

**SUPPLY
CHAIN**

**SUPPLY CHAIN
BUSINESS
OPPORTUNITIES
AND RISKS**



ADVISORY SERIES

ABOUT CAO

The Office of the Compliance Advisor Ombudsman (CAO) is the independent accountability mechanism for the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA), members of the World Bank Group. CAO addresses complaints from people affected by IFC and MIGA projects with the goal of improving environmental and social outcomes on the ground and fostering greater public accountability of IFC and MIGA. CAO reports directly to the President of the World Bank Group.

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**SUPPLY
CHAIN**

OVERVIEW



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INTRODUCTION

This memo is the first in a series of Advisory memos developed by CAO to provide IFC with recommendations on supply chain business opportunities and risks. CAO saw the opportunity to develop advice on this topic given the dependence of the private sector on global supply chains for sourcing raw materials and products, as well as IFC's focus on developing markets in fragile and conflict-affected states, where supply chain risks are likely to be most acute for IFC clients. CAO based its advice on lessons derived from a review of CAO cases, particularly compliance findings related to environmental and social supply chain risk, external supply chain expertise, and interviews with IFC staff.

This memo provides an overview of the supply chain issues and observations drawn from CAO's review. Priority areas identified by CAO are addressed in more detail in three technical memos that cover, respectively:

- Supply Chain Memo A. Risk Analysis
- Supply Chain Memo B. Policies and Performance Standards
- Supply Chain Memo C. Voluntary Standards and Certification

CAO intends the memos to serve as a starting point for IFC in developing ways to improve supply chain analysis and implementation, based on issues and recommendations identified by the review.

OBJECTIVES

The goals of the memos are to:

- Provide a general overview of the challenges CAO sees in the three areas examined in the technical memos, and why they are critical for both IFC risk assessment and development impact.
- Establish key questions and challenges related to each of these issues, and potential methods for addressing them.
- Initiate discussions with IFC on planning targeted activities, including documentation, training, and workshops, in any areas where IFC sees that CAO may provide value in addressing these recommendations.

The memos suggest avenues for institutional development for IFC, as opposed to capacity building and development for IFC clients, with a focus on implementation across all sector departments at IFC. CAO recognizes that much of its advice is based on work that is being done within IFC's agribusiness department, where there are pockets of high capacity among agribusiness staff with strong expertise related to supply chains. Thus, strategies for implementing this advice should be developed in collaboration with these internal experts and centered around applying the practical experiences of IFC staff in implementing projects. It will also be important to consult with external experts in supply chain analysis in other sectors. There may also be benefits in reviewing best practices from different industries and other international financial institutions, with the goal of improving IFC's internal capacity to assess the best strategies for taking up the recommendations outlined in these memos.

TARGET AUDIENCE

The memos take into account the different needs of at least three target audiences at IFC:

- 1. IFC Senior Management:** Senior management has the responsibility to address some of the more structural and cultural issues that exist related to supply chain risk. Management can signal that supply chain risk analysis and mitigation are critical to IFC's business and that staff will be endowed with the proper resources, time, and performance rewards to be able to assess the issues early and often.
- 2. Investment and Portfolio Management Staff:** Learning from these memos will help increase awareness among investment staff about supply chain opportunities and risks, particularly enabling them to ask their clients the right questions in order to assess their capacity with regard to supply chains, and how and where to draw on the necessary internal and external expertise to improve client supply chain management.
- 3. Environmental and Social (E&S) Specialists:** E&S staff are aware of many of the challenges associated with supply chain work. However, these staff may benefit from updated guidance related to the more technical elements of supply chain risk assessment and management, as well as better dissemination of expert knowledge within their departments.

The three technical memos prepared by CAO recommend target audiences, but recognize that more detailed discussions will need to take place to identify relevant staff, and to consider the specific needs and responsibilities of each target audience. They draw on industry best practice and lessons from CAO casework, and highlight opportunities for IFC to implement the advisory recommendations in cooperation with CAO and external experts, where relevant.

OBSERVATIONS

THERE IS GROWING ATTENTION TO SUPPLY CHAIN RISK MANAGEMENT AT IFC, BUT CAPACITY AND IMPLEMENTATION REMAIN.

IFC has recognized the importance of environmental and social (E&S) risks in client supply chains, in its Policy and Performance Standards on Environmental and Social Sustainability, and in its response to the World Bank Group's 2009 palm oil moratorium. Between 2007 and 2011, a number of complaints were made to CAO relating to investments in a palm oil merchandising and trading company, and in a palm oil processing facility supported by IFC. The complainants emphasized unacceptable practices in the company's palm oil supply chain. CAO's subsequent compliance work and concerns raised by complainants eventually led the World Bank Group President to implement a moratorium on palm oil investments in 2009. In consultation with stakeholders around the world, IFC and the World Bank Group developed a palm oil strategy and action plan in 2011, after which the moratorium was lifted.

While CAO's compliance work highlighted some of the gaps that existed within IFC processes related to palm oil, the issues it identified also had implications for supply chain risk management more broadly. IFC's subsequent work on palm oil has created an awareness of supply chain issues among staff, particularly within the agribusiness department, that has extended beyond the palm oil sector. An increasing number of IFC staff are aware of supply chain risks and have developed tools and expertise to address these issues.

