants can map and check the flow of items from one party to another. This concept is currently being investigated in practice by WWF in Fiji, New Zealand and Australia, using technology and capabilities provided by TraSeable[187] and ConsenSys[188], and the boats of fishing company Sea Quest[189], to improve the transparency of the Pacific tuna industry[190]. This uses Radio Frequency ID (RFID) tags attached to individual fish, allowing consumers to scan each purchase with a smartphone and learn the exact source and journey of their fish, and verify that it was legally caught with no exploitative working practice.

[183] Rueda, 2017 [184] Michelin et al, 2018 [185] Wang et al, 2017 [186] Plet-Hansen et al, 2017 [187] https://traseable.com/ [188] https://consensys.net/
[189] http://seaquestfiji.com/ [190] https://www.wwf.org.nz/what_we_do/marine/blockchain_tuna_project/

Setting out a plan with clear actions, timescales and ownership within the organisation is a vital step. Good practice is for board-level ownership, given that many of the issues being addressed will be reported on in companies' annual reports, but companies will need to balance the importance of senior accountability at a strategic level with the effective knowledge and supply chain relationships at a tactical level. For example, Ikea has a strong corporate reputation and policies on sustainability[191], but devolves responsibility for compliance to a country level.

As in all aspects of business, following a structured approach to sustainability and human rights improvement is important. Organisations can draw on guidance from many sources, but most emphasise that any improvement process should be seen as a cycle. A popular model is the 'Plan, Do, Check, Act/Adjust' cycle, visualised in Figure 3 below, which underpins the ISO management standards and also features in the OECD guidance described in Figure 2.

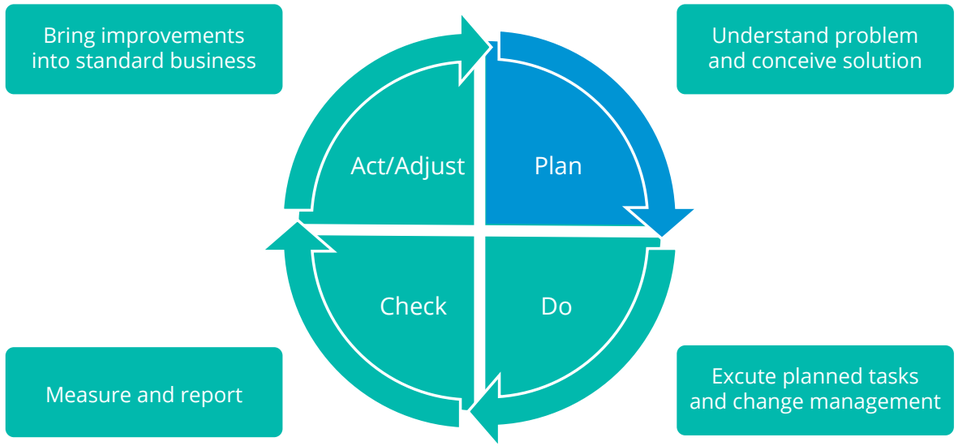

FIGURE 3: 'PLAN, DO, CHECK, ACT/ADJUST' CYCLE OF BUSINESS IMPROVEMENT

CASE STUDY:

COMPANY AND INDUSTRY ACTION IN RESPONSE TO THE RANA PLAZA DISASTER

OVER 1,100 PEOPLE LOST THEIR LIVES AND A FURTHER 2,500 WERE INJURED

In 2013, the eight-story Rana Plaza building in Dhaka, Bangladesh, collapsed. Over 1,100 people lost their lives and a further 2,500 were injured. The building had contained five garment factories, housing thousands of workers, and significant safety concerns had previously been identified. This was the largest such accident in Bangladesh, although there have been many similar incidents, before and since.

