



## **Responsible Supply Chains:**

ESG considerations impacting multinational companies' supply chain decisions

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## **About this report**

Responsible Supply Chains: ESG considerations impacting multinational companies' supply chain decisions is an Economist Impact report that is supported by USAID. It explores how ESG considerations are impacting multinational companies' investment and supply chain decisions in the food and beverage, and textile and apparel sectors. The report is based on a survey of 200 global executives in the focal sectors across the UK, European Union, US, UAE, Turkey, India and Pakistan. The survey was conducted in October and November 2021.

### Expert interviews

To supplement the literature review and survey results, Economist Impact conducted an in-depth interview programme with experts and senior executives in October and November 2021. We thank the following individuals (in alphabetical order) for their time and valuable insights:

Federico Caniato, Professor of Supply Chain and Procurement Management, School of Management, Politecnico di Milano

Mario Cerutti, Institutional Relations and Sustainability Officer, Lavazza Group

Charbel Jose Chiappetta Jabbour, Global Professor, EMLYON Business School, France; University of Lincoln, UK

Emma Fawcett, former Senior Evaluation Officer and Learning Advisor, Oxfam

Lena Fursova, Associate Director, Sustainable Finance (ESG), Fitch Ratings

Sarah Jastram, Professor of International Business Ethics and Sustainability at Hamburg School of Business Administration

Marina Papanastasiou, Chair International Business at Leeds University Business School, UK

Wendy Savage, Director Social Responsibility and Traceability, Patagonia, Inc.

Edite Strazdina, Technical Key Account Manager Central Asia, Latvia and Russia, Global Gap

Jan-Willem Vosmeer, Global Manager Sustainable Development & Stakeholder Engagement, The HEINEKEN Company

Tensie Whelan, Director Centre for Sustainable Business, NYU Stern

Chendi Zhang, Professor of Finance and Director of Exeter Sustainable Finance Centre, University of Exeter

Suzanne Zweben, Senior Advisor, Oxfam

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The report was produced by a team of Economist Impact researchers, writers, editors and graphic designers, including:

Matus Samel – Project manager

Syedah Ailia Haider – Research lead

Tom Nolan – Survey lead

Gabriele Bowen – Research analyst

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#### **Executive summary**

Multinational companies (MNCs) are looking beyond the bottom line when making investments and selecting suppliers. In addition to financial considerations, MNCs are increasingly considering non-financial factors when making crucial business decisions. The use of environmental, social, and governance (ESG) metrics as a serious evaluation of how multinational companies are integrating environmental and social factors in their business operations is accelerating. There are already numerous ESG frameworks, reporting and accounting standards that are driving changes in corporate behaviour. Most MNCs in the food and beverage and textiles and apparel sectors have made net-zero carbon-emission commitments, signed up to relevant frameworks to ensure adherence to basic labour and human rights, and otherwise signalled or begun planning to reduce waste-related pollution and the intensity of resource use. However, MNCs today struggle to apply ESG criteria among suppliers with whom they have contractual relationships (i.e., Tier 1 suppliers) as well as their respective subcontractors (i.e., Tier 2 suppliers and beyond).

Economist Impact's Policy & Insights team developed this report to explore the key ESG considerations that are impacting MNCs' supply chain decisions and how suppliers are expected to adapt. We focus on two priority sectors—food and beverage, and textiles and apparel. The report builds on a global survey<sup>1</sup> of 200 corporate executives across both sectors that reveals MNCs' ESG priorities, challenges with addressing them and expectations of suppliers' ESG performance.

MNCs are increasingly considering non-financial factors when making crucial business decisions, including environmental, social, and governance (ESG) performance. The use of ESG metrics as a serious evaluation of how multinational companies are integrating environmental and social factors in their business operations and supply chains is accelerating. This has been driven by increasing pressure from regulators (according to 35% of survey respondents), consumers (33%) and investors (23%).

Both priority sectors—food and beverage, and textiles and apparel—are particularly exposed to ESG risks because they have some of the most complex, multi-tiered supply chains of any global industry. Both sectors depend on labour-intensive, emissions-intensive and environmentally demanding production, frequently in countries with poor human rights records that provide crucial inputs for fully globalised supply chains. Survey respondents show particular concern over community health and safety (43.5%) and sustainable raw material sourcing (42%) in both sectors. Effective and efficient use of resources is another leading risk in the textiles and apparel sector (39%), while in the food and beverage sector respondents recognise the importance of protecting cultural heritage (31%).

MNCs have made varying progress in making their supply chains more ESG-compliant, with considerable difference between the two sectors. Most companies in the food and beverage sector have set companywide targets to achieve net-zero carbon emissions by 2050. In addition, many pledged to reduce

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<sup>1</sup> Conducted between October and November 2021

water consumption in areas of high water stress—10% by 2025 and 30% by 2030. These companies are also looking to implement regenerative, sustainable farming practices for the commodity end of the supply chain. Meanwhile, textiles and apparel firms have lagged behind their counterparts in the food and beverage sector when it comes to transparent reporting and ESG metrics. An enthusiasm gap emerges from the Economist Impact executive survey—56% of sector respondents cite ensuring ESG-compliant sourcing practices as a top priority, 20% lower than among food and beverage respondents.

In order to make their supply chains more resilient, MNCs are conscious of specific compliance issues when selecting their suppliers. Particularly in emerging markets, suppliers could be keeping a close eye on chemical and hazardous materials pollution (35%), human rights abuses (34%) and biodiversity loss (34%)—three of the topmost significant issues that deter MNCs from working with them.

At the same time, MNCs across both sectors recognise that overcoming these issues and becoming more ESG-compliant is no easy feat for their suppliers. Financial constraints (44%), lack of ESG knowledge (37%) and loose regulatory environments (35%) remain issues for suppliers in both sectors to further, making it difficult for them to align with MNCs' ESG objectives.

Moving forward, executives from MNCs across both sectors recommend that their suppliers focus on two key ESG-related activities to catch their attention—developing robust strategic targets and investing in new technology. The importance of publishing environmental sustainability strategies, Health and Safety policy and fair and ethical standards for employment, suppliers signal increased levels of accountability to MNCs. Meanwhile, investments in technologies such as blockchain, 3D printing and data analytics solutions can support data collection efforts; improve analytics and resulting ESG recommendations; and support the consolidation of key stakeholders within a supply chain.

To bridge the gaps between the actions suppliers could be taking and the limitations holding them back, MNCs see that there are specific incentives drawing suppliers to become more ESG-compliant. Suppliers in the food and beverage sector are driven by push factors including the rise in local ESG regulations (42%), growing pressure from NGOs and local associations (38%) and the broader environmental pressures to reduce carbon emissions (35%). Meanwhile, suppliers in the textiles and apparel sector are more likely to be incentivised by pull factors such as greater access to capital generally (44%) and access to more diverse sources of funding from new investors (38%).

Beyond what MNCs and their suppliers could be doing, other stakeholders have a role to play including other MNCs, civil society and governments. There is a consensus across stakeholders that the private sector cannot implement ESG metrics alone due to the challenges they face. The growing plethora of ESG reporting standards and frameworks is overwhelmingly fragmented which adds a cost and time burden to companies. As such, there is a need for strong and harmonised national regulatory frameworks, coupled with multi stakeholder cooperation to drive collective action towards supply chain ESG-compliance.

## Chapter 1. Defining ESG risks

ESG metrics have become a priority for investors and MNCs over the last 15 years. These metrics are intended to allow companies to measure and disclose the impact, sustainability and ethical considerations built into their own business practices and operations as well as those of suppliers and counterparties by setting non-financial performance indicators. ESG concerns vary considerably by sector and country, which has necessitated attempts to create international principles intended to align benchmarks between different sectoral organisations, companies and financial institutions. International frameworks have largely been driven by the United Nations (UN), whether in the form of the UN Global Compact, Sustainable Development Goals (SDG), or the Principles for Responsible Investment (PRI) with private and private-public initiatives building on these first principles.

The PRI provides shared definitions for each ESG risk category— environmental criteria, social criteria, and governance criteria.<sup>2</sup> Environmental criteria apply to corporate stewardship of the environment in various forms, ranging from emissions to land and resource use, maintenance of biodiversity and commitments to use green energy and invest in energy efficiency. Social criteria evaluate the impact of corporate practices on the wellbeing, rights and interests of individual people and communities employed or otherwise affected by company and supplier operations with a particular focus on child, slave or bonded labour. Governance criteria concern how the corporation, and its suppliers, govern themselves and are intended to encourage maximally transparent, responsible practices that address ESG metrics on the ground.

**Figure 1. ESG risk categories**

	<b>Definition</b>	<b>Examples</b>
<b>Environmental</b>	Issues relating to the quality and functioning of the natural environment and natural systems.	Biodiversity loss; greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric ozone depletion, changes in land use, ocean acidification and changes to the nitrogen and phosphorus cycles.
<b>Social</b>	Issues relating to the rights, well-being and interests of people and communities.	Human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities, activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons
<b>Governance</b>	Issues relating to the governance of companies and other investee entities. This category may also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented.	Board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its other stakeholders.

<sup>2</sup> [https://www.unpri.org/Uploads/x/l/q/maindefinitionstoprireportingframework\\_971173.pdf](https://www.unpri.org/Uploads/x/l/q/maindefinitionstoprireportingframework_971173.pdf)

Source: Principles for Responsible investment (2018)

Sustainability is a broad concept applied by the SDGs and various existing metrics defined in 1987 by the UN's Brundtland Commission as "meeting the needs of the present without compromising the ability of future generations to meet their own needs."<sup>3</sup> Sustainability extends beyond environmental concerns to include the treatment of labour, health and nutrition, safety and the full gamut of what the UN has termed 'human security'. The eradication of poverty and inclusive economic growth are just as integral as efforts to combat greenhouse gas (GHG) emissions. Efforts to align and harmonise sustainability reporting and governance standards have been led by the Global Reporting Initiative (GRI) and the Value Reporting Foundation (VRF), a merger between the Sustainability Accounting Standards Board (SASB) and International Integrated Reporting Council (IIRC). Unfortunately, there are still considerable doubts on whether corporations will adopt a unified standard internationally despite consolidation in the reporting space.<sup>4</sup>

At present, there are concerns that differing standards make it more difficult to ensure that data and disclosures from corporations lead to like-for-like comparisons within and between companies and sectors. "We feel that there should be more integration between standards as this will make companies more comparable," says Jan Willen Vosmeer, global manager sustainable development and stakeholder engagement at the Heineken Company, a Dutch multinational beverage company. Sustainability can also lend itself to ambiguity on some matters. For instance, the proliferation of "net-zero" targets intended to balance emissions with offsets has led to considerable debate and concerns about greenwashing that undermine the reduction of emissions. This is particularly concerning for the taxonomy of emissions risks as defined by the Greenhouse Gas Protocol, which established three "scopes" for accounting, disclosure, and reduction targets. Scope 1 refers to direct emissions from company assets and operations, scope 2 refers to the indirect emissions from the energy sources powering or fuelling company operations, and scope 3 refers to the indirect emissions associated with a company's supply chain beyond its direct operations.<sup>5</sup> Companies begin struggling when trying to target scope 3 emissions due to the lack of control and oversight across the full supply chain. Similar principles apply when discussing tiers of suppliers whereby Tier 1 refers to directly contracted parties and successive tiers refer to subcontractors and suppliers outside the scope of an MNC's direct supervision with contractual counterparties.

**Figure 2. Emissions scopes explained**

Emissions	Emission Type	Detail
<b>Scope 1 Emissions</b>	Direct	Direct emissions generated from operations of reporting company
<b>Scope 2 Emissions</b>	Indirect	Indirect emissions generated from required energy requirements, including electricity, heating or cooling <sup>6</sup>
<b>Scope 3 Emissions</b>	Indirect	Product life cycle emissions which can arise from raw materials production, transport, storage, sale, use and disposal not directly owned by the reporting company <sup>7</sup>

Source: Deloitte

<sup>3</sup> <http://www.un-documents.net/our-common-future.pdf>

<sup>4</sup> <https://gresb.com/nl-en/2021/04/26/a-unified-standard-needed-to-take-esg-to-the-next-level/>

<sup>5</sup> [https://www2.deloitte.com/uk/en/focus/climate-change/zero-in-on-scope-1-2-and-3-emissions.html?gclid=CjwKCAiA55mPBhBOEiwANmzoQlksKVwVrUYFun2reh42Xpn9PFwrOIE-FEN-a8Ri1\\_6aV6tLTBkMxxoCzm4QAvD\\_BwE](https://www2.deloitte.com/uk/en/focus/climate-change/zero-in-on-scope-1-2-and-3-emissions.html?gclid=CjwKCAiA55mPBhBOEiwANmzoQlksKVwVrUYFun2reh42Xpn9PFwrOIE-FEN-a8Ri1_6aV6tLTBkMxxoCzm4QAvD_BwE)

<sup>6</sup> <https://www.anthesisgroup.com/scope-1-2-3-emissions/>

<sup>7</sup> [https://ghgprotocol.org/sites/default/files/standards\\_supporting/FAQ.pdf](https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf)

### ***Sector sensitivities for food and beverage and textiles and apparel firms***

The food and beverage and textiles and apparel sectors are particularly exposed to ESG risks because they have some of the most complex, multi-tiered supply chains of any global industry. Both depend on labour-intensive, emissions-intensive and environmentally demanding production, frequently in countries with poor human rights records that provide crucial inputs for fully globalised supply chains. As Suzanne Zweben, advisor at Oxfam—global organisation that fights inequality to end poverty and injustice —noted in an interview, “unless buyers are using [ESG metrics] in their key performance indicators, it is unclear how they are being implemented through and across supply chains.”<sup>8</sup> These aren’t just matters of public interest. Shifting consumer sentiments and political priorities are already pushing companies to adapt to maintain their brands, please shareholders and adjust business practices accordingly. The resulting cross-dependencies between industries make the adoption and execution of ESG reporting an urgent matter lest companies fall behind and fail to implement ESG reporting and implementation standards among their respective suppliers.