While acknowledging progress made by IFC to address supply chain risks, CAO's review led to the following observations:

- 1.** IFC has created tools that have targeted both internal and external parties' risk assessment of supply chains, but these tools could be more consistently applied to achieve the desired outcomes.
- 2.** There are many expert staff within the agribusiness team at IFC, on both the investment and E&S sides, who have excellent knowledge about supply chains. However, knowledge sharing and dissemination of practices and tools from these staff could be improved.
- 3.** Supply chain risk analysis and mitigation is not yet a consistent element of routine analysis for all IFC deal team staff.
- 4.** There is a perception among some IFC staff that more stringent requirements to reduce supply chain risks may eventually limit opportunities to invest in challenging sectors.

THERE IS A NEED TO STRENGTHEN SUPPLY CHAIN AWARENESS AND IMPLEMENTATION WITHIN IFC.

CAO's review identified the need for proper use of existing tools, development of new methods, and provision of better information to staff who do not have expertise in supply chain risk analysis and mitigation. However, this work will not be effective without first raising broader staff awareness about supply chains and supply chain risks. As noted, information gathered from CAO interviews with IFC staff in the agribusiness department indicates a growing awareness of supply chain issues, but this awareness is still limited to select individuals and departments. Effective supply chain risk review, analysis, and management should become an element of mainstream thinking on profitable business models, where risks are identified at every stage of the project life cycle. This requires staff to consistently ask the right questions and look for specific information to answer those questions.

Provided that there is sufficient management support that embeds supply chain analysis in a culture of change and strengthens supply chain awareness within IFC, technical issues identified by CAO's review may be more readily resolved. The following issues were identified based on past CAO casework, as well as discussions with IFC staff, and relate primarily to IFC staff without supply chain expertise:

- 1. There is a need for a clear set of guidance questions, readily accessible tools, and incentives to assist staff in basic supply chain analysis.** This aspect is developed further in Supply Chain Memo A on supply chain risk analysis.
- 2. Staff would benefit from clearer guidance on how to implement IFC's Policies Performance Standards with regard to supply chains.** This aspect is developed further in Supply Chain Memo B on implementation of supply chain requirements in IFC's Policy and Performance Standards.
- 3. Staff would benefit from clearer guidance on when, and how, voluntary standards and certification can be used effectively, and their relationship to IFC's own policies and standards.** This aspect is developed further in Supply Chain Memo C on the use of voluntary standards and certification.

A

**SUPPLY
CHAIN
MEMO**

RISK ANALYSIS

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ADVISORY SERIES

SUMMARY

Attention to environmental and social (E&S) risks in client supply chains is growing in IFC. Issues related to palm oil supply chains prompted IFC to develop policies that now extend beyond the palm oil sector, particularly within the agribusiness department. This has resulted in better formulation of supply chain requirements in the IFC Performance Standards and has led to the development of supply chain assessment tools. However, drawing on insights from its casework and interviews with IFC staff, CAO has identified a number of challenges for IFC in the implementation of this higher-level strategic work.

Specifically, CAO observes that:

- **Implementation of IFC's work in supply chain risk analysis and mitigation has lagged behind IFC's strategic gains in supply chain policies and procedures.**
- **IFC has made strides in developing information and tools related to supply chain analysis, but many of these tools have been developed for IFC clients, not staff. Tools that might benefit IFC staff are not used as widely or effectively as they could be.**
- **IFC needs to develop more flexible analytical tools that are adaptable to a variety of sectors, clients, and project contexts.**

To address these issues, CAO recommends that IFC considers the following actions:

- 1. Develop a guide with key questions (“thinking steps”)** to be asked by E&S and investment staff in different stages of IFC’s business cycle.
- 2. Train staff in supply chain analysis,** so that they are knowledgeable about the appropriate tools and resources available to address risks raised throughout the project cycle process.
- 3. Create an enabling environment** that formalizes the recognition of, and performance rewards for, staff who conduct robust supply chain analysis and risk mitigation.

CONTEXT

SUPPLY CHAIN RISKS AFFECT CURRENT AND FUTURE PROFITABILITY OF COMPANIES AND THE ENVIRONMENTAL AND SOCIAL WELFARE OF COMMUNITIES THEY WORK WITH.

Supply chain risks may have a significant impact on a company’s current and future profitability and the environmental and social welfare of communities in their sphere of operations. Investors need an understanding of the business risks caused by supply chain issues and related reputational risks that may be damaging for the client, as well as the investor. Therefore, an increasing number of investors, including IFC, require an assessment of a client’s supply chain risks and the quality of their supply chain management as a standard element in their due diligence process.

EFFECTIVE SUPPLY CHAIN RISK MANAGEMENT THAT MINIMIZES NEGATIVE ENVIRONMENTAL AND SOCIAL IMPACTS IS BECOMING PART OF MAINSTREAM BUSINESS ACTIVITIES.

Effective supply chain management that minimizes the risks of unsustainable environmental and social practices and stimulates sustainable practices is no longer only an activity for corporate social responsibility managers. It has become a core management task for those responsible for sourcing in manufacturing, processing, and trading companies. Large multinational companies in the food and beverage sector have taken the lead, and others are following. Sustainable supply chain management in those companies is becoming a mainstream business activity to secure profitability and minimize risks.¹

However, smaller companies may not readily adopt the strategies employed by large multinationals. Where companies have less market influence and fewer resources, supply chain risk management must be approached differently. Given the demands of global value chain integration, these smaller companies arguably need to be even more agile in adapting and controlling their supply chains. Companies that do not prioritize supply chain control and management face higher risk of supply chain disruption and quality problems, along with environmental and social supply chain risks.

IFC'S DEVELOPMENT IMPACT CAN BE ENHANCED THROUGH ITS DIRECT INFLUENCE ON ITS CLIENTS, AS WELL AS THROUGH THEIR CLIENTS' WORK TO IMPROVE THEIR SUPPLY CHAINS IN CHALLENGING SECTORS.