The disaster caused a significant amount of international media coverage and retailers who sourced garments from the factory issued statements in response, including Primark who offered compensation to the victims' families as well as an immediate hardship fund. Some firms experienced falls in their share prices shortly after their link to the accident became known (Boudreau et al, 2015). In response to the disaster, some firms produced an agreement known as the Bangladesh Accord on Fire and Building Safety, which mandated factory inspections, creation of workers health and safety committees and a funding mechanism for retailers to underwrite factory improvements and renovations. This group of companies included Mothercare, Tesco, H&M, Marks & Spencer and Next. Others, such as Gap and Wal-Mart, did not join this effort but contributed to an alternative agreement – the Alliance for Bangladesh Worker Safety – considered by a number of sources to be less binding and effective.

This example shows action taken by companies after a risk has materialised. The human and corporate impacts would have been much less if companies had proactively approached the problem of poor working conditions before a disaster occurred – however, it does demonstrate a number of positive actions which can be taken and some lessons:

- Joint action together with multiple companies and NGOs can be an effective way to approach risks or issues, giving significantly greater leverage than single firms.
- Signatory firms provided full details of which suppliers and factories they sourced from, demonstrating that concerns over supply chain opacity and commercial confidentiality can be overcome when it is accepted that a problem is real.

The Accord is considered effective by a number of sources (e.g. Reinecke and Donaghey, 2017; Vogt, 2017), and so is a useful model for firms in other sectors considering individual or joint action as part of EHRDD.

[191] https://www.ikea.com/ms/en_JP/customer_service/faq/help/about_ikea/social_environment.html

DUE DILIGENCE FOR RESPONSIBLE FINANCE

Corporate contacts interviewed during this project noted that pressure was emerging from institutional investors for companies to disclose more completely their exposure and management plans with regards to environmental and human rights risks. Some examples exist of financial institutions providing a credible challenge to potentially unsustainable activities, such as HSBC's action to alert the RSPO to Noble Plantations' illegal deforestation plans[192].

This raises the prospect of companies generating increased investment attractiveness from carrying out EHRDD which results in more complete disclosure and stronger action on issues uncovered. Some sources perceive there to be an 'adverse selection' issue currently, whereby investors (in the absence of better information) assume the worst and price in negative assumptions[193]. There are clearly challenges around sharing commercially sensitive information about risk exposure, but the growth of the Financial Stability Board's Taskforce on Climate-related Finance Disclosure (TCFD) project, the Bank of England's recent consultation on climate change 'stress-testing'[194], and the Financial Conduct Authority's proposal to improve climate disclosure of those issuing equity investments[195] suggest that both investors and regulators are interested in firms' own risk management. Indeed, as part of Climate Action 100+, over 450 investors managing over US$40 trillion in assets committed to acting on the TCFD recommendations. Decisions made by these parties to invest, disinvest or lobby in particular sectors and countries have far reaching effects – in developing countries with low financial depth (low ratio of private credit to GDP, with credit typically provided by only a few lenders such as Brazil's BNDES or Russia's Sberbank) financial institutions withdrawing debt services could have a substantial effect[196].

One of the recommendations of the GRI is for financial institutions to be covered by any EHRDD policy, obliging them to investigate and ensure that their activities (customer services such as credit facilities or fund raising as well as internal operations such as holding investment positions etc) do not fund deforestation. This is somewhat different from a supply chain due diligence obligation, as it relates to the activities of their customers (downstream) as well as suppliers (upstream), and may need different mechanisms to achieve its aims. However, many UK financial institutions have a poor track record of financing numerous agribusinesses who in turn invest in deforestation, land degradation and polluting activities[197]. In turn, it is recognised that these activities represent a significant risk to the 80% of company market value not captured by tangible asset reporting[198], and so there is a strong case for including the finance sector within an EHRDD obligation.