Food and beverage production accounts for as much as 34% of total annual GHG emissions globally<sup>9</sup> and depends heavily on commodities production, many of which are energy and resource-intensive and frequently rely on low-wage and, in some cases, coerced labour. This combination makes the food and beverage supply chain high-risk from an ESG perspective, yet the sector has done much to embrace sustainability reporting. A KPMG study from 2020 found that from the 5,200 companies surveyed, 73% engaged in sustainability reporting. However, that figure hasn’t risen since 2017, indicating that progress has stalled and a new impetus for action is needed.<sup>10</sup>

The global textiles industry also has a huge environmental and social footprint, one that’s expected to grow. By 2050, textiles and apparel could account for as much as 25% of global GHG emissions.<sup>11</sup> Exploitative practices ranging from wage suppression and overwork to coerced labour and child labour have also been widely reported across the fashion supply chain. The 2021 Fashion Transparency Index surveyed 250 of the world’s top firms and reported an average score of 23%, highlighting the relatively low level of disclosure and

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<sup>8</sup> Economist Impact Interview with Suzanne Zweben, Senior Advisor, Oxfam (2021)

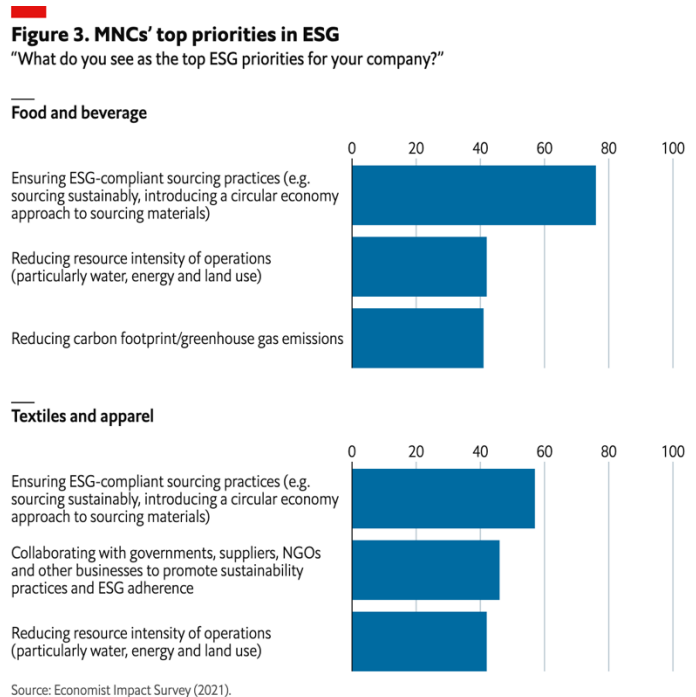
<sup>9</sup> <https://www.fao.org/news/story/en/item/1379373/icode/>

<sup>10</sup> <https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/11/the-time-has-come.pdf>

<sup>11</sup> [https://cdn.businessoffashion.com/reports/The\\_State\\_of\\_Fashion\\_2018\\_v2.pdf](https://cdn.businessoffashion.com/reports/The_State_of_Fashion_2018_v2.pdf)

transparency among apparel firms.<sup>12</sup> Though 79% of the top fashion firms publish a company policy on GHG emissions, only 30% have committed to timelines to decarbonise their operations and supply chains.

The combined environmental and social footprint of these two sectors is immense. The divergent state of reporting and disclosure between them reflects the slightly different challenges they face. In order to explore these trends, Economist Impact's Policy & Insights team conducted a global survey<sup>13</sup> of 200 corporate executives across both sectors that reveals priorities in line with these dynamics. On average, across both sectors, 66.5% of survey respondents from MNCs cited ESG-compliant sourcing practices as a top priority. The complexity of both sectors' supply chains clearly leaves them vulnerable to considerable reputational and practical risks. Both sectors' exposure to primary commodity production is also reflected in survey responses. Over 40% of respondents cited reducing resource intensity, collaborating with governments, suppliers, other MNCs and NGOs to promote sustainable practices and adherence to ESG standards as top priorities. This was mirrored by 40% of respondents citing reducing carbon footprints and GHG emissions. Upholding good human rights and labour practices ranked fifth, at 24%. The relative importance of human and labour rights standards is linked to the prominent role of commodity production, particularly in developing countries, for both sectors, as well as the limited capacity companies frequently possess to enforce standards outside of their own operations. Sector-level survey responses regarding the greatest risks firms face show shared concerns about the sustainability of raw material sourcing—41% of food and beverage respondents and 43% of textiles and apparel respondents included it in their list of concerns.



Overall, survey responses indicate that companies may often be more concerned with environmental benchmarks than social ones because they're more "transparent" to measure and enjoy a higher degree of harmonisation in accounting and reporting standards within and between sectors. Despite this, community health and safety posed the biggest perceived risks for respondents across both sectors. The absence of stronger shared standards for social metrics may increase business risks over time due to the dearth of high-quality data in the face of investor and consumer demands. These concerns are reinforced by forward-looking survey findings. Executives in both sectors identify the availability of reliable data as the most important factor affecting company improvement in meeting ESG targets in the future.

**Food and beverage sector**

<sup>12</sup> <https://www.fashionrevolution.org/about/transparency/>

<sup>13</sup> Conducted between October and November 2021

Since food production alone accounts for more than 30% of global energy consumption<sup>14</sup>, and food demand continues to grow with the global population, climate impacts have received much attention from leading MNCs operating in this industry. Food and beverage MNCs are focusing their ESG priorities around the issue of climate change. Most have set companywide targets to achieve net-zero carbon emissions by 2050, in line with the Paris Climate Accord Agreements. A smaller number of these companies have also signed up to The Climate Pledge—an agreement to achieve net zero by 2040—including Heineken, Coca-Cola Europacific Partners, Quorn Foods, Nespresso, Greencore and Sainsbury's. Danone, Coca-Cola Europacific Partners and Kellogg have also set interim carbon targets aiming to reduce between 25% and 45% of scope 1, 2 and 3 emissions by 2030, while other MNCs, like Nestle, have plans to go net zero across specific product offerings. Many firms have pledged to reduce water consumption in areas of high water stress—10% by 2025 and 30% by 2030—and are looking to implement regenerative, sustainable farming practices for the commodity end of the supply chain. Strong efforts are made to avoid the use of child and forced labour of different kinds. Despite these and other initiatives, the spectrum of ESG considerations poses considerable challenges for further progress and gaps in practice.



Though a majority of food and beverage companies apply the GRI sustainability framework. The absence of a comprehensive, universal set of reporting standards makes it far more difficult to compare companies against each other, follow up on targets and hold them accountable. This leads to gaps in accounting and reporting, which, if not measured, inevitably fall off the agenda. For instance, a survey by KPMG of 2,690 firms in 2020 found that only 36% of food and beverage MNCs report biodiversity loss risks.<sup>15</sup> Economist Impact survey results also show that biodiversity protection is a low priority for food and beverage companies, with only 7% citing this as a top ESG priority. However, in this sector the top priorities for surveyed executives are overwhelmingly environmentally focused—including reducing resource-intensity of operations and reducing their carbon footprint and GHG emissions. The top priority is ensuring ESG-compliant sourcing practices, which reflects both the need to be aligned in terms of sustainability and the stringent health and safety standards that tend to be highly regulated. The corporate focus on environmental sustainability follows market trends with consumers increasingly shifting their consumption to healthier options, with a greater awareness of the environmental footprint of food production.

Occupational health and safety, wage levels and other human rights standards also receive less attention given the conflict between the need to operate profitably and to act in a socially responsible and sustainable manner that meets standards and appeals to shifting consumer and investor sentiment. For instance, only 13% of executives in the food and beverage sector cited promoting a diverse and inclusive workforce as a top priority. Similarly, only 14% of sector respondents cited anti-corruption and anti-fraud practices as a priority concern. These responses may reflect the fact that food and beverage firms source a greater part of their supply chain from developed markets with comparatively stronger institutions, greater transparency and data collection, as well as better performance across social ESG metrics.<sup>16</sup> Despite this, 44% of food and beverage sector executives still cited the availability of reliable data as the most important driver for company improvement and 39% cite national ESG regulatory frameworks as the second most significant

<sup>14</sup> <https://www.sciencedirect.com/science/article/pii/S1364032121001507>

<sup>15</sup> <https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/11/the-time-has-come.pdf>

<sup>16</sup> <https://www.sciencedirect.com/science/article/pii/S1364032121001507>

factor. In short, there are considerable gaps, even for firms operating with more supplier exposure across developed markets.

The sector struggles to apply Tier 1 supplier codes of conduct across the full length of the supply chain because of its complexity and the lack of transparency beyond this first tier. MNCs can embed requirements for the treatment of labour or environmental practices with suppliers but are limited in their ability to audit compliance with contractual requirements. Without frequent surveillance of adherence to contracts, it also becomes difficult to know or assess second tier suppliers when the contracted parties are forced to subcontract to another party to fill an order. Business models also matter. Costs and the frequent need to train suppliers in ESG principles are difficult to manage given the first stages of the food supply chain are businesses that operate on tight margins. Strengthening the bargaining power of labour and raising wages can leave MNCs and their suppliers at a competitive disadvantage. The combined lack of managerial control, business pressures and complexities in the fulfilment of contractual ESG obligations requires joint efforts between businesses, civil society and governments to resolve. As long as reporting and accountability standards aren't unified, food and beverage MNCs are most likely to focus on what they can directly control, which in this case equates primarily to environmental measures.

### ***Textiles and apparel sector***

Like food and beverage production, the textiles and apparel industry has a large environmental and social impact globally. Today, it accounts for approximately 10% of GHG emissions—more than international flight and shipping combined—and 20-35% of the microplastics found in oceans.<sup>17</sup> The use of child labour, overworking and suppression of wages and union organisation are endemic to large parts of the supply chain, worsened by the global shift towards “fast fashion” in the last 20 years. Disclosure levels remain far too low, and the fragmented nature of supply chains makes it difficult to trace and account for ESG criteria. Per the 2021 Fashion Transparency Index, only 47% of companies disclose their manufacturing facilities, only 11% publish their raw material suppliers, just 5% disclose water footprint data for raw material suppliers and only 2 out of 250 companies surveyed provide data on how many workers in their supply chain are paid a living wage.<sup>18</sup> Globalisation of supply chains has shifted many stages of production to developing countries with lower labour costs, weaker regulatory regimes, dirtier energy complexes and weaker environmental standards.

Textiles and apparel firms have lagged behind their counterparts in the food and beverage sector when it comes to transparent reporting and ESG metrics. An enthusiasm gap emerges from the Economist Impact survey—56% of sector respondents cite ensuring ESG-compliant sourcing practices as a top priority, 20% lower than among food and beverage respondents. Greater reliance on competitive labour and production inputs from developing markets affects sector priorities in the other direction, however. For instance, twice as many textiles and apparel respondents (28%) cited anti-fraud and anti-corruption as a priority and almost double the number cited promoting diversity and inclusion in the workforce compared to food and beverage respondents.

The same problems of supply chain complexity hinder efforts to improve traceability, disclosure and application of social and environmental metrics. Concerns about competitiveness are amplified for textiles and apparel MNCs because of their dependence on production in developing countries, inflating additional costs such as training suppliers or higher wages. The labour-intensity of clothing manufacture makes labour costs and efficiency the most important sources of competitive advantage for any firm when sourcing its

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<sup>17</sup> <https://www.europarl.europa.eu/news/en/headlines/society/20201208STO93327/the-impact-of-textile-production-and-waste-on-the-environment-infographic>

<sup>18</sup> <https://www.fashionrevolution.org/about/transparency/>

supply chains, generally in Asian economies that dominate the low and intermediate stages of the textiles and apparel value chain. Though less than half of the world's largest companies disclose their manufacturing facilities, based on their contractual relationships with Tier 1 suppliers, the number of firms doing so in 2020 had nearly quadrupled from its 2016 level.<sup>19</sup>

As is the case with the food and beverage sector, environmental standards tend to have the strongest prospects for uniformity of standards. Many large fashion firms have signed up to the UN's Charter for Climate Action, establishing net-zero targets for 2050 and setting concrete steps such as the phaseout of coal-fired boilers for production. Surprisingly, few companies have moved to include programmes establishing concrete targets to reduce water consumption, given the water-intensity of crops such as cotton. Levi's is a notable exception, aiming to decrease the amount of water used for denim finishing by 96% by 2030.<sup>20</sup> Many MNCs have signed on to the Better Cotton Initiative (BCI) to reduce the use of coerced labour, expand disclosure and internal governance standards to include factors such as water use and soil health, and increase the use of recycled and sustainably produced materials. The most significant advancement in health and safety protections and standards setting comes from the Bangladesh Accord, a 5-year legally binding global framework, signed in 2013, requiring all signatories to establish safer working conditions among Tier 1 suppliers.