While assessing supply chain risks is becoming good practice for businesses generally, IFC's commitment to sustainability, its Performance Standards, and its responsibilities as a multilateral development organization mean that it must often go beyond the requirements used by other investors. Particularly when IFC is operating in contexts where the regulatory environment is challenging, or where clients have limited leverage to affect the sector through market power alone, it is important for IFC to identify the potential risks and provide early guidance on mitigation measures. It is also important for IFC to provide its clients with tools for how to address potential risks that may arise

¹ See Ceres, *Roadmap for Sustainability*, <https://www.ceres.org/roadmap-assessment/sector-analyses/food-beverage>. I. A. Ionescu-Somers, "Business Logic for Sustainability," in *The Palgrave Series on Global Sustainability*, Palgrave Macmillan, 2008; R. de Man and I. A. Ionescu-Somers, *A Practitioner's Guide for the Sustainable Sourcing of Agricultural Materials*, *Sustainable Food Lab*, 2013.

over the course of a project. IFC and its clients are vulnerable to considerable business risks if they do not have the motivation, knowledge, and capacity to manage their supply chain risks. A well-managed supply chain goes beyond mitigating environmental and social risks and helps move companies toward positive development impact. When done well, supply chain management can help individual clients improve the inputs to their production. For smaller clients that find themselves between the capacity of small-scale producers on one end, and the demands for supply chain transparency and sustainability by multinational conglomerates on the other, IFC's investment and guidance has the potential to provide the support needed to integrate these companies in global markets.

OBSERVATIONS

1. IMPLEMENTATION OF IFC'S WORK IN SUPPLY CHAIN RISK ANALYSIS AND MITIGATION HAS LAGGED BEHIND STRATEGIC GAINS IN SUPPLY CHAIN POLICIES AND PROCEDURES.

IFC has made good progress in formulating requirements related to supply chains in its E&S policies and in addressing supply chain issues in the Performance Standards (see Supply Chain Memo B). Practical expertise on supply chain issues in IFC is also growing. This work was catalyzed following several complaints to CAO in 2007 regarding IFC investments in palm oil supply chains. CAO's resulting compliance work identified shortcomings in IFC's review of the client's supply chain risks and led the World Bank Group to implement a moratorium on investments in the sector until a strategy was developed. The gaps that were highlighted relating to palm oil have informed IFC's evolving approach to supply chains.

Despite this progress, IFC's implementation of supply chain requirements lags behind its strategic ambitions for several reasons. Awareness of strategic changes appears to be higher at the management level than in operations, and also appears to be largely concentrated in the agribusiness department. Knowledge and experience are available within IFC through specific staff with high-level supply chain expertise, but this expertise is not yet being shared effectively and broadly across the institution with other staff and departments that have minimal knowledge. There is also a need for adequate tools for analyzing and managing client supply chain risks that fit into IFC's operational

processes. IFC would also benefit from a well-structured risk assessment process guided by a number of key questions that investment staff can ask their clients in the different phases of IFC operations.

These gaps point to the need for IFC to create a favorable enabling context for supply chain risk analysis and mitigation by making knowledge, expertise, and analytical tools more available to support operational work. The effective use of supply chain-related knowledge and tools is critically dependent on the creation of incentives for staff in addressing E&S opportunities and risks in client supply chains.

2. IFC HAS DEVELOPED RESOURCES TO SUPPORT SUPPLY CHAIN ANALYSIS, BUT MANY OF THESE TOOLS HAVE BEEN DEVELOPED FOR IFC CLIENTS, NOT STAFF. TOOLS DESIGNED FOR IFC STAFF ARE NOT USED AS WIDELY OR EFFECTIVELY AS THEY COULD BE.

IFC has developed a number of effective tools for assessing and managing supply chain risks. CAO also observes that, in principle, information on supply chain risks (country risks, sector risks, risks related to specific companies, etc.) is widely available through open information sources (such as Google) and through specific service providers. As a direct spinoff of IFC's 2011 palm oil strategy and action plan, tools, and handbooks have been developed by, and for, IFC's agribusiness department, notably a supply chain mapping tool and IFC's *Good Practice Handbook: Assessing and Managing Environmental and Social Risk in an Agro-Commodity Supply Chain*. Tools provided by external service providers such as RepRisk (reprisk.com), IBAT (Integrated Biodiversity Assessment Tool), Maplecroft, and Sigwatch (sigwatch.com) are also being used by some IFC staff to assess certain supply chain risks.

While many of these tools and information sources are useful, they will only result in good decision making if they are appropriately used and staff awareness and knowledge of supply chains continues to grow. Moreover, CAO's interviews and review indicated that while tools like IFC's *Good Practice Handbook* are thorough, they may be too complex for many IFC clients. They also may not provide adequate practical guidance to IFC staff. Finally, while many of these tools are useful for supply chain experts, staff for whom this is not their primary field of expertise may not find them easy to use.

3. IFC SHOULD DEVELOP MORE FLEXIBLE ANALYTICAL TOOLS THAT ARE ADAPTABLE TO A VARIETY OF SECTORS, CLIENTS, AND PROJECT CONTEXTS.

In its review, CAO observed that IFC has not sufficiently developed flexible analytical tools that are adaptable to different sectors, clients, and project contexts. IFC clients have a great variety of supply chains. Supply chains vary for different commodities, and they may also vary for the same commodity across regions or countries. Moreover, supply chain risks are as dependent on the nature of the supply chain as the relationship between IFC's client and its suppliers. Because of rapid changes in markets and policy environments, developing opportunities while reducing risks in supply chains calls for tailor-made and flexible solutions. The practical value of even the best handbook knowledge is very limited because these documents are often too general and rapidly become outdated. For this reason, flexible, analytical tools are needed to help IFC clients and staff translate supply chain requirements to the specific local context.