"THE POSSIBILITY THAT CLIMATE CHANGE WILL REDUCE THE LONG-TERM RETURNS ON INVESTMENTS MAKES IT A MATTER OF FIDUCIARY DUTY". DIETZ ET AL, 2016

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[192] https://www.theguardian.com/sustainable-business/2017/jul/17/hsbc-investigation-palm-oil-company-deforestation-allegations-noble-plantations [193] Lerch, 2017
[194] https://www.bankofengland.co.uk/news/2019/december/boe-consults-on-proposals-for-stress-testing-the-financial-stability-implications-of-climate-change
[195] https://www.fca.org.uk/news/press-releases/fca-announces-proposals-improve-climate-related-disclosures-listed-companies
[196] Ansar et al, 2013 [197] EIA, 2013; Global Witness, 2019 [198] King, 2018

SECTOR-SPECIFIC CONSIDERATIONS

Financial institutions include organisations such as banks, asset managers, private equity firms and insurance companies (Sustainable Finance Advisory, 2013). Many of these activities are undertaken by different departments within the same organisation or corporate group. Some of the largest UK companies are financial organisations (HSBC, Barclays, Lloyds Banking Group, Prudential, Royal Bank of Scotland and Standard Chartered, for example) with each having a significant international presence and market capitalisations in excess of £20 billion.

The sector is regulated by the Financial Conduct Authority, which covers the services provided to clients and the conduct of market participants, and the Prudential Regulation Authority which is concerned with the risk-taking and soundness of banks.

Sustainable and responsible finance has become high-profile in recent years, with the establishment of numerous initiatives such as the Task Force for Climate-related Financial Disclosures (TCFD), the UN's Principles for Responsible Investment (PRI) and the central banks' Network for Greening the Financial System (NGFS). Some countries and finance centres have started to position themselves to highlight their credibility, with regional brands such as the City of London's Green Finance Initiative and Guernsey Green Finance. However, there is a distinction to be made between the promotion of specific 'green' investments, which channel funds to renewables and similar investments, and initiatives which aim to improve the sustainability and ethicality of the wider investment and finance landscape.

SOURCES HAVE FOUND THAT LEVELS OF DUE DILIGENCE CURRENTLY ARE HIGHEST IN CORPORATE CREDIT

Sources have found that levels of due diligence currently are highest in corporate credit, asset-based finance and investment (95-100%) and lowest in insurance and capital markets (55-75%)[199]. These might be regarded as upper limits, as they are from a self-selected survey and do not provide a view of the quality or depth of due diligence undertaken. Conducting due diligence was not universally seen as an advantage by respondents, especially by financial institutions in countries which do not adhere to the OECD Guidelines.

Several approaches have been published to help organisations carry out sustainability and human rights due diligence in the finance sector. These include:

- TCFD guidance, including methodologies and data for scenario analysis[200]
- EU Action Plan for Sustainable Finance[201], including Technical Expert Group's Taxonomy[202]
- Current Approaches and Practices: Environmental and Social Risk Due Diligence in the Financial Sector[203] – published as part of the OECD Working Party on Responsible Business Conduct
- Equator Principles for responsible project finance
- United Nations Environment Programme Finance Initiative (UNEP FI), including:
  - Principles of Responsible Banking[205]
  - Principles of Responsible Insurance[205]
- IFC Performance Standards on Environmental and Social Sustainability[206]
- Investor Alliance for Human Rights Investor Toolkit on Human Rights[207]

[199] Sustainable Finance Advisory, 2013
[200] https://www.fsb-tcfd.org/publications/final-technical-supplement/ [201] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en
[203] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf
[203] http://mneguidelines.oecd.org/global-forum/2013_WS1_1.pdf [204] www.unepfi.org/banking/bankingprinciples/ [205] www.unepfi.org/psi/
[206] https://www.ifc.org/wps/wcm/connect/c02c2e86-e6cd-4b55-95a2-b3395d204279/IFC_Performance_Standards.pdf?MOD=AJPERES&CVID=kTjHBzk
[207] https://investorsforhumanrights.org/investor-toolkit-human-rights

Certain aspects of the finance sector differ from other sectors.