This patchwork of existing agreements does not, however, provide a shared basis for accounting and reporting. Environmental measures and reducing the use of child labour remain the most pressing issues to resolve for companies, after which concerns about profitability and the difficulties of transparency of business relationships many steps removed from contracting parties undermine progress. Efforts to implement circular fashion and the recycling of inputs and finished products across the value chain to minimise environmental impact face similar difficulties.

**Box 1: ESG risks in Central Asia**

Though national contexts vary, ESG risks for food and beverage and textiles and apparel firms across Central Asia are relatively consistent. Conflicts over water use persist because water resources are unevenly distributed between states, water stress remains a problem, forced labour is often used to pick cotton, soils have degraded in quality with desertification threatening arable land.<sup>21</sup> The region also lacks well-functioning transboundary water management agreements.<sup>22</sup> Transboundary water cooperation and dialogue for two of the region's most significant rivers—Amu Darya and Syr Darya—is formally managed through the International Fund for saving the Aral Sea (IFAS) framework. IFAS is an institutional arrangement aimed at improving the social and economic, ecological situation in the basin of the Aral Sea. While discussions are ongoing, the dialogue and cooperation through the IFAS framework is fragmented, and increasingly through bilateral channels.<sup>23</sup>

The introduction of monocultural farming practices in the region poses a potential problem. Damage to local soils and water systems render production unsustainable and negatively affect local communities.<sup>24</sup> Moreover, the region is extremely vulnerable to natural disasters, including those related to climate

<sup>19</sup> <https://www.fashionrevolution.org/about/transparency/>

<sup>20</sup> <https://www.levistrauss.com/2019/03/25/world-water-day-2019-saving-h2o/>

<sup>21</sup> Economist Impact Interview with Lena Fursova, ESG Investing & Sustainability Strategy, Fitch Ratings (2021)

<sup>22</sup> <https://bluepeaceindex.eiu.com/#/amu-darya>; <https://bluepeaceindex.eiu.com/#/syr-darya>

<sup>23</sup> [https://bluepeaceindex.eiu.com/pdf/EIU\\_Blue%20Peace%20Index\\_2020.pdf](https://bluepeaceindex.eiu.com/pdf/EIU_Blue%20Peace%20Index_2020.pdf)

<sup>24</sup> [https://ec.europa.eu/research-and-innovation/en/horizon-magazine/rise-and-fall-monoculture-farming#:~:text=Growing%20the%20same%20crop%20year,becomes%20depleted%20of%20these%20nutrients.&text=Although%20lost%20nutrients%20can%20be,is%20expensive%20to%20do%20so.](https://ec.europa.eu/research-and-innovation/en/horizon-magazine/rise-and-fall-monoculture-farming#:~:text=Growing%20the%20same%20crop%20year,becomes%20depleted%20of%20these%20nutrients.&text=Although%20lost%20nutrients%20can%20be,is%20expensive%20to%20do%20so.;); <https://www.nhm.ac.uk/discover/soil-degradation.html>

change such as droughts, floods and mudslides.<sup>25</sup> On the social side, broader concerns about basic human rights and labour rights have persisted in the region for decades.<sup>26</sup>

Each of these problems are, in turn, aggravated or eased at the national and local level by the quality of governance, acceptance of international institutional frameworks and norms, and the political salience of a given industry or good. For example, the government of Uzbekistan has made a concerted effort to collaborate with the International Labour Organisation (ILO), external stakeholders, and domestic civil society to reduce the use of forced labour for cotton harvests, introduce minimum wages and raise pay for workers in worse conditions, and introduce market reforms for enterprises that were previously state-owned. According to the ILO, the use of forced labour in the Uzbek cotton sector fell 87% between 2016 and 2019.<sup>27</sup> Reform efforts are by no means widely shared across the region. Uzbekistan is somewhat of a special case due to the impact of state-owned enterprises and extensive export controls on cotton. The political complexity of local conditions for suppliers makes it quite difficult to adopt best practices, including the centralisation of sustainability information for suppliers and subcontractors. Frequent pressure on local civil society actors can limit the space to partner with NGOs, forcing companies to work through formal political institutions whose interests are not always aligned with corporate ESG goals. In contexts where this legitimacy is lacking, enforcement and adoption of regulations locally may not be as consistent or transparent. National political contexts weigh heavily on companies' available range of partners.

## Chapter 2. Adapting to a changing market

MNCs in the two assessed sectors have pivoted in recent years to align business decisions with ESG pillars in response to the challenges outlined in the previous section. Corporate efforts to align business activity and supply chains with non-financial ESG indicators follow several tracks: target setting for overall corporate activity; target setting for individual product offerings; setting contractual expectations for non-financial standards with Tier 1 suppliers; and developing sustained relationships with suppliers to educate them on sustainable practices and encourage the adoption of similar metrics by contracted counterparts.

### *MNCs' sector-specific adaptations*

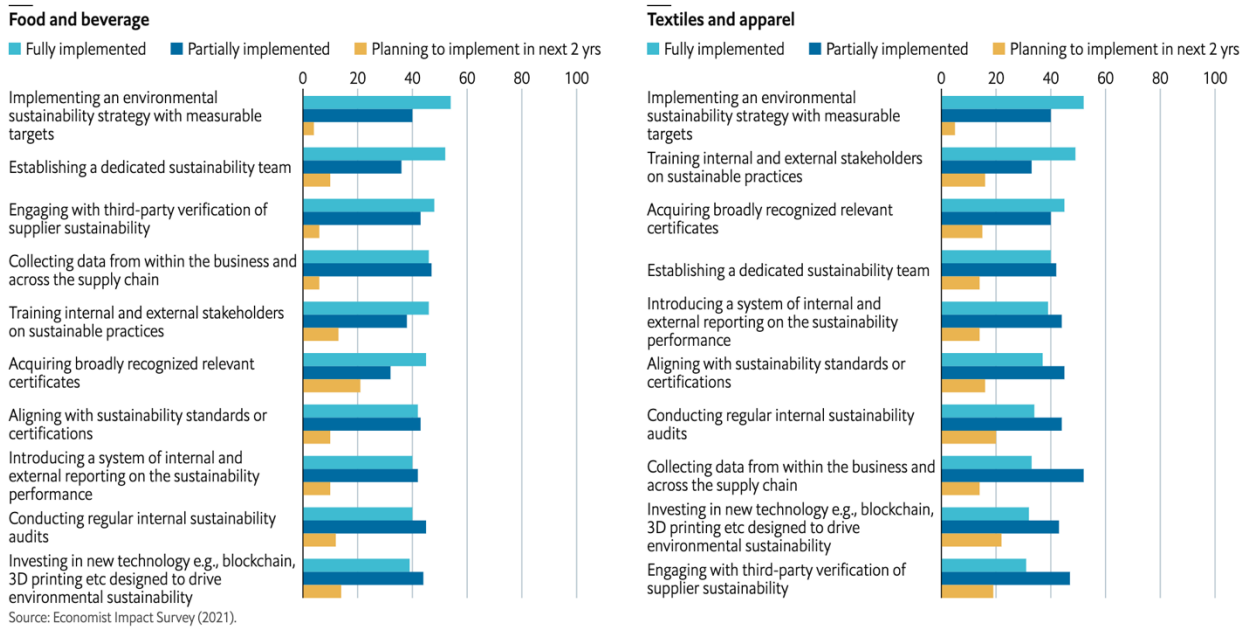
<sup>25</sup> <https://www.worldbank.org/en/news/opinion/2021/07/01/envisioning-central-asia-s-green-recovery>

<sup>26</sup> <https://www.ilo.org/moscow/areas-of-work/labour-migration/lang--en/index.htm>; <https://www.business-humanrights.org/en/blog/putting-eastern-europe-central-asia-on-the-business-human-rights-agenda/>

<sup>27</sup> [https://www.ilo.org/washington/news/WCMS\\_767753/lang--en/index.htm](https://www.ilo.org/washington/news/WCMS_767753/lang--en/index.htm)

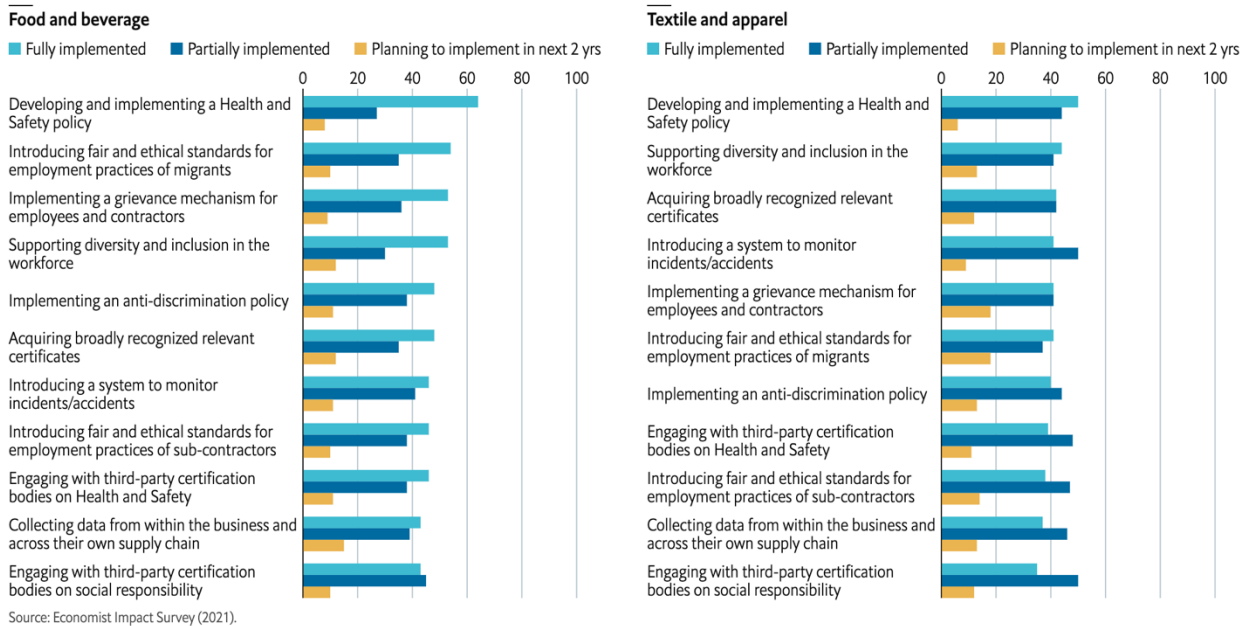
**Figure 5. MNCs' implementation of ESG strategies (environmental)**

"To what extent has your organisation implemented the following in order to be more environmentally sustainable?"



**Figure 6. MNCs' implementation of ESG strategies (social)**

"To what extent has your organisation implemented the following in regards to the social pillar of ESG?"



Companies in both sectors have targeted their environmental impacts because of the high salience of climate change for investors, their large shares of global emissions, high dependency on intensive resource use and health and safety concerns surrounding labour. Concerns from surveyed corporate leadership reflect this. Over half of food and beverage and textiles and apparel respondents—54% and 52% respectively—cited that their companies were already implementing environmental sustainability strategies with measurable targets as the most important step to achieving environmental sustainability across the supply chain. There are

ample examples of companies across both sectors that are setting out their key sustainability targets. In the food and beverage sector, Coca-Cola has opted to set a target of 100% water regeneration for its activities, for example.<sup>28</sup> In the textiles and apparel sector, H&M is aiming to use at least 30% recycled fibres in its clothes by 2025 to accelerate industry-wide adoption of better technology and practices,<sup>29</sup> while Patagonia already uses 100% organic cotton.<sup>30</sup>

Following sustainability target-setting, there is a key focus on knowledge sharing and capacity building with respect to the environment pillar of ESG. Almost 50% of respondents across both sectors have already fully implemented training on sustainable practices for internal and external stakeholders—as in the Lavazza and Patagonia examples (see case studies)—and 46% of respondents have fully implemented the creation of dedicated sustainability teams for their supply chains.

On the social pillar of ESG initiatives, respondents from both sectors are prioritising the development and implementation of health and safety policies—64% of food and beverage respondents and 50% of textiles and apparel respondents cited this as foundational to the achievement of the social ESG pillar, and the highest priority in both cases.

Almost half of respondents across both sectors have implemented policies to support inclusion and diversity in the workforce. In recent years, MNCs have started to regularly publish and apply gender action plans for gender equality and are incorporating targets into relationships with their Tier 1 suppliers. As noted by Emma Fawcett, regional manager at TechnoServe, a US-based non-profit organisation, regarding the growth of gender equality initiatives in the last two years, “I see more action being taken around gender. People realise the purchasing power that women have, especially in emerging middle-income economies.”<sup>31</sup>

Meanwhile, just under 50% of respondents have also adopted policies introducing fair and ethical standards for the employment of migrants. This reflects how MNCs in both sectors are actively working with the International Labour Organisation (ILO) and other international initiatives to ensure that labour at company-owned facilities, as well as Tier 1 suppliers, are able to work in safe environments that respect basic rights, including protection from overwork.