RECOMMENDATIONS

On the basis of the previous observations, CAO recommends that any work done by IFC on managing E&S risks in client supply chains should focus on the effective implementation of policies and standards by optimizing work processes at the operational level. Where necessary, policies should be clarified to assist staff in interpreting and implementing them, and thereby improve performance. (This is further discussed in Supply Chain Memo B.) IFC's objective should be to increase the effectiveness of existing information and tools for IFC E&S and investment staff with regard to supply chain-related tasks for every phase of the project cycle, including:

- Assessing the client's potential supply chain E&S risk, taking into account specific commodity/sector risks, regional or country risks, and company risks.
- Assessing the options for moving clients with high-risk supply chains to lower-risk supply chains.
- Assessing the client's options for adequately managing supply chain E&S risks.
- Incorporating the client's obligations for adequate risk management into the Environmental and Social Action Plan (ESAP).
- Including supply chain E&S issues during project monitoring.

CAO therefore recommends that IFC should:

1. DEVELOP PRACTICAL PROCEDURAL STEPS, PARTICULARLY FOR STAFF WITHOUT SUPPLY CHAIN EXPERTISE, THAT OUTLINE “THINKING STEPS” REQUIRED TO ASSESS SUPPLY CHAINS, AND IDENTIFY APPROPRIATE SOURCES OF INFORMATION.²

- **Activities:** IFC should develop practical procedures based on guiding questions (“thinking steps”) for use by staff at the different phases of the IFC project cycle, notably during project review and development of the E&S action plan, and during supervision. This guidance should be easy to understand and digest, and should incorporate other resources that are well integrated into existing business procedures. The priority should be to apply these resources in a well integrated work flow based on the better understanding gained by staff through these “thinking steps.” Knowledge of the appropriate questions to ask at each stage of the project cycle would help staff streamline information gathering and analysis of supply chain risks, without the process being overly complicated. These practical thinking steps should also distinguish between tools and information necessary for IFC staff to conduct supply chain analysis, and tools tailored for IFC clients (such as IFC’s *Good Practice Handbook*).
- **Responsibilities:** Guidance should be developed by E&S supply chain experts in IFC, with possible external expertise.
- **End Result:** The exercise would yield a set of practical thinking steps, including key questions to be asked at the different stages of the IFC project cycle by staff without supply chain expertise, with reference to internal and external sources of information and tools. The steps should then be used in training sessions and workshops, and be available as a reference for IFC staff.

2 An example of a potential methodology for this work can be seen in *A Practitioner’s Guide to the Sustainable Sourcing of Agricultural Raw Materials*, <https://www.bsr.org/files/fba/sustainable-sourcing-guide.pdf>.

- **Target Audience in IFC:** Investment and portfolio staff, and E&S staff who do not have supply chain expertise (all sectors). Potential objectives for these thinking steps, which should be developed with input from senior supply chain experts, are:
 - Are all E&S and investment staff able to identify the potential for supply chain risk as derived from project and contextual risks, so that they can flag issues for staff with supply chain expertise?
 - Are all E&S staff able to ensure that the client has incorporated supply chain issues as part of the E&S assessment?
 - Do all E&S staff have access to appropriate expertise to review the adequacy of the client's assessment on supply chains and to incorporate ESAP requirements, or Conditions of Disbursement (CoDs)?
 - Are all investment officers aware of the types of internal controls at IFC that might be necessary and appropriate for clients with high-risk supply chains?

2. TRAIN STAFF IN SUPPLY CHAIN ANALYSIS SO THEY ARE KNOWLEDGEABLE ABOUT THE APPROPRIATE TOOLS AND RESOURCES AVAILABLE TO ADDRESS RISKS THROUGHOUT THE PROJECT CYCLE.

- **Activities:** At a minimum, staff should be trained in:
 - Internally and externally available supply chain tools and information sources, such as IFC's supply chain mapping tool (GMAP), Maplecroft country risk reports, contextual risk analysis, reoprisk.com, and IBAT tool.
 - How these tools are being used to conduct supply chain risk analysis by IFC's operations teams, and to what effect.
 - How effective the use of these tools is according to the main users, in terms of identification of gaps and assessing areas for improvement.
- **Responsibilities:** IFC management, in close cooperation with supply chain/E&S experts in IFC.
- **End Result:** IFC staff have access to internal tools and information sources, as well as those available from external service providers/private sector companies.
- **Target Audience in IFC:** This should be considered in collaboration

with supply chain experts in IFC, and with reference to the thinking steps process outlined in recommendation 1.

3. CREATE AN ENABLING ENVIRONMENT THAT FORMALIZES THE RECOGNITION OF, AND PERFORMANCE REWARDS FOR, STAFF WHO CONDUCT ROBUST SUPPLY CHAIN ANALYSIS AND RISK MITIGATION.