- Due diligence may need to be carried out on 'downstream' activities i.e. the environmental and social aspects of the activities of customers, rather than suppliers. This is similar to provisions in the arms industry, as well as building on existing 'Know Your Customer' practices.
- Financial organisations usually carry out due diligence when making a decision to lend, invest or provide a financial service, rather than as a recurring, regular process across their value chain.
- Investments may be into funds which do not hold physical assets themselves. Investors may therefore have to rely on intermediaries (fund managers) to carry out appropriate due diligence.
- Some fund managers perceive their fiduciary duty to maximise value for clients or beneficiaries as meaning other objectives such as sustainability should not be considered.

HOW ARE DIFFERENT ENVIRONMENTAL AND HUMAN RIGHTS RISKS PERCEIVED AND MANAGED TODAY BY FINANCIAL INSTITUTIONS?

Certain environmental and human rights risks have been recognised by financial institutions for a relatively long time, and due diligence to manage these risks as part of usual activities is well established (for example, land contamination risks covered by the Comprehensive Environmental Response, Compensation, and Liability Act[208]). Discussions with professionals in the field confirmed that certain risks, particularly 'conventional' environmental risks such as land contamination and water and air pollution were well understood as part of acquisition due diligence, and increasingly well understood within supply chain due diligence. However, social or human rights risks are considered to be more difficult to identify, assess and manage, needing specialist external expertise which was not readily available.

ACTIONS AVAILABLE TO FINANCIAL INSTITUTIONS IN RESPONSE TO DUE DILIGENCE FINDINGS

Approaches may include policies which prohibit investment or engagement with particular countries (such as those subject to trade embargoes) or sectors (such as weapons). Such policies could be broad or narrow and will depend on their execution for their effectiveness. They include:

- Declining or withdrawing investments or services (whether based on blacklisting policies, benchmarking, or other approaches)
- Engagement and challenge e.g. via investors and analysts calls, shareholder activism
- Use of legal covenants as part of an investment contract to ensure certain environmental or human rights standards are met and maintained

"CLIMATE RISK IS INVESTMENT RISK". LARRY FINK, BLACKROCK CEO

Financial institutions also consider themselves to have varying amounts of leverage over clients to exercise the approaches described above. This leverage depends on:

- Technical factors, such as the magnitude and duration of funding or holdings
- Nature and strength of relationship (e.g. historical relationship with existing client, ownership stake) – this was perceived to be a significant factor by survey respondents[209]
- Potential for poor E&S approach to negatively impact client/investee company performance and shareholder value, or the reputation of the associated financial institution

[208] Weber, 2012 [209] Sustainable Finance Advisory, 2013

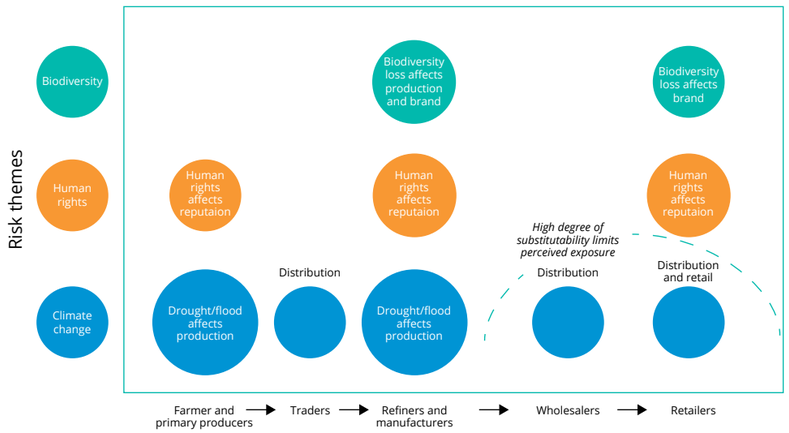
EVALUATION

The case for a comprehensive EHRDD obligation for UK businesses has never been clearer. International and national practices have moved swiftly in the past few years (the French Devoir de Vigilance in 2017; the OECD Due Diligence Guidance for Responsible Business Conduct in 2018; and the proposed EU due diligence legislation arriving in 2021) and the UK should take action to remain at the forefront of responsible global trade. Enacting an EHRDD obligation will help the government meet promises made in the 25 Year Environment Plan and in its commitment to the United Nations Guiding Principles on Business and Human Rights.