A similar share across both sectors also developed grievance mechanisms for employees and contractors, which allow workers and suppliers to communicate dissatisfaction with corporate practices and address problems that arise locally in MNC approaches. For example, H&M publishes its human rights policies and engages in public affairs work at the national and supranational level to encourage compliance among counterparties and to pressure other firms to follow suit.<sup>32</sup>

Over the next two years, survey respondents' plans differ by sector. To become more sustainable, respondents in the food and beverage sector are looking to acquire broadly recognised relevant certificates (21%) that prove alignment with ESG goals and targets. By doing this, MNCs in the sector can further signal to authorities and partners of their verified ESG progress while improving brand reputation, investment potential and potentially even lowering costs.<sup>33</sup> Meanwhile, in the textiles and apparel sector, the focus is shifting mostly to investing in new technology designed to drive environmental sustainability (22%) and

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<sup>28</sup> <https://www.coca-colacompany.com/news/2030-water-security-strategy>

<sup>29</sup> <https://hmgroupp.com/wp-content/uploads/2021/03/HM-Group-Sustainability-Performance-Report-2020.pdf>

<sup>30</sup> <https://eu.patagonia.com/gb/en/our-footprint/organic-cotton.html>

<sup>31</sup> Economist Impact Interview with Emma Fawcett, Regional MEL Manager, Latin American and Caribbean, TechnoServe (2021)

<sup>32</sup> [https://hmgroupp.com/sustainability/fair-and-equal/human-rights/our\\_approach/](https://hmgroupp.com/sustainability/fair-and-equal/human-rights/our_approach/)

<sup>33</sup> <https://earlymetrics.com/esg-ratings-how-can-a-business-environmental-and-social-impact-be-measured/>

conducting regular internal sustainability audits (20%), both of which could facilitate improvements in transparency, predictability, accountability, and traceability.<sup>34</sup>

On the social side, food and beverage respondents are more focused on collecting data from within the business and across their own supply chain in the next two years (15%). This data will be a critical component in monitoring compliance with social KPIs that the MNC sets and will increase accountability through the supply chain. In the textiles and apparel sector, the focus for the next two years is on implementing a grievance mechanism for employees and contractors (18%) and introducing fair and ethical standards for employment practices of migrants (18%), measures which will provide increased support to a larger set of stakeholders that are at risk of being negatively impacted by ESG risks.

### ***MNCs' supplier demands***

The relative distribution of risks across the supply chain is perhaps best embodied by the difficulty in applying emissions-reduction targets based on scopes 1, 2, and 3 defined in the first section. Scope 1 emissions are most easily addressed because they reflect direct emissions from the activity of company-owned and operated assets. Scope 2 emissions require conscious efforts and investments into renewable energy capacity as well as local partnerships to reduce indirect emissions from corporate activity. Scope 3 is by far the hardest to make progress on because it requires the ability to effectively surveil supplier and end-user behaviour to match corporate commitments. For that reason, most progress on emissions has focused on scope 1, with few firms yet able to make considerable progress imposing emissions-reduction benchmarks deeper into their respective supply chains. As a result, while MNCs are aligning their direct activities to be more ESG-compliant, they are also raising the bar for what they expect from their Tier 1 suppliers. Two thirds of surveyed executives across both sectors claim that ESG considerations are the leading factor for investment and procurement decisions in their industry. It is crucial for suppliers to align with such expectations if they expect to sign potentially lucrative contracts with large MNCs.

70% of surveyed food and beverage executives and 49% of textiles and apparel executives expect their suppliers to ensure ESG-compliant sourcing practices, including implementing circular economy approaches. The gap in share between the two sectors is likely explained by their relative capacities. Since food and beverage firms source more of their inputs from suppliers in developed markets, expectations are higher. This divergence between sectors is also likely due to considerably stricter health and safety standards for food and beverage products.

Beyond this, executives from both sectors share their expectations more generally. Across both sectors, reducing the intensity of resource use is in the top three priorities MNC respondents look for in their suppliers—44% for food and beverage, 40% for textiles and apparel. This is unsurprising given both industries' heavy dependence on inputs such as water and energy. Collaboration with governments, suppliers, NGOs and other businesses to promote sustainable practices is also highly cited by executives from both sectors—41% in the food and beverage sector and 47% in textiles and apparel. This reflects the growing acceptance that reaching ESG targets is not an easy feat that can be achieved alone; rather there is a need for collective action between key stakeholders that have something to gain from aligning with ESG goals and something to lose if they do not.

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<sup>34</sup> <https://www.weforum.org/agenda/2021/10/how-technology-and-digitization-can-make-the-fashion-industry-more-ethical/>

**Figure 7. MNCs' ESG priorities for suppliers**

What ESG priorities does your company look for in local suppliers when making its investment and investment/procurement decisions?



Source: Economist Impact Survey (2021).

The actions that MNCs expect from their suppliers are reflected in real world examples. So far, most MNC efforts to apply targets and social goals to supply chain activities have focused on suppliers with whom companies have a direct contractual relationship. For example, apparel company Kering has started integrating biodiversity considerations into raw material sourcing when choosing partners.<sup>35</sup> In line with this, the company has created an assessment mechanism to determine whether agricultural practices are regenerative. Coffee producer, Lavazza, has made efforts to support supplier adoption of regenerative and sustainable agricultural practices to make its supply chain resource use more sustainable (see case study). The chief aim of these practices is to reverse soil degradation in at-risk areas that provide key commodities.<sup>36</sup>

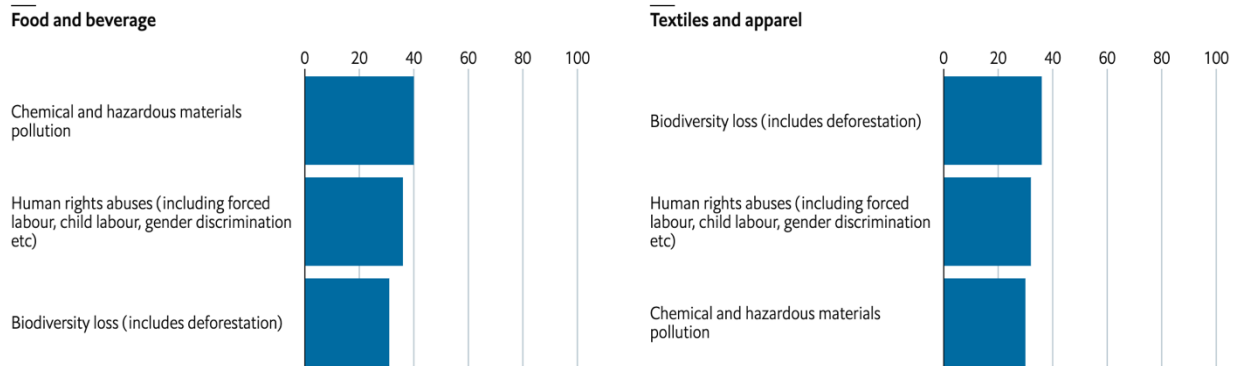
While MNCs have clear expectations of what their suppliers should be doing to become ESG-compliant, they are also conscious of what their suppliers should not do. Many efforts and expectations fall short because of conflicting priorities and capacities, with trends between both sectors aligning closely. Executives in both sectors cite similar non-compliance concerns when asked to rank them for both developed markets and emerging markets. These concerns are such that respondents would be deterred from working with suppliers who fall short. On average, in both priority sectors, 70% of executives stated that their companies have ended partnerships with suppliers who did not comply with ESG standards or supplier guidelines, highlighting the importance of ESG standards in supply chain decision-making.

<sup>35</sup> <https://www.kering.com/en/news/kering-publishes-biodiversity-strategy-and-sets-biodiversity-targets>

<sup>36</sup> <https://www.lavazzagroup.com/en/how-we-work/the-sustainability-report.html>

**Figure 8. Non-compliance issues (emerging markets)**

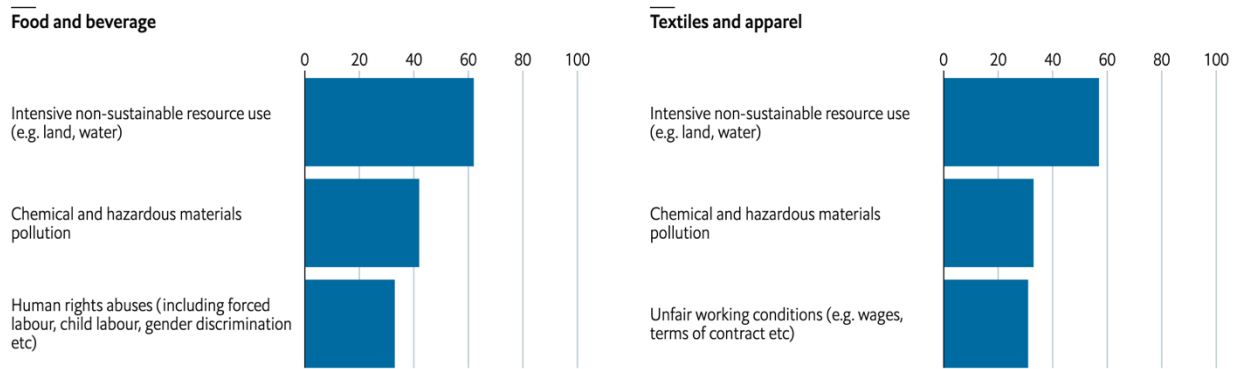
"What are the most common forms of ESG non-compliance that prevent international companies such as yours from engaging with local businesses?"



Source: Economist Impact Survey (2021).

**Figure 9. Non-compliance issues (developed markets)**

"What are the most common forms of ESG non-compliance that prevent international companies such as yours from engaging with local businesses?"



Source: Economist Impact Survey (2021).

In developed markets, both sectors are most concerned with intensive non-sustainable resource use (62% for food and beverage and 57% for textiles and apparel respondents) and chemical and hazardous materials pollution (42% and 33% respectively), with different social criteria coming in third place; human rights abuses for food and beverage executives (33%) and unfair working conditions for textiles and apparel firms (31%).

Working with suppliers in emerging markets is top of mind for executives in both sectors, but there is a general consensus that ESG-misalignment is a key deterrent. Non-compliance examples in emerging markets were similar for food and beverage and textiles and apparel respondents—chemical and hazardous materials pollution (40% vs. 30%), human rights abuses (36% vs. 32%), and biodiversity loss (31% vs. 36%). These areas of concern face frequent interruptions to training and business engagement efforts with suppliers intended to inculcate better business practices in line with ESG targets. Larger firms can more often bear the costs of investing in ESG-focused practices, employee knowledge, and technology to ensure compliance in expectation of a future payoff.

**Box 2: ESG considerations for portfolio and asset managers**

ESG priorities are playing an increasingly important role among investors and portfolio managers. ESG risks and opportunities now influence investment decisions, with an ever-increasing appetite for ESG investments, however there is still reluctance to actively move away from companies with poor ESG

credentials. A recent PwC survey of 325 investors globally highlights the commitment to ESG goals in their investing activities and as a strategic priority for their portfolio companies.<sup>37</sup>

According to this survey, 79% of respondents stated that ESG risks are an important factor in investment decision-making, with 75% of respondents agreeing that companies should address ESG issues, even if it comes at the cost of short-term profitability. On the other hand, while 49% are willing to divest from companies that are not taking enough action on ESG issues, only 34% of respondents are willing to accept a lower rate of return in exchange for societal or environmental benefit. Chendi Zhang, professor of finance at Exeter University confirms that investors are still largely unwilling to accept the trade-off. "Despite a strong appetite for ESG, sacrificing returns is a big ask, only a small fraction of investors is willing to do that", says Zhang.<sup>38</sup>

The supporting tools that help investors guide their ESG-related investment are not without challenges, which vary across different geographies. The complexity of ESG reporting, as well as the multitude of frameworks and accounting standards, poses significant challenges for the investing space. Despite seeing some consolidation within sustainability reporting frameworks, like the recent merger of the IIRC and SASB into the VRF (as mentioned above), investors and shareholders lament that a further drive towards common standards and greater transparency is needed. Only one-third of respondents in the PwC survey state that the quality of the reporting is good enough. Mr Vosmeer at the Heineken Company also highlights how, based on conversations had with shareholders, their main request is for more harmonised standards.<sup>39</sup>

Finally, complexity and difficulty in tracking ESG data alongside the lack of high-quality ESG data in emerging markets may pose a threat to the growth of ESG investing. Tracking and accounting for Scope 3 emissions (resulting from activities such as using the goods or services of a company) are incredibly hard to account for, as is tangibly measuring a company's impact on the loss of biodiversity. Low availability of high-quality ESG data to inform investor decision-making in emerging markets is a crucial issue that needs to be overcome. Despite seeing increased appetite for ESG investing in emerging markets, demand remains lower than in developed markets. "As demand for ESG data in emerging markets increases, hopefully so will the supply," says Professor Zhang.<sup>40</sup>

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<sup>37</sup> <https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/esg-investor-survey.html>

<sup>38</sup> Economist Impact Interview with Chendi Zhang, Professor of Finance, University of Exeter (2021)

<sup>39</sup> Economist Impact Interview with Jan-Willem Vosmeer, Global Manager Sustainable Development & Stakeholder Engagement, Heineken (2021)

<sup>40</sup> Economist Impact Interview with Chendi Zhang, Professor of Finance, University of Exeter (2021)

### **Chapter 3. The state of ESG considerations in supply chains**

Though suppliers have lagged behind MNCs in adapting their operations to ESG initiatives, they have begun to change operations in line with the approaches taken by their corporate partners. Progress is slow and happening unevenly between the two sectors covered in this report. Food and beverage suppliers are more likely to have made gains compared to textiles and apparel suppliers because of how many operate in developed markets with stronger institutions and better regulatory oversight. Geographic concentration across supply chains matters in this regard. But the bottom line is that suppliers have begun incorporating ESG practices in response to evolving MNC policies and business practices.

Many suppliers now sign codes of conduct with larger partners, laying out expectations and, in some cases, contractual obligations. The supplier then tries to apply the principles agreed to in the best fashion possible. Sometimes these arrangements are organised through “preferred supplier” programmes, whereby a company gives preference to suppliers who meet ESG criteria. This creates an incentive to compete for business given the commanding role of large MNCs in terms of orders of key inputs and procurement of goods and services. In practice, this means that suppliers try to apply relevant practices where they can reasonably do so. That can take the form of deploying regenerative farming techniques that preserve soil quality, working with an MNC partner and local civil society actors to monitor and prevent violations of workers' rights, or sourcing electricity from cleaner sources of power if possible.

Some suppliers have even started investing in more automation and digitalisation to improve productivity, reduce labour concerns, and make it easier to trace product inputs and finished or semi-finished products through the supply chain. Others have worked with MNC partners to introduce more formal means of monitoring transactions with Tier 2 suppliers while agreeing to institute grievance mechanisms that allow labour and business partners to demand action when ESG terms of contracts or expectations within a business relationship aren't met. Federico Caniato, Professor of Supply Chain and Procurement Management at Milan Polytechnic points to the limitations of solely relying on a supplier code of conduct. “Introducing suppliers' code of conduct is simply not enough. Suppliers may lack the financial resources to improve and innovate processes. There is a need to directly audit what happens in the supply chain and to provide training resources”, says Professor Caniato.<sup>41</sup>

#### ***Challenges facing MNCs***

There is evidence of progress but there is a need to understand the scale of the challenge facing MNCs when trying to implement ESG metrics across the supply chain. First and foremost, companies struggle because of the complexity of transactions and business relationships between lower-tier suppliers. Without adequate means of ensuring transparency and collecting data, it's difficult to extend any requirements established with upper-tier suppliers further down the supply chain. These gaps highlight the extent to which MNCs cannot implement ESG criteria alone.<sup>42</sup>

Help from local and national governments, civil society and local businesses is vital to drive further progress, especially in jurisdictions with weaker regulatory regimes and governing institutions. NGOs have a particularly important role to play because of the limited capacity firms have to effectively audit supplier operations. Audits often occur just once a year, leaving large gaps where various criteria are being violated without the firm's knowledge. NGOs provide a valuable conduit for feedback and information that might

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<sup>41</sup> Economist Impact Interview with Federico Caniato, Professor of Supply Chain and Procurement Management, Milan Polytechnic (2021)

<sup>42</sup> <https://news.bloomberglaw.com/esg/why-is-the-esg-focus-on-private-companies-not-the-government>; <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>; <https://www.economist.com/by-invitation/2021/11/04/tariq-fancy-on-the-failure-of-green-investing-and-the-need-for-state-action>

otherwise slip through the cracks and let suppliers off the hook. NGOs can provide certification labels after inspecting the operations of various suppliers to provide assurance to MNCs and consumers that standards are being met. This is the approach taken by the Fair-Trade Organisation, which independently audits suppliers to certify that labour is fairly treated and compensated.

The lack of transparency amplifies a related problem—MNCs lack managerial control over supplier operations. While collaboration with outside organisations can improve their ability to audit operations and maintain standards, ultimately, codes of conduct and similar contractual or quasi-contractual mechanisms are weak without managerial oversight. Implementation can be drawn out, adherence is difficult or impossible to ensure in the absence of strong civil society or peer organisations at a local level, and MNCs can struggle to get suppliers to adopt a business culture conducive to meeting ESG targets. These limitations dovetail with the uneven adoption of technology to manage administrative processes and business operations. Without uniform practices and shared or similar technological platforms, it's far more difficult to assess supplier operations. Despite acknowledging these problems, MNCs are often reluctant to invest large amounts of capital to provide these capacities to suppliers.

All these factors interact with the local political context within which suppliers operate. For example, jurisdictions with comparatively weak regulations and property rights protections, or personalistic governmental practices are a much higher risk for any commitment of capital to address capacity shortcomings. Similarly, these operating environments can put more pressure on MNCs to maintain good relationships with national and local political leaders and institutions, which can conflict with stated ESG goals. When poor labour and environmental practices are incentivised by local political factors, working with suppliers to change their behaviour and practices is that much more difficult.

Finally, MNCs struggle to enforce environmental and labour criteria with suppliers due to the risk of operating at a competitive disadvantage relative to other firms. Unless standards are uniformly adopted and enforced, ESG metrics face a collective action problem. The two priority industries are poorly positioned to regulate themselves in cases where sustainability threatens profitability, though there are firms leading the way, including the case studies below.

### ***Case Study 1: Tackling Recruitment Fees in Patagonia's Supply Chain***

#### About Patagonia

Patagonia is a US-based textiles and apparel company operating across 5 continents with facilities in 16 countries. Patagonia has historically committed to environmental and social activism, demonstrating its role at the forefront of the sector's sustainability agenda both internally and throughout its supply chain. For example, since 2010, the company audited close to 100% of its Tier 1 'cut and sew' suppliers and began auditing its Tier 2 material suppliers in 2011.<sup>43</sup>

#### Issue

Commencing i n 2011, company officials identified egregious illegal migrant worker hiring practices at Tier 2 suppliers—fabric mills in Taiwan. This was detected through the 'Raw Materials Supplier Social Responsibility Programme'. The programme, which started in January 2011, was aimed at mapping and

<sup>43</sup> <https://www.patagonia.com/our-footprint/working-with-factories.html>

monitoring Tier 2 of the supply chain—fabric suppliers and their sub-suppliers—and providing internal training on migrant worker issues.<sup>44</sup>

The practice of hiring migrant workers is common and legal in Taiwan, where domestic workers are unable to provide enough labour to meet manufacturing production demand. The Taiwan Ministry of Labour allows employment brokers to charge recruitment fees. However, 'service fees' should not exceed US\$750 per year.<sup>45</sup> Red flags were raised when the auditing programme highlighted that migrant workers were charged fees as high as US\$7,000 by third-party labour recruitment brokers, hired by Patagonia's suppliers to take care of visas, transportation and relocation.<sup>46</sup> Often unable to pay the sum upfront, workers were forced to repay these fees over several years. Given that labour contracts typically last only three years in Taiwan, some workers spent the majority of their employment contract repaying broker fees.<sup>47</sup> The results of the audit highlighted that these were systemic practices used to employ migrant workers in the Taiwanese manufacturing industry.

Response: Developing a new standard for suppliers and the collective action imperative

Patagonia's response to the audit findings involved engagement with a mix of stakeholders, including suppliers, non-profits, other businesses and the public sector.

Patagonia set out a comprehensive strategy to develop a new standard<sup>48</sup>, institute changes across their supply chain, reimburse the affected migrant workers and share new standards with other companies in the textiles and apparel industry.<sup>49</sup>

The first step involved Patagonia setting up a dedicated taskforce to work directly with suppliers hiring migrant workers, hiring a corporate and social responsibility (CSR) field manager based in Taiwan and a CSR expert at their US headquarters. The company also engaged in outreach to different businesses in the sector to discuss issues of forced labour and human trafficking across the sector-wide supply chain.

Patagonia, in partnership with Verité, a labour rights NGO specialising in supply chain risk assessment and with a track record of field work in high environmental, social, and governance (ESG) risk commodities such as food and textiles, conducted in-depth migrant worker assessment on Taiwanese suppliers. The findings confirmed the systemic practice of migrant worker exploitation. The review also uncovered that after analysing all aspects of the migrant worker lifecycle, including recruitment fees, discrimination, housing, wages, contracts, and repatriation, it could take up to two years to repay broker fees.

Patagonia and Verité worked together to develop a new 'Migrant Worker Employment Standard and Implementation Guide'. The standard covers issues in labour contracts, pre-hiring interactions, wages and fees, reimbursement, passport retention, living and working conditions, grievance procedures and repatriation policies.

Once internal expectations were set, Patagonia announced the new standard to its Taiwanese Tier 2 suppliers via email and in-person through a leadership team composed of the Chief Operating Officer

<sup>44</sup> <https://www.patagonia.com/static/on/demandware.static/-/Library-Sites-PatagoniaShared/default/dwd52f9d06/PDF-US/Migrant-Workers-Time-Line-1-25-21.pdf>

<sup>45</sup> <https://chinapost.nownews.com/20200928-1834132>

<sup>46</sup> <https://www.patagonia.com/stories/the-unacceptably-high-cost-of-labor-a-new-migrant-worker-standard-from-patagonia/story-17743.html>

<sup>47</sup> <https://www.patagonia.com/stories/the-unacceptably-high-cost-of-labor-a-new-migrant-worker-standard-from-patagonia/story-17743.html>

<sup>48</sup> Migrant Worker Labour Standard

<sup>49</sup> <https://www.iccr.org/best-practice-guidance-ethical-recruitment-migrant-workers-0>

(COO), supply chain directors and CSR officers. This underpinned Patagonia's intention to work together with suppliers to implement improvements and ensure remediation. According to Wendy Savage, Director of Social Responsibility and Traceability at Patagonia, this collaborative approach with suppliers is essential. "Imposing changes on suppliers without their buy-in is unhelpful, rather companies should bring them along on the journey, ensure clear lines of communication and provide the support needed for sustainable remediation "

Suppliers were encouraged to adopt the standards through a phased approach, with Patagonia mandating deadlines for recruitment fees over the Taiwanese legal limit to be reimbursed and enforcing suppliers to cover the cost of future recruitment fees. Patagonia acknowledged the financial burden incurred by suppliers and has since acted to share with suppliers methods of recruitment that lower employment fees,<sup>50</sup> like running pre-selection due diligence on third-party employment brokers,<sup>51</sup> and developing internal supplier capabilities for directly hiring migrant workers. Patagonia also provided suppliers with ongoing support in implementing the standard through webinars, in-person workshops and one-on-one meetings.

To comprehensively address the issues of forced labour in its supply chain, Patagonia engaged with employment brokers to understand their practices and supported suppliers in sourcing brokers that comply with the company standard. Moreover, Patagonia engaged with public sector stakeholders, such as Taiwan's Workforce Development Agency, an arm of the Taiwan Ministry of Labour, to provide updates on Patagonia's migrant workers standards, learn how the government is trying to address forced labour issues and promote areas for further dialogue and collaboration to improve the system for all companies sourcing from Taiwan.<sup>52</sup> In collaboration with Taiwan's Ministry of Labour's Direct Hiring Service Centre, Patagonia organised training on direct hiring for their Tier 2 fabric mill suppliers.<sup>53</sup> In March 2015, Patagonia extended its new standard to all Tier 1 and Tier 2 suppliers outside of Taiwan, including garment manufacturing and fabric suppliers.

Collaboration with other fashion brands is also key. Patagonia's 'Migrant Worker Employment Standard and Implementation Guide' has been made publicly available for other companies in the textiles and apparel sector to implement across their supply chains. Given the systemic nature of the problem in Taiwan, this move recognises that one company alone cannot eliminate the issue. The company has stressed the importance of business-led collective action to address ESG risks in textiles and apparel supply chains. There is power in collective actions, says Ms Savage at Patagonia, "brand collaboration is one of the most important steps when solving for ESG requirements. Acting together brands can provide clarity and support ".<sup>54</sup>

The Patagonia case, of migrant workers in Taiwan, highlights the importance of collaboration between a portfolio of stakeholders to drive forward ESG-alignment in the textiles and apparel industry, ranging from the suppliers themselves to wider industry leaders. It also suggests how suppliers can communicate challenges to multinational corporations—such as the higher costs faced by new standards and practices—

<sup>50</sup> <https://www.iccr.org/best-practice-guidance-ethical-recruitment-migrant-workers-0>

<sup>51</sup> [https://www.patagonia.com/static/on/demandware.static/-/Library-Sites-PatagoniaShared/default/dw604fc14d/PDF-US/Migrant\\_Worker\\_Employment\\_Standards.pdf](https://www.patagonia.com/static/on/demandware.static/-/Library-Sites-PatagoniaShared/default/dw604fc14d/PDF-US/Migrant_Worker_Employment_Standards.pdf)

<sup>52</sup> <https://www.iccr.org/best-practice-guidance-ethical-recruitment-migrant-workers-0>

<sup>53</sup> [https://www.fairlabor.org/sites/default/files/documents/reports/patagonia\\_reaccreditation\\_assessment\\_october\\_2017\\_0.pdf](https://www.fairlabor.org/sites/default/files/documents/reports/patagonia_reaccreditation_assessment_october_2017_0.pdf)

<sup>54</sup> Economist Impact Interview with Wendy Savage, Director Social Responsibility and Traceability, Patagonia (2021)

and work together to address these issues. Finally, the public sector plays an important role, especially when governments and national governing bodies are open to business-led initiatives.

Best practices:

- Establishing robust communication channels with suppliers and an on the ground presence, focusing on improving know-how and capacity building
- Introducing and adopting a new labour standard and applying it across its global supply chain
- Engagement between Patagonia's senior leadership team and Tier 2 suppliers
- Fostering business-led collective action initiatives and engagement with non-profits and the public sector

### ***Case Study 2: Increasing climate change resilience in Lavazza's coffee supply chain***

#### About Lavazza

Lavazza is an Italy-based coffee product manufacturer, roaster and distributor operating in 140 countries. It has manufacturing plants in Italy and across 5 other countries. Lavazza, being a long-time importer of coffee beans, has focused efforts on sustainable coffee production across its supply chain, seeking to improve the quality of coffee while minimising environmental issues and poor living conditions affecting local coffee farmers.<sup>55</sup>

#### Issue

Coffee is one of the traded agricultural commodities that is most at risk from the influence of climate change. Increased water use coupled with lower rainfall and rising temperatures are threatening coffee harvests that sustain entire communities in developing countries. According to several studies, the influence of climate change on coffee production has highlighted systemic declines in coffee yields, loss of areas optimal for coffee bean production and a rise in pest damage and disease in coffee cultivation.<sup>56</sup>

Vietnam's Central Highlands are one of the world's key coffee producing areas, and a major source of Lavazza coffee beans. However, the Central Highlands are at risk of losing land for cultivation as a result of climate change.<sup>57</sup> To respond to this threat, Lavazza, through its foundation partnered with a consortium of global multinational companies, including coffee suppliers and social enterprises, to support Vietnamese Central Highland farmers. This business-led initiative, executed between 2016 and 2020, was designed to address and improve the climate change resilience of coffee production in Dak Lak Province (part of the Central Highlands region of Vietnam).<sup>58</sup>

Challenges to address included the use of chemicals, greenhouse gas (GHG) emissions and water scarcity. Widespread use of agro-chemicals and irrigation in coffee crop production led to an increased build-up of toxic chemicals in the soil and depletion of water resources during periods of low rainfall. The use of these chemicals also contributed to high levels of GHG emissions.<sup>59</sup> Farming systems with limited shade and

<sup>55</sup> <https://www.lavazza.com/en/sustainability.html>

<sup>56</sup> <https://link.springer.com/article/10.1007/s10584-019-02538-y>

<sup>57</sup> [https://www.sustaincoffee.org/assets/resources/Vietnam\\_CountryProfile\\_Climate\\_Coffee\\_6-11.pdf](https://www.sustaincoffee.org/assets/resources/Vietnam_CountryProfile_Climate_Coffee_6-11.pdf)

<sup>58</sup> <https://www.idhsustainabletrade.com/uploaded/2016/11/ISLA-factsheet-Olam-Lavazza-VN.pdf>

<sup>59</sup> <http://creativecommons.org/licenses/by/4.0>

intercropping<sup>60</sup> led to increased water evaporation and higher levels of water demand. Local growers were poorly equipped to deal with these climate challenges.

Response: Collecting supplier data, identifying critical areas for improvement and sharing best practices

Between 2016 and 2020, Lavazza supported the project design and financing<sup>61</sup> of The Sustainable Trade Initiative (Initiatief Duurzame Handel - IDH), a Netherlands-based foundation focused on sustainable trade in global value chains. Through this initiative, Lavazza supported 1,245 Vietnamese farmers in Dak Lak Province in becoming climate change resilient. The project was implemented by Olam, a global coffee and agricultural product supplier, in partnership with the Vietnamese Department of Agriculture and Rural Development (DARD) and local farmers' union organisations.<sup>62</sup>

The project strategy spanned two phases. The first phase was called the Farmers Field Book (FFB). This was an audit phase during which a random sample of 150 farmers were asked to keep daily records of their activities, investments and outputs. The aim of this phase was to gather multi-crop performance data and insights about coffee suppliers. Olam provided technological instruments to allow regular testing of key variables for soil, irrigation systems and fertiliser quality testing. Agri-Logic, an agricultural consultancy, developed special software functionalities for this program and supported the training of field staff.

The second phase—the Farmer Field School (FFS)—was a series of methodological and technical capacity-building discussions based on the data obtained from the FFB phase.<sup>63</sup> The aim was to inform suppliers on the results and disseminate best practices based on critical areas of improvement highlighted during the FFB phase.

The project supported the development of evidence-based recommendations for farmers to improve their use of resources and therefore increase their adaptivity and resilience to climate change. Farmers can reduce their carbon footprint by optimising fertiliser use. The analysis found that larger users of fertiliser were significantly less profitable and also larger carbon emitters. Optimising fertiliser use decreases carbon emissions and fertiliser costs.<sup>64</sup> Moreover, the level of tree and crop diversification did not significantly increase the employment of water resources. This is beneficial both in terms of soil quality and increasing farmers' market resilience to risk from relying on a single type of crop.<sup>65</sup> Mario Cerutti, Chief of Institutional Relations and Sustainability Officer at Lavazza, also stressed the programme's role in sharing water-reducing best practices: "the use of water resources was far too high in the Vietnamese Highlands. This led to spiralling costs. This programme ultimately proved that you could have the same yields with a 20-40% reduction in water use".<sup>66</sup> Lavazza has committed to another initiative with IDH, which started in 2019 and will run through to 2024. It focuses on intervention and implementation to improve the responsible use of agricultural inputs, improve farmer well-being and disseminate best weed-management practices.<sup>67</sup>

<sup>60</sup> Growing two or more crops in proximity of each other.

<sup>61</sup> Economist Impact Interview with Mario Cerutti, Institutional Relations & Sustainability, Lavazza (2021)

<sup>62</sup> <https://www.idhsustainabletrade.com/uploaded/2016/11/ISLA-factsheet-Olam-Lavazza-VN.pdf>

<sup>63</sup> <https://www.idhsustainabletrade.com/uploaded/2016/11/ISLA-factsheet-Olam-Lavazza-VN.pdf>

<sup>64</sup> <https://www.idhsustainabletrade.com/news/idh-coffee-companies-support-vietnamese-farmers-become-climate-resilience-reduce-carbon-footprint/>

<sup>65</sup> <https://www.idhsustainabletrade.com/news/idh-coffee-companies-support-vietnamese-farmers-become-climate-resilience-reduce-carbon-footprint/>

<sup>66</sup> Economist Impact Interview with Mario Cerutti, Institutional Relations & Sustainability, Lavazza (2021)

<sup>67</sup> Lavazza (2021) Collective Action Initiative

The Lavazza case highlights the importance of business-led collaboration between different stakeholders and the critical role of data across the supply chain. Mario Cerutti emphasises the merits of this: “collaboration is a way to keep competition out of the equation, by putting the priorities of the grower first. Moreover, the synergic efforts of sharing the financial burden and sharing knowledge goes a lot further for the coffee growing industry”.<sup>68</sup> Data collection on early-tier suppliers improves transparency and facilitates the tracking of progress against set performance indicators. From a multinational corporation perspective, developing a robust framework for data collection allows for regular transparent monitoring of supplier practices. From a supplier perspective, providing this data openly can help create optimum working environments, as was evident in this case, with the data showing the need to reduce fertiliser use and costs. Bridging these two is the benefit of becoming more ESG-compliant.

Best practices:

- Fostering business-led collective-action initiatives including coffee suppliers and social enterprise companies.
- Actively engaging with the lowest tier of the supply chain: sponsoring training and education on agronomy of coffee bean production and sharing known best practices to improve environmental sustainability and climate change resilience.
- Tailoring sustainability projects according to the territories' and communities' actual requirements and challenges.
- Introducing data collection efforts at early tiers of the supply chain to optimise use of factors of production.

### ***Challenges facing suppliers***

Financial resources are one of the biggest problems for most suppliers when trying to meet ESG criteria established by contracted MNCs. When asked what they believe are the key limiting factors holding their suppliers back from transitioning to ESG practices, 52% of food and beverage executives and 36% of textiles and apparel executives cite high the cost of transition as the key challenge. Most suppliers of commodity inputs or intermediate finished products cannot make significant investments into more sustainable practices without support. These problems are most acute for early-stage suppliers in commodity supply chains that operate on particularly tight margins, such that sustainable practices may erode their profits to a significant extent. The lack of resources to encourage more sustainable practices is effectively a market failure, one that highlights the extent to which governments, transnational organisations, and civil society must play a supporting role in achieving ESG targets.

Suppliers also lack the specific area knowledge necessary to effectively achieve various criteria. Training on standards, certification processes and best practices is often necessary for farmers, commodity producers and early-stage manufacturers. 44% of textiles and apparel executives and 29% of food and beverage executives cite insufficient in-house ESG knowledge and expertise as a notable challenge for their suppliers. Tier 1 suppliers' area knowledge may benefit from sustained MNC engagement, but that knowledge doesn't necessarily filter down through to lower-tier suppliers. The result is a large deficit in the awareness needed to encourage compliance and inculcate a business culture that incorporates ESG considerations.

This lack of awareness is compounded by frequently weak or uncertain legal requirements and industry standards. Evolving ESG regulations and uncertainty surrounding compliance is a serious limiting factor for supplier operations, particularly in the food and beverage sector (38%). Meanwhile, 38% of textiles and

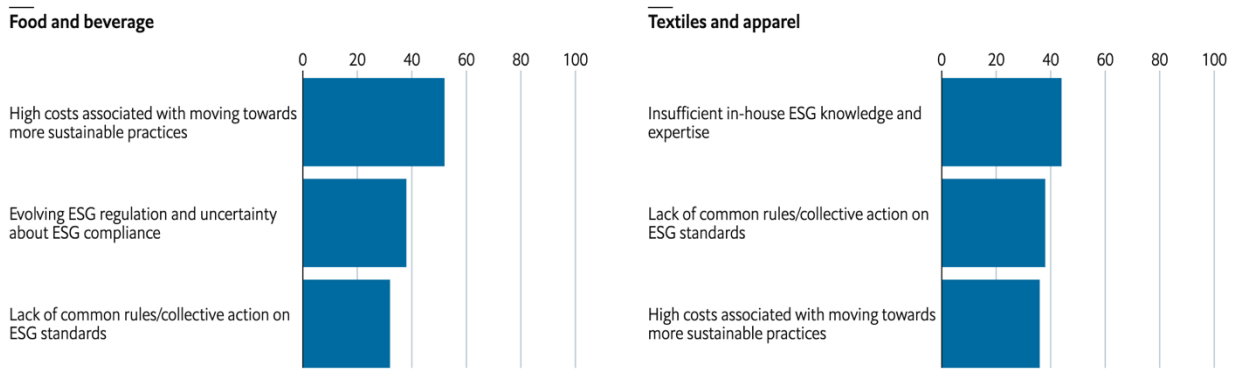
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<sup>68</sup> Lavazza (2021) Collective Action Initiative

apparel executives and 32% of food and beverage executives cite a lack of common rules and collective action within the industry on ESG standards as a problem. Rapidly changing regulatory environments and investor expectations clash with industries lacking shared systems of accounting, reporting and implementation. Without uniform reporting, accounting and enforcement standards at the industry level, suppliers also have less incentive to allocate resources for investments into technology or more sustainable practices, particularly in instances where they can compete for business from other MNCs that may have different internal practices and ESG schema.

**Figure 10. Challenges to suppliers**

"What challenges are limiting the successful integration of ESG standards in local businesses within your supply chain?"



Source: Economist Impact Survey (2021).

Moreover, frequently poor supporting infrastructure and time pressures face suppliers who cannot afford to implement proper ESG practices. Countries that lack the capacity to make significant investments into rail and road infrastructure, renewable energy, and other public goods make it more difficult for suppliers with significant financial constraints to match MNCs' ambitions. The lack of accredited testing labs for food and other commodities complicates the use of certifications that can be verified by NGOs and external partners to signal compliance with labour or environmental standards. Geographic limitations also frustrate MNC attempts to cut out Tier 1 suppliers that effectively act as middlemen and establish direct relationships with businesses that provide commodities and early-stage inputs to improve product traceability and managerial oversight. When physical and regulatory infrastructure linking businesses to markets are lacking, transaction costs rise and MNCs' ability to develop and maintain knowledge of working practices rely more heavily on local intermediaries, whether they be contracted partners, NGOs or political officials, to make supply chains work.

Finally, suppliers face considerable pressures from their MNC counterparts and consumers to deliver on time at a competitive price. During periods where consumer demand shifts—the rotation of consumer spending from services into food and goods during pandemic lockdowns is a prime example—suppliers are frequently forced to work overtime, or else risk being dropped by their MNC partner as a supplier.<sup>69</sup> Surges in demand place more pressure on Tier 1 suppliers whose business operations are audited infrequently to subcontract deliveries to Tier 2 suppliers who potentially face the same production pressures. The result is a cascade effect whereby financial obligations and delivery needs override ESG considerations. There is no effective mechanism to prevent shifts in consumer demand from causing these pressures unless supply chains become entirely traceable and accountable to uniform or harmonised standards.

<sup>69</sup> <https://hbr.org/2020/03/a-more-sustainable-supply-chain>; <https://esg.moodys.io/insights-analysis-reports/persistent-social-risks-will-further-test-post-pandemic-resilience-of-supply-chains>; <https://journals.sagepub.com/doi/10.1177/0887302X211014973>

### **Due diligence mechanisms**

Corporate due diligence of ESG considerations often suffers from a proliferation of standards, labels, and certifications without adequate harmonisation. Miscellaneous arrangements make like-to-like comparisons more difficult and risk MNCs adopting standards that are most convenient for their own competitiveness and operations rather than the most effective at achieving ESG goals. The differing thematic frameworks both complement and compete with each other.

On environmental matters, both sectors have adapted to the 2050 net-zero targets established by the Paris Agreement in 2015. For the food and beverage sector, a limited number of firms have signed the Climate Pledge to achieve the same net-zero targets by 2040. Within the textiles and apparel sector, emission-reduction targets are set by the Fashion Industry Charter for Climate Action, led by the UN in line with the Paris Agreement. The following are examples of differing initiatives, frameworks, and ad hoc approaches within both sectors that are frequently not aligned.

**Figure 11: ESG collaborative initiatives**

Initiative	Sector	Objective	Participants
<b>Make Fashion Circular Initiative<sup>70</sup></b>	Textiles and apparel	Offers guidance and encourages apparel companies to make longer-lasting clothes using recyclable materials from renewable inputs.	<ul style="list-style-type: none"> <li>Leading organisation: Ellen Macarthur Foundation</li> <li>Participating companies: H&amp;M, Inditex, Lacoste, Primark, PVH Corp, Ralph Lauren and others</li> </ul>
<b>Better Cotton Initiative<sup>71</sup></b>	Textiles and apparel	Acts as a non-profit governance group that has partnered with 2,100 members within the textiles and apparel sector to promote sustainable practices and educate the farmers and suppliers that participate.	<ul style="list-style-type: none"> <li>Cotton associations: including those in Australia, Turkey, Mozambique etc.</li> <li>Participating companies: H&amp;M, Ikea, Gap, Levi Strauss etc.</li> </ul>
<b>Coalition on Food Waste<sup>72</sup></b>	Food and beverage	A consortium of companies targeting food waste reduction with the aim of halving food waste within its members' operations by 2025 and supporting wider UN Sustainable Development Goals on the issue.	<ul style="list-style-type: none"> <li>Leading organisation: The Consumer Goods Forum</li> <li>Participating companies: Tesco, Barilla, McCain, Costco, Majid Al Futtaim etc.</li> </ul>
<b>Bangladesh Accord<sup>73</sup></b>	Textiles and apparel	A legally binding agreement between global brands and retailers and global and local trade unions to work towards a safe and healthy garment and textiles industry in Bangladesh.	<ul style="list-style-type: none"> <li>Participating companies: Hugo Boss, H&amp;M, Mango, Tesco, American Eagle Outfitters etc.</li> <li>Participating trade unions: UNI Global Union, IndustriALL Global Union</li> </ul>

The diverse range of accounting standards and patchwork of private and public initiatives make due diligence a complicated endeavour. In short, businesses see the problem primarily as a function of lost profits, costs and competitiveness in the absence of a universal standard that can be agreed, and enforced, among MNCs, governments, NGOs, and suppliers.

**Box 3: Third-party certification bodies**

<sup>70</sup> <https://ellenmacarthurfoundation.org/topics/fashion/who-we-work-with>

<sup>71</sup> <https://bettercotton.org/who-we-are/annual-report-2020/>

<sup>72</sup> <https://www.theconsumergoodsforum.com/environmental-sustainability/food-waste/about/>

<sup>73</sup> <https://bangladeshaccord.org/resources>

As ESG makes its way higher up the corporate agenda, companies and their suppliers are increasingly facing requests for third-party verification and 'seals' of their ESG achievements, driven by stakeholders ranging from consumers to investors, banks and supply chain buyers. The importance of such practices is evident, with almost 80% of surveyed executives across both priority sectors stating that it is essential that suppliers are accredited by national accreditation bodies.

Almost 50% of executives in the food and beverage sector claim their companies have already implemented third-party verification of suppliers' sustainability, while almost one-fifth of respondents in the textiles and apparel sector plan to do so in the next two years. Moreover, around 40% of respondents across both industries have already engaged with these bodies specifically on health and safety and social responsibility certifications.

While obtaining third-party certification can be costly and time consuming, companies stand to benefit from becoming eligible for new sources of capital, reduced premiums and cheaper risk-insurance products. Moreover, such practices can detect non-compliance risks and collateral exposure that could impact profitability and alignment with growing regulations.

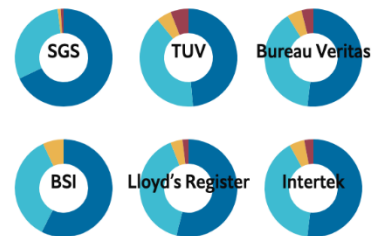
While MNCs have been leveraging these services, they have fewer expectations for their suppliers to do so. Only 17% of respondents from MNCs across both sectors believe their suppliers ought to be engaging with third-party verification bodies on Health and Safety. This percentage is even less for certification of social responsibility (4%) and supplier sustainability (2%). This divide perhaps suggests that while this is a high priority for large, established companies—such as those included in the Economist Impact survey—it is less of a priority for their suppliers who have more preliminary steps to take before reaching the certification stage.

While there remains a certain degree of scepticism, a majority or near majority would trust each of the third-party certification bodies presented in the Economist Impact survey—see Figure 9.

**Figure 12. MNCs' trusted certification bodies**

"Which of the following third-party certification bodies would you trust in your investment and supply chain decisions?"

■ Yes, I would trust    ■ Maybe  
■ No, I would not trust    ■ Not applicable



Source: Economist Impact Survey (2021).

## Chapter 4. The outlook for ESG considerations

Though there are some variations on specific focuses between sectors, the general consensus in both priority sectors is that ESG-specific capacity has to be built up to enable the realisation of ESG targets. Capacity-building flows from growing internal knowledge, setting targets and collecting data against those targets.

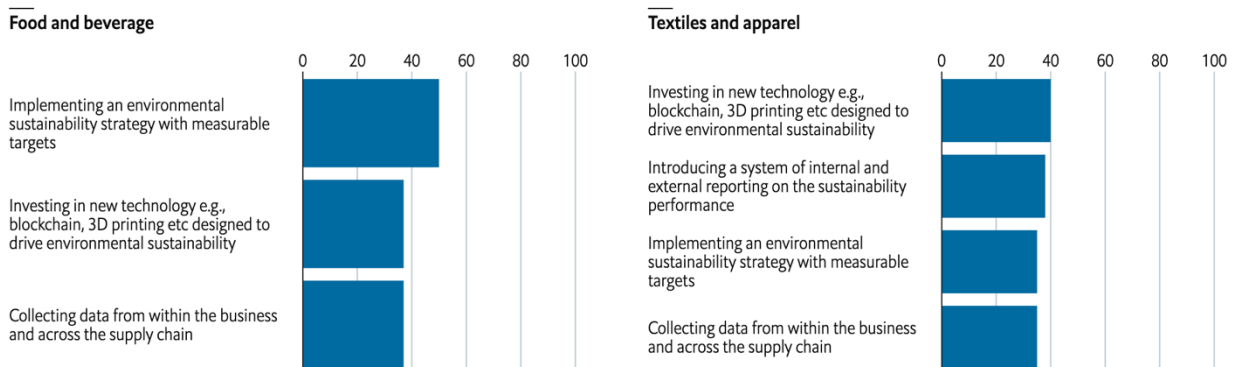
On the sustainability side, executives in the food and beverage sector advise their suppliers to implement environmental sustainability strategies with measurable targets as a first step (50%). This is followed by investing in new technology, such as blockchain, 3D printing and data analytics solutions (37%), and collecting data from within the business and across the supply chain (37%). These two go hand-in-hand as investments in technologies can support data collection efforts, which, in turn, can further improve analytics and resulting recommendations. Moreover, technological solutions could support the consolidation of key stakeholders within a supply chain onto one integrated platform that ensures greater visibility of each party's activities.<sup>74</sup>

For the textiles and apparel sector, MNCs similarly recommend that suppliers invest in technologies (40%) and linked to this is the recognition that suppliers ought to introduce a system of internal and external reporting on sustainability performance (38%). In this sector there is a great focus on building in-house knowledge, with almost two-fifths of executives advocating for the establishment of a dedicated sustainability team.

When looking at the social pillar of ESG, executives in both the food and beverage and textiles and apparel sectors have similar advice. The top recommendation to suppliers is to implement a Health and Safety policy (46% and 39% respectively) as the baseline signal of a commitment to being compliant to the 'S' component of ESG. This should be followed by introducing fair and ethical standards for employment practices of sub-contractors (34% and 42% respectively), which would allow suppliers to demonstrate to MNCs their commitment to ensuring ESG-alignment throughout their own supply chains.

**Figure 13. MNCs' perceptions on suppliers' ESG activities (environmental)**

"What are the main measures your suppliers can/should be working on to be more environmentally sustainable?"

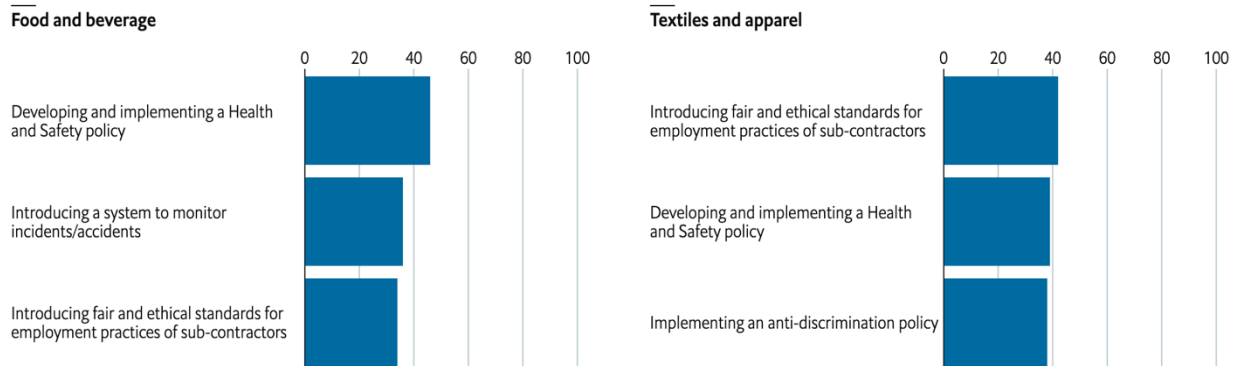


Source: Economist Impact Survey (2021).

<sup>74</sup> <https://impact.economist.com/perspectives/strategy-leadership/treasury-connected/connected-with-suppliers/>

**Figure 14. MNCs' perceptions on suppliers' ESG activities (social)**

"Which of the following are the main measures your suppliers can/should be working on to align with the social pillar of ESG?"



Source: Economist Impact Survey (2021).

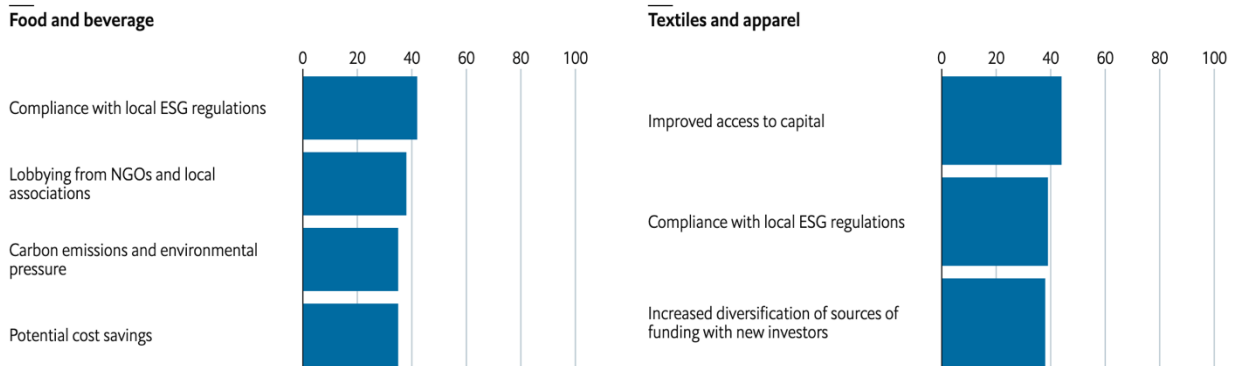
These focuses form important cornerstones to strengthening ESG implementation among multiple supply chain tiers and enabling Tier 1 suppliers to set their own sustainability objectives that are feasible and actionable. However, incentives for becoming more aligned with ESG goals are equally important. For both of the priority sectors in this report, there are two different types of incentives that MNCs believe should be driving them to focus on ESG.

Change in the food and beverage sector is driven by factors that are *pushing* it to become more ESG-compliant. Survey respondents in this sector believe that the top incentive that can promote ESG among suppliers is compliance with local ESG regulations (42%). This is inevitable due to the growing plethora of ESG regulations globally, along with the sector's strict food safety and hygiene requirements. Following this, suppliers can be pushed towards ESG alignment by growing pressure from NGOs and local associations (38%). Thirdly, given the sector's high vulnerability to general climate risks, as explained earlier in the report, suppliers should be driven by environmental pressures to reduce carbon emissions.

Meanwhile, in the textiles and apparel sector, suppliers can be incentivised by *pull* factors that encourage them to pivot towards ESG goals. While many think this sector should also be motivated by growing ESG regulations (39%), 44% of surveyed respondents think that suppliers in this sector should think about the potential for improved access to capital that could result from becoming ESG-compliant, while 38% think increased diversification of sources of funding from new investors will drive suppliers. In the textiles and apparel sector, the potential financial gains seem to be the most promising drivers of ESG performance.

**Figure 15. Incentives to drive suppliers' ESG engagement**

"Which of the following are the most impactful incentives for local companies to align with ESG standards?"



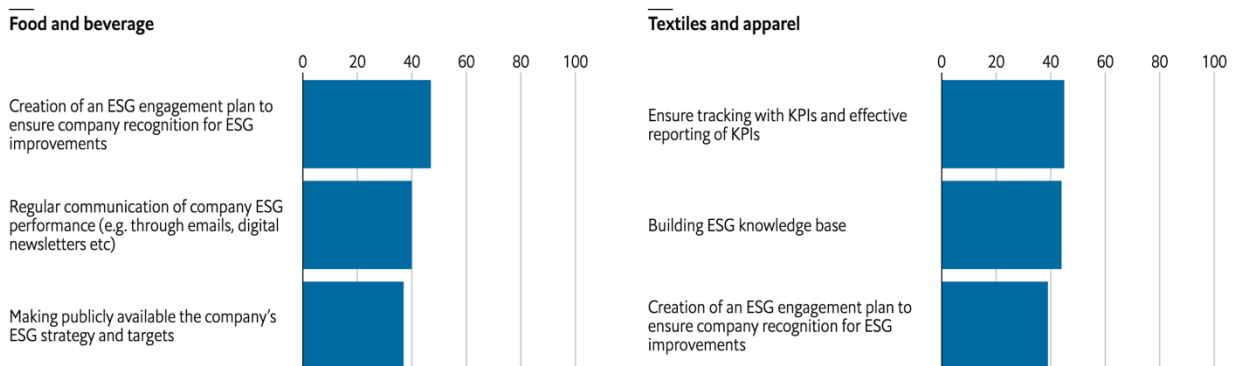
Source: Economist Impact Survey (2021).

**Meeting MNC expectations**

While the identification of *what* suppliers should be doing is crucial, surveyed executives are also conscious of *how* suppliers can communicate their ESG activities to partners. In the food and beverage sector, the key tools MNCs believe their suppliers can use centre on communication. Almost 50% of executives in this sector advise their suppliers to create an ESG engagement plan that communicates ESG progress and achievements to partners. Strongly linked to this, food and beverage executives think suppliers can benefit by making publicly available the company's ESG strategy and targets (40%) and regularly communicating ESG performance by using simple yet effective tools such as emails, digital newsletters and social media.

**Figure 16. Communicating ESG performance to MNCs**

"Which of the following tools/activities can local companies use to communicate their ESG performance to multinational companies such as yours?"



Source: Economist Impact Survey (2021).

Textiles and apparel executives differed in their advice. While communication through an engagement plan is also a top tool for suppliers (39%), almost half of executives in this sector believe tracking and effective reporting of key performance indicators is the most effective tool for suppliers. This is followed by the need for suppliers to focus on building their internal ESG knowledge base.

The sectoral differences between these responses imply that the food and beverage sector may be past the point of newly setting targets, perhaps owing to the already strict health and food safety requirements and standards that the sector is accustomed to. Meanwhile, the textiles and apparel sector faces ongoing media

attention due to companies continuing to engage in practices that go against ESG goals, suggesting that the sector as a whole still needs to do the initial groundwork to become ESG compliant.

Overall, suppliers are likely to improve their access to financing, enable more cost-savings, and otherwise manage potential downside ESG risks to their business models by focusing on effective measurement and communication of relevant activity to MNC partners.

### ***The role of government***

The importance of collaboration has been a recurring theme throughout this report. However, it is essential to remember that governments have a vital role to play in providing strong regulatory frameworks that encourage sustainable practices and address areas where private sector action falls short, whether that be in developed or emerging markets. Moreover, they can address areas where trade-offs are unavoidable. Large corporations and smaller suppliers alike often lack the capabilities to address these problems. Public action and investments are frequently needed, both to address these problems head on and to bring in private capital otherwise unwilling to invest over concerns surrounding the viability of returns or other ESG metrics.

When MNCs are reluctant to invest in accredited labs for testing and unable to provide for the construction of more basic public needs—adequate roads, transport and efficient utility systems—governments must take on that role. For contexts where fiscal resources are scarce and institutions weak, this will entail a greater degree of cooperation and collaboration with the private sector to reduce the risks investors face. This is acutely true for emissions and related environmental risks from energy systems that are incomplete, underdeveloped, reliant on fossil fuels, and energy inefficient. The provision of basic physical and human infrastructure is also an area where international cooperation is urgently needed to best direct development aid budgets and resources to local and transnational NGOs in a manner that supports these goals.

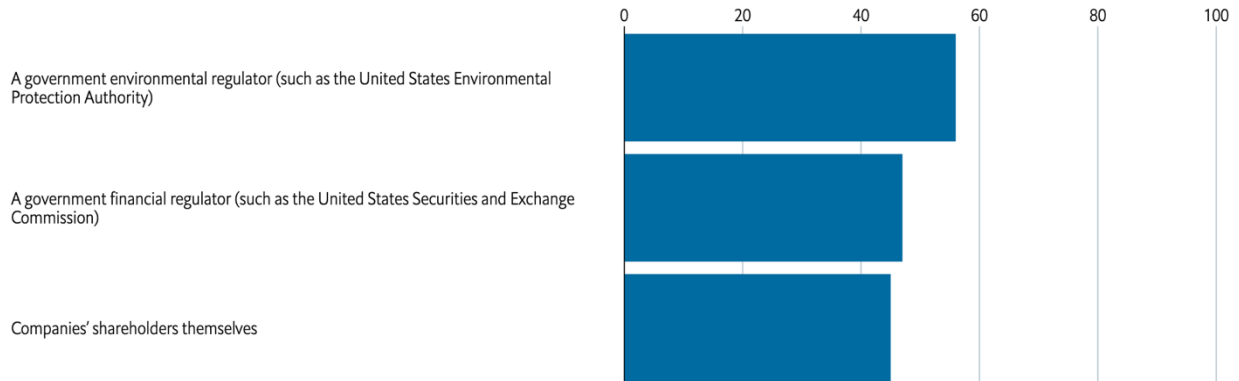
Shareholder preferences must also be taken into account. Responses from executives in both the food and beverage and textiles and apparel sectors show that while a government environmental regulator (55%) and government financial regulator (47%) were identified as the top two institutions that should determine ESG reporting metrics for publicly traded companies, company shareholders (45%) come in a close third. By implication, companies want government institutions to take the lead role in setting, harmonising and unifying accounting and reporting standards for ESG metrics, followed by those to whom the companies have a legal fiduciary responsibility. While there is much debate surrounding the friction between these two sets of interests, there are also signs of progress towards a more aligned approach to policy between these two stakeholder groups, for example with governments across the world having formally incorporated sustainability in the mandates of their financial regulators.<sup>75</sup> Meanwhile, private-sector participants, such as stock exchanges, ratings agencies or consortia of companies, score lower.

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<sup>75</sup> <https://www.unepfi.org/news/industries/investment/an-updated-look-at-fiduciary-duty-in-the-21st-century/>

**Figure 17. Regulating ESG**

"Who should determine the materiality of ESG reporting metrics for publicly traded companies?"



Source: Economist Impact Survey (2021).

Large companies evidently react to shifting financial market regulations. The Securities and Exchange Commission (SEC) in the US can do a great deal to consolidate reporting and accounting standards for ESG metrics, as companies are forced to adhere to standards to list shares on US exchanges.<sup>76</sup> Signalling intent to add and expand reporting and accounting standards rewards companies that proactively do so ahead of any proposed regulatory changes. The European Union, as a bloc, has similar powers to advance human rights due diligence as market participants await an expected legislative proposal still in development that would trigger sanctions on companies in the event of non-compliance. MNCs have made clear that regulatory bodies are needed to determine the material bases upon which ESG metrics are determined and applied to address collective action problems.

As it stands, executives across both sectors turn to specific existing standards and certifications. Environmental reporting takes precedence. In the food and beverage sector the GRI was the leading framework, followed by the Task Force on Climate-related Financial Disclosures (TCFD) and the SASB. Meanwhile, in the textiles and apparel sector, executives make use of the TCFD most, followed by the IIRC and the International Organisation for Standardisation's Management Systems Standards. However, executives across both sectors argue that while they rely on these existing frameworks, there is insufficient government-driven ESG regulation to facilitate ESG integration across supply chains (69%), claiming that mandatory ESG reporting is needed (75%). This may be partly driven by MNCs in these sectors struggling to source consistent ESG data, which is a significant challenge for their broader supply chain decisions.

<sup>76</sup> <https://www.sec.gov/news/speech/can-the-sec-make-esg-rules-that-are-sustainable>; <https://www.americanprogress.org/article/the-sec-should-write-its-own-environmental-social-and-governance-rules/>; <https://supplychaincompliance.bakermckenzie.com/2021/03/10/sec-takes-significant-step-towards-exercising-esg-and-climate-disclosure-powers/>

**Figure 18. Top ESG standards**

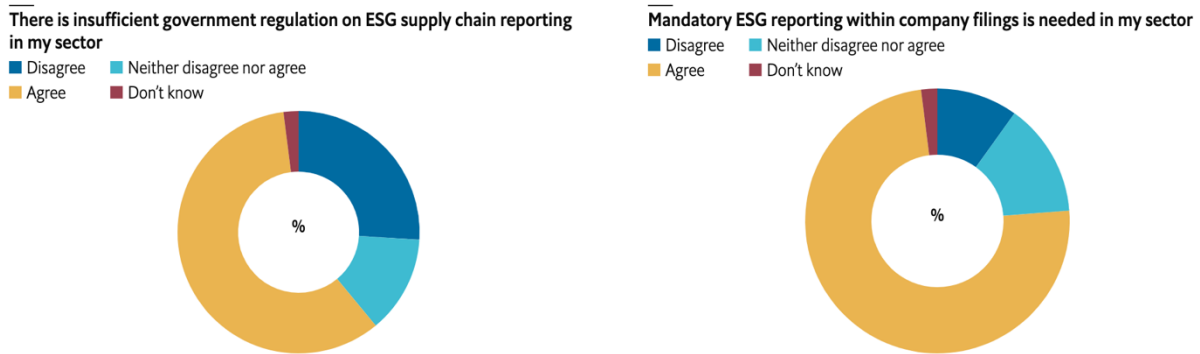
"Which of the following sets of ESG standards and certifications do you think are most important in investment and supply chain decision-making at your company?"



Source: Economist Impact Survey (2021).

**Figure 19. Government regulation is needed**

"To what extent do you agree or disagree with the following statements:"



Source: Economist Impact Survey (2021).

However, while there is an acceptance that regulation is needed, the plethora of ESG reporting standards and frameworks is overwhelmingly fragmented. Such fragmentation inevitably adds a cost and time burden to MNCs who have to channel resources towards interpreting the wide range of rules, collecting data on numerous indicators and going through laborious red tape and paperwork for each framework. This is reflected in the survey, with almost three quarters of food and beverage executives and 80% of executives in the textiles and apparel sector reporting that unified standards in their sector are needed. Moreover, across both sectors, over two-fifths of respondents see a need for increased alignment between national regulations and sectoral best practices. Governments have a leading role to play in resolving many of these issues.

## Conclusion

MNCs have made serious progress in developing and implementing environmental standards and action plans as well as applying environmental and social standards and accounting with Tier 1 suppliers. However, there remain challenges with the proliferation of frameworks and initiatives for environmental and social criteria that create an uneven patchwork of ESG action plans that lack standardisation. The lack of comprehensive, universal standards adds to the difficulty in monitoring supplier activity and tracking subcontracted transactions intended to fulfil contractual orders with MNCs. Therefore, while businesses have made significant strides in implementing or planning to implement standards for their own operations, they face recurring challenges in expanding these standards across their supply chains. Weak administrative capacities within MNCs and suppliers to monitor operations discourage MNCs from investing more of their own financial resources into sustainable practices, procuring technology to help supplier operations, or providing compensation and investment to offset potential short-term losses from more sustainable practices. This is particularly true for the textiles and apparel sector where transparency lags behind the food and beverage sector and is negatively affected by reliance on production in developing countries with weak labour law protections.

Concerted efforts to improve coordination and collaboration between businesses, NGOs, international bodies and national and local governments are needed to build on the current critical mass of MNC efforts to develop and implement ESG plans. Suppliers must improve their ESG knowledge and efforts to communicate their activity to MNC partners, which will ultimately attract new, and retain existing, capital sources. National governments and financial regulators have considerable power to improve national regulatory contexts and support the activity of national accreditation bodies as well as the brand certifications reliant on NGOs and transnational organisations who monitor supply chain activity where MNCs fail to. Companies are ill-suited to ensure compliance across supply chains themselves, especially in cases where suppliers and MNCs have different incentives to maintain their competitiveness. Steps to create standardised frameworks and standards, adopt corporate goals, and product-level targets have provided the necessary basis for the future application of ESG criteria. Businesses and market observers are clear, however, that next steps require political intervention and cross-sector cooperation to achieve the levels of compliance necessary to meet the intended goals.