- **Activities:** Recommendation 1 will require that deal team staff are provided with an environment that enables them to assist clients in identifying and managing risks in supply chains. An internal working group should be convened with, at a minimum, staff with knowledge of IFC performance rewards and staff with knowledge of the operational realities of implementing supply chain requirements. This group should review how the current performance evaluation structure promotes and/or hinders effective supply chain risk analysis and management. This review could then form the basis for recommendations for potential changes to this structure that would reward staff who have identified and mitigated risks early in the project cycle, leading to better client supply chain performance. It is important to note that while changing the enabling structures around supply chain risk analysis is critical to the success of the implementation of recommendation 1, this process will necessarily require long-term efforts. Therefore, this recommendation should be conducted in tandem with the previous recommendations.
- **Responsibilities:** IFC senior management and operational staff.
- **End Result:** A favorable enabling context and positive performance rewards throughout the IFC organization for dealing with E&S opportunities and risks in client supply chains. Also, greater awareness among staff about the available supply chain knowledge and experience more widely available to support operational work in a form that is effective.
- **Target Audience in IFC:** All staff who are responsible for supply chain risk analysis and management throughout the project cycle.

B

**SUPPLY
CHAIN
MEMO**

**POLICIES AND
PERFORMANCE
STANDARDS**

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ADVISORY SERIES

SUMMARY

IFC has formulated supply chain requirements in both its Policy on Environmental and Social Sustainability and its Performance Standards (PS), particularly PS1 on Assessment and Management of Environmental and Social Risks and Impacts, PS2 on Labor and Working Conditions, and PS6 on Biodiversity Conservation and Sustainable Management of Living Natural Resources. The rationale for these requirements is to reduce supply chain risks, both to IFC and to its clients. However, CAO's work has identified that a range of understanding and perceptions of language related to supply chains in the Performance Standards is limiting their effective contribution to risk reduction. Specifically, CAO has observed:

- **There is an inconsistent understanding among staff of the requirements for the implementation of Performance Standard 1 with regard to supply chain control.**
- **Differences in understanding regarding implementation of these requirements may reduce IFC's ability to improve client capacity for greater supply chain control.**
- **There is a perception among IFC staff that supply chain risk analysis has inhibited investment in clients with high-risk supply chains, and may continue to do so.**

To address these issues, CAO recommends that IFC considers taking the following actions:

- 1. IFC management should provide clear and updated guidance to all staff involved in the implementation of the supply chain provisions in PS1 and related Performance Standards.**
- 2. IFC staff should be provided with information and training on the updated guidance and its implication for effective implementation of the Performance Standards.**
- 3. As part of the next consultative process for review of the Performance Standards, IFC should include specific guidance regarding supply chains in all Performance Standards, beyond the current references in PS1, PS2, and PS6.**

CONTEXT

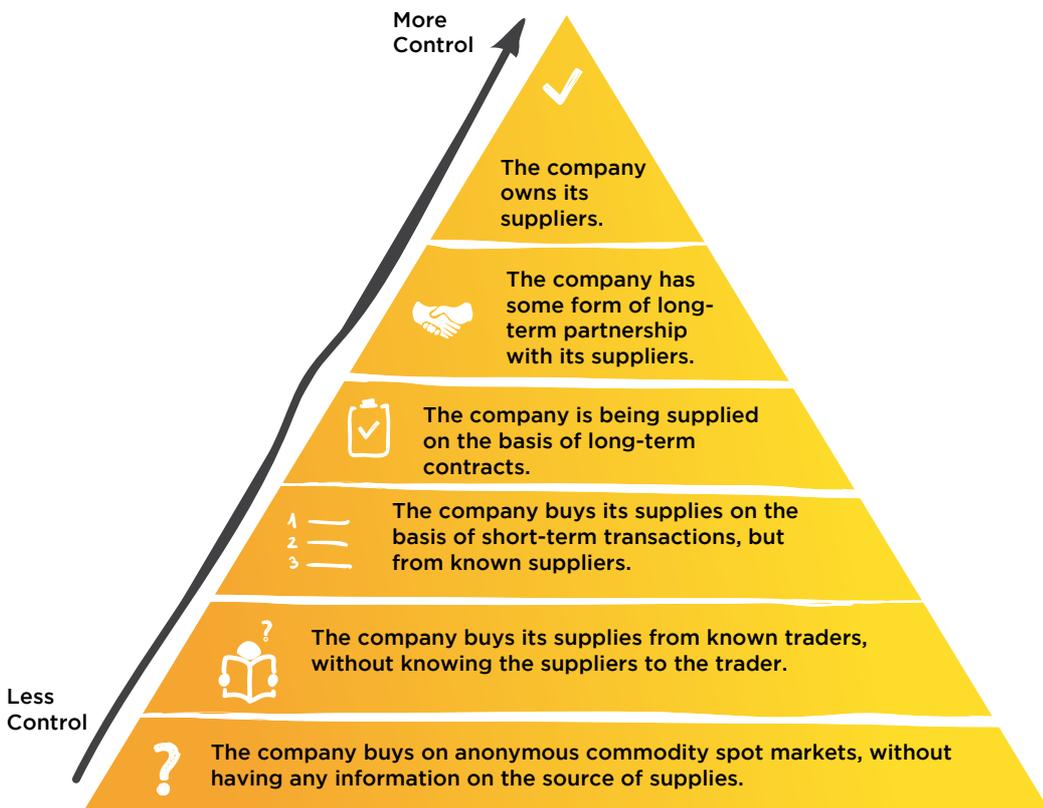
THE EXTENT TO WHICH IFC CLIENTS CAN MANAGE E&S RISKS EFFECTIVELY IN THEIR SUPPLY CHAINS IS HIGHLY DEPENDENT ON THEIR SUPPLY CHAIN CONTROL. INCREASED CONTROL MAY REQUIRE REORGANIZATION OF THE SUPPLY CHAIN AND THE DEVELOPMENT OF A PLAN TO ACHIEVE THIS OVER A REASONABLE PERIOD OF TIME.

A client's lack of supply chain control can be a major source of E&S risk and can reduce potential development impact, either because of a failure to reach suppliers where IFC's influence can make a difference, or by supporting market systems that run contrary to IFC's goals for environmental and social sustainability. IFC clients' supply chain risks are highly dependent on the degree to which they can exert effective influence over their suppliers to ensure that unacceptable practices are being prevented. For projects covered by IFC's policies and Performance Standards, clients will need to have more supply chain control or leverage to minimize risks in areas where the potential for supply chain risk is high (such as in high-risk sectors and/or high-risk countries).

IFC clients may have different degrees of control over their supply chains, varying from virtually full control to a complete lack of control. Companies need to increase control in order to reduce supply chain risks and increase their positive impact on the market. As reflected in Figure B.1, gaining control means clients moving their sourcing from spot markets and unknown sources toward fixed contracts and known sources. Clients with control should use it to move suppliers in the right direction. Supply chain risk management may therefore require reorganization of supply chains, which may be a challenging but necessary element of IFC engagement to reach its goals of improving the E&S performance of its clients.

CAO has observed that current staff understanding of supply chain requirements in the Performance Standards may not be placing the necessary emphasis on clients developing a plan to gain control of their supply chains over time.

FIGURE B.1. SUPPLY CHAIN CONTROL



OBSERVATIONS

Based on CAO casework and interviews with IFC staff, CAO notes inconsistencies in the understanding of supply chain requirements in the Performance Standards, and the perception that requirements may limit investment opportunities in clients with high-risk supply chains. Specifically, CAO has observed that:

1. THERE IS AN INCONSISTENT UNDERSTANDING OF THE REQUIREMENTS FOR THE IMPLEMENTATION OF PERFORMANCE STANDARD 1 WITH REGARD TO SUPPLY CHAIN CONTROL.

The importance of reviewing the client's identification of third-party risks, including supply chain risks, as part of IFC's due diligence process is well recognized in IFC's Policy on Environmental and Social Sustainability, and in the Performance Standards (PS1, PS2, PS6).¹ PS1 articulates the importance of supply chain risk analysis and management across the breadth of a project's impact.² PS2 and PS6 provide specific language on third-party risks. PS2 addresses child labor, forced labor, and safety issues in the supply chain, and addresses the client's supply chain control. PS6, on protecting areas with natural or critical habitats, contains a similar clause on shifting supply chains to "suppliers that can demonstrate that they are not significantly adversely impacting these areas." However, in spite of the clear commitment IFC has made in this language to reduce supply chain risks, challenges remain in how staff and clients are implementing the Sustainability Policy and Performance Standards.

PS1 sets the expectation that supply chain analysis will be conducted in a manner that is "commensurate with the client's control and influence over

1 "IFC, as part of its own due diligence process, will review clients' identification of third-party risks, and will determine whether such risks are manageable, and if so under what conditions, so as to create outcomes consistent with the Performance Standards. Certain risks may require IFC to refrain from supporting the proposed business activity" (IFC Policy on Environmental and Social Sustainability, page 5).

2 Para. 9 states: "In the event of risks and impacts in the project's area of influence resulting from a third party's actions, the client will address those risks and impacts in a manner commensurate with the client's control and influence over the third parties, and with due regard to conflict of interest." Para. 10 states: "Where the client can reasonably exercise control, the risks and impacts identification process will also consider those risks and impacts associated with primary supply chains, as defined in Performance Standard 2 (paragraphs 27-29) and Performance Standard 6 (paragraph 30)."

the third parties” and that it is relevant “where the client can reasonably exercise control.” As highlighted in a CAO case related to IFC’s investments in Wilmar Group, the conclusion being drawn by staff from this formulation is that a client that does not have control over its supply chain would not need to analyze and manage its supply chains. This may lead to results that are contrary to IFC’s policies and PS1, which clearly states “where the client can reasonably exercise control” and not “is controlling today.”³

On the basis of PS1, the client can, and should, be required to reorganize its supply chains toward more control, and less risk, over time. This potential need for clients to develop less risky supply chains is well-articulated in PS2 and PS6, as outlined above, and is similarly recognized by other frameworks, such as the UN Guiding Principles.⁴

2. DIFFERENCES IN UNDERSTANDING OF HOW TO IMPLEMENT SUPPLY CHAIN CONTROL REQUIREMENTS MAY REDUCE IFC’S ABILITY TO IMPROVE CLIENT CAPACITY FOR GREATER SUPPLY CHAIN CONTROL.

Large companies with sufficient resources and dominant market positions will generally have the capacity to reorganize their supply chains. Good examples of this can be found in the agro-food sector, where companies such as Unilever and Nestlé have focused on supply chain control through direct sourcing of their inputs (including coffee, cocoa, milk, and tea) from farmers, often in close cooperation with certification organizations such as Rainforest

3 The Wilmar-3 compliance investigation report notes: “... a lack of control and influence over a supply chain would excuse the client from the requirement to analyze or mitigate its supply chain risks. This leads to a paradoxical situation whereby an IFC client’s supply chain analysis requirements may become lower as supply chain risks increase. In CAO’s view, this approach is not in line with good international industry practice (GIIP), which would require analysis of the supply chain as an initial step, followed by a risk identification exercise, and engagement to identify options to exercise control or adapt the supply chain to better manage E&S impacts and risks. In this context CAO notes clarification of the supply chain requirements under the 2012 Performance Standards may be beneficial.” Compliance Investigation IFC Investment in Delta-Wilmar, Complaint 03, March 8, 2016, pg. 32.

4 UN Guiding Principles make this point very clearly: “If the business enterprise has leverage to prevent or mitigate the adverse impact, it should exercise it. And if it lacks leverage there may be ways for the enterprise to increase it. Leverage may be increased by, for example, offering capacity building or other incentives to the related entity, or collaborating with other actors.” Guiding Principles on Business and Human Rights - Implementing the United Nations “Protect, Respect and Remedy” Framework, UN Human Rights Office of the High Commissioner, New York/Geneva, 2011, p. 22.

Alliance. Where direct sourcing is not an option (for example, palm oil and soya), they have taken the lead in setting up global commodity roundtables and certification systems, including chain-of-custody certification.⁵

Smaller and less-experienced companies with more restricted resources will often have greater difficulties in effectively changing their supply chains. However, there may be options to do so in cooperation with other companies, certification bodies, public organizations, and nongovernmental organizations (NGOs) that can provide both the needed knowledge and market influence. There are examples in the agro-food sector of these types of mutually beneficial partnerships between larger and smaller players. One example is a small producer of fruit smoothies that sources second-class fruit from a processor that also delivers first-class fruit to a large multinational. The smaller company initiated cooperation with the processor and the multinational to organize sustainable fruit supplies to the processor. International training and partnership programs for supporting growers, organized by large retailers, food companies, international industry associations, roundtables, and NGOs, often provide similar opportunities for smaller companies and farmer organizations.⁶

It is clear that having no control or leverage today does not exempt clients from the obligation to control their supply chains in the near future. On the contrary, clients should do everything reasonable to regain control. For IFC clients to keep a risky supply chain unchanged may endanger their profitability, lead to negative social and environmental impacts on communities, and harm IFC's reputation. IFC should therefore work with its clients to build the capacity needed to create better supply chains. There is also the potential for IFC to work effectively as a broker, linking low-capacity clients to organizations, platforms, and initiatives with relevant knowledge and influence.

5 See, for example, Jason Potts et al., *The State of Sustainability Initiatives Review 2014 – Standards and the Green Economy*, IISD, Winnipeg, 2014; International Trade Centre, *The State of Sustainable Markets – Statistics and Emerging Trends 2015*, Geneva, 2015.

6 See *A Practitioner's Guide for the Sustainable Sourcing of Agricultural Raw Materials*, 2013, especially Chapter 6, "Implementing Sustainability Standards in Your Company's Supply Chain."

3. THERE IS A PERCEPTION AMONG IFC STAFF THAT SUPPLY CHAIN RISK ANALYSIS HAS INHIBITED INVESTMENT IN CLIENTS WITH HIGH-RISK SUPPLY CHAINS, AND MAY CONTINUE TO DO SO.

In interviews conducted around this supply chain work, CAO noted a concern among some IFC staff that IFC's supply chain-related policies (mainly developed as a response to problems with palm oil supply chains) and supply chain-related clauses in the Performance Standards make it difficult to work with clients that have high-risk supply chains. More specifically, there is a concern that these policies and strategies potentially reduce IFC's role in major sectors and countries where supply chain challenges are complex and risks are high. IFC's Sustainability Policy provides that IFC, as part of its own due diligence process, will review clients' identification of third-party risks and will determine whether such risks are manageable (and, if so, under what conditions), in order to create outcomes consistent with the Performance Standards.⁷ The Policy recognizes that, in some circumstances, risks posed by third parties (including suppliers) may require IFC to refrain from supporting the proposed business activity.

IFC management should convey a clear message to staff that clients with high supply chain risks should not necessarily be excluded as potential partners. Rather, IFC should determine through its due diligence whether the project context provides a vehicle for IFC to work with these clients on analyzing and mitigating such risks. This will likely include measures to reorganize supply chains in a way to improve the client's leverage and control over its suppliers.

⁷ IFC Policy on Environmental and Social Sustainability, para. 23, 2012.

RECOMMENDATIONS

1. IFC MANAGEMENT SHOULD PROVIDE CLEAR GUIDANCE TO ALL STAFF INVOLVED IN THE IMPLEMENTATION OF THE SUPPLY CHAIN PROVISIONS IN PS1 AND RELATED PERFORMANCE STANDARDS.

- **Activities:** CAO recommends that IFC provide better guidance to staff on the implementation of the supply chain clause in PS1, especially with respect to the client's actual and potential leverage in its supply chains. The text in the guidance should emphasize that, in case of deficits in a supply chain that the client insufficiently controls, working with the client to improve/reorganize its supply chain is the first priority. The guidance should also make clear that the supply chain requirements formulated in PS1 equally apply to areas not explicitly addressed in PS2 and PS6. A draft proposal for content of this guidance is included in Box B.1, and should be discussed by IFC management and relevant experts.
- **Responsibilities:** This work should be based on existing expertise in IFC. CAO proposes that the language outlined in Box B.1 be considered during the drafting of this guidance.
- **End Result:** A clear and consistent set of guidelines for implementing supply chain requirements in PS1.
- **Target Audience in IFC:** Environmental and social specialists in all sector departments who do not have supply chain expertise, and any new E&S staff who will be required to assess and implement supply chain requirements as outlined in PS1.

BOX B.1. PROPOSAL FOR STAFF GUIDANCE ON PERFORMANCE STANDARD 1

With regard to managing third-party risks (including supply chain risks), Performance Standard 1 states that “the client will address those risks and impacts in a manner commensurate with the client’s control and influence over the third parties....” Furthermore: “Where the client can reasonably exercise control, the risks and impacts identification process will also consider those risks and impacts associated with primary supply chains ...”

CAO suggests that IFC incorporate the following elements, at a minimum, in updated guidance to IFC staff: The client should provide relevant information on its supply chains and potential risks, if any, in them. Clients that lack supply chain control should also be required to analyze the risks caused by this lack of control. IFC’s due diligence should determine whether the client has the knowledge, capacity, and motivation to do this properly and is taking the right actions to minimize its supply chain risks. IFC staff should assess how these risks might affect the potential development impact of the project.

- If there are no relevant E&S risks in the client’s supply chains (considering the industry sectors, regions, etc.), the process of further assessment/mitigation measures may not be necessary.
- If there are relevant E&S risks in the client’s supply chain(s), and the client has a high level of control (through long-term contracts, etc.), IFC should assess whether the client is effectively managing those risks. If not, the Environmental and Social Action Plan (ESAP) should include steps to work toward better risk management.
- If there are relevant E&S risks in the client’s supply chain(s), and the client is not sufficiently in control (no long-term contracts, many rapidly changing suppliers, buying from spot markets, etc.), there are two potential responses:
 - If there are options to reorganize the client’s supply chain, leading to better control and enabling the client to manage its supply chain risks, the ESAP should contain steps toward this reorganization. In addition, the ESAP should contain steps for implementing effective risk management of the reorganized supply chain.
 - If it is unlikely that the client can realize better control over its supply chain and supply chain E&S risks appear to be considerable, IFC should consider refraining from working with the client on the envisaged project.

2. IFC STAFF SHOULD BE PROVIDED WITH INFORMATION AND TRAINING ON THE BASIS OF THE UPDATED GUIDANCE AND ITS IMPLICATIONS FOR EFFECTIVE IMPLEMENTATION OF THE PERFORMANCE STANDARDS.

- **Activities:** On the basis of the updated guidance, IFC should organize a seminar or workshop for staff on practical implementation of supply chain-related requirements in IFC's Policy and Performance Standards.
- **Responsibilities:** Those IFC staff responsible for drafting guidance would provide training on the guidance updates.
- **End Result:** The training would enable IFC staff with expertise in supply chain management to share their expertise. Staff without supply chain expertise will become more knowledgeable about the supply chain expectations within the sustainability framework.
- **Target Audience in IFC:** Participants would primarily be E&S staff, with broader training for any relevant investment staff, as identified by E&S and investment managers.

3. AS PART OF THE NEXT CONSULTATIVE PROCESS FOR REVIEW OF THE PERFORMANCE STANDARDS, IFC SHOULD INCLUDE SPECIFIC GUIDANCE REGARDING SUPPLY CHAINS IN ALL PERFORMANCE STANDARDS, BEYOND THE CURRENT REFERENCES IN PS1, PS2, AND PS6.

- **Activities:** CAO recommends that supply chain-related language in PS1 and other Performance Standards should be made more consistent and easier to understand and implement. This could be done in the context of a future update of the Sustainability Framework, and through consultation. At a minimum, this revision should include supply chain-related language in PS3, PS4, PS5, and PS7, not only PS2 and PS6.
- **Responsibilities:** Senior E&S policy staff, as well as any external experts, where it is deemed relevant.
- **End Result:** Supply chain risks will be effectively incorporated into the mitigation hierarchy for each Performance Standard, with adequate guidance to staff and clients on how to implement these requirements in the client's business.
- **Target Audience in IFC:** All IFC staff and management.



**SUPPLY
CHAIN
MEMO**

**VOLUNTARY
STANDARDS AND
CERTIFICATION**



ADVISORY SERIES

SUMMARY

IFC has recognized the positive role that voluntary standards and associated certification and traceability systems can play in reducing environmental and social (E&S) risks in supply chains.¹ Voluntary standards may address many of the E&S issues that are central to IFC's policies and Performance Standards, and certification systems can contribute to effective compliance. Chain-of-custody (CoC) certification can effectively exclude unacceptable inputs into the client's supply chain, and thereby substantially reduce the client's E&S risks.

While IFC's knowledge about, and experience with, voluntary standards, certification, and traceability is growing, better understanding is needed among staff about when and how these tools can be used most appropriately. Drawing on insights from casework and interviews with IFC staff, CAO has observed the following, particularly with regard to staff without supply chain expertise:

- **Staff may incorrectly assume that IFC requirements are automatically covered by voluntary certification systems.**
- **Expectations that certification can effectively manage environmental and social risks related to supply chains may be too high.**

¹ IFC, *Building a Roadmap to Sustainability in Agro-commodity Production*, October 2013, <http://www.ifc.org/wps/wcm/connect/2fc71b0042cf55d987c5ef384c61d9f7/2013+IFC+Standards+Study.pdf?MOD=AJPERES>.

- **Staff have limited understanding of what membership in voluntary standard organizations indicates about a client’s environmental and social performance with regard to its supply chain.**
- **There is limited understanding among staff about the benefits and limitations of traceability and chain-of-custody (CoC) certification.**

To address these challenges, CAO recommends the following actions for IFC’s consideration:

- 1. Develop an internal reference system** for staff without expertise in supply chain issues that makes the following knowledge readily accessible: a comparison of voluntary standards to IFC Performance Standards; the quality and integrity of certification systems (auditing, accreditation of auditors, complaint procedures, etc.); and the quality of sectoral and regional implementation of certification systems. Where these tools already exist, they should be disseminated more widely to enable staff without expertise to flag potential issues in client supply chains on a case-by-case basis.
- 2. Conduct training workshops** on voluntary standards, certification, and traceability for relevant deal team staff who are not experts in these areas of supply chain risk analysis.

CONTEXT

VOLUNTARY STANDARDS, CERTIFICATION