The impacts of business on the environment and people worldwide are clear and troubling. Yet the practical capability of companies to map, understand and mitigate these impacts, both directly and through their supply chains, has expanded greatly in recent years. Professional and technological solutions are now widely available, drawing on the increasing availability of data, digital tools and capabilities available from start-ups and established businesses. Leaving a supply chain opaque and unscrutinised is now a poor and risky business decision – and one which the best British businesses will be glad to move away from.

While the economic case for the EHRDD obligation depends on several assumptions and viewpoints, certain themes emerge. Firstly, the costs are unlikely to be exceptionally onerous, and increasingly represent the costs of simply doing business in a responsible and smart way. Secondly, the benefits directly to businesses themselves are significant, particularly over the medium- to- longer term. British businesses today are exposed to numerous risks due to supply chain environmental and human rights factors. However, risk does not lie equally across the value chain. Some vulnerabilities, particularly to biodiversity loss, are focused on the upstream end of the value chain – particularly where retailers and manufacturers can adapt their offering and use substitute inputs if risks materialise. This is visualised in Figure 4 below. There are some exceptions to this – for example, there are few substitutes for cocoa available to chocolate manufacturers, so they may be relatively exposed to production shocks.

Figure 4: Risk themes across the agri-food value. Magnitude of risk to the participant is shown by size of circle.



THE IMPACTS OF BUSINESS ON THE ENVIRONMENT AND PEOPLE WORLDWIDE ARE CLEAR AND TROUBLING

© PETER CHADWICK / WWF

THE GREATEST BENEFITS OF A DUE DILIGENCE OBLIGATION TO THE UK ARE THEREFORE LIKELY TO BE:

- There is evidence to suggest that action to preserve habitats and reduce the disturbance of wildlife by humans could also serve to reduce the risk of some pandemics, particularly those of zoonotic origin[210]. Due Diligence will drive action by business to assess and respond to environmental risk and impact, and is therefore an important step in setting the conditions for recovery and green growth in a post-COVID-19 economy.

- Greater visibility and action on water risks, both domestically and internationally. Becoming more resilient domestically could help mitigate hazards such as the 2010-12 drought which may have cost British agriculture £400 million (see Chapter 5.5). Water availability is one of the most immediate priority risks to food security[211], and is intricately connected with water stress (a human rights issue), land degradation and water quality issues from pollution. The UK's overseas water footprint today is far too concentrated in countries with limited water availability.

- Greater visibility and action on human rights and deforestation risks internationally, which are high priority reputational risks to businesses. Businesses who take action in this space will not only avoid reputational impact and potential supply chain disruption in the short term from high-profile disasters, but gain from stronger and more sustainable supply chain and consumer relationships in the long term.

- Greater visibility of climate risks more broadly, and smarter adaptation action as a result. Businesses are unlikely to mitigate or adapt to climate change effectively without the input of consumers and government, but an EHRDD obligation may help reduce the 'offshoring' of emissions.

- Greater resilience of operations and supply chains to Environmental, Human Rights and other risks. For agri-food supply chains, this may make price shocks and the resultant impacts on consumers less likely, as well as providing visibility of which commodities and business models will more gradually become unviable. This could help mitigate the risks of significant production shocks and 'breadbasket' failures, which are projected to become more than three times as likely by 2040[212].

- Improved reputation of British businesses and other interests worldwide. An EHRDD obligation offers a unique opportunity to align the work and influence of British businesses domestically and overseas with the priorities and vision of British society and consumers.

[210] WWF, 2020 [211] Godfray and Garnett, 2014 [212] Global Food Security Programme, 2015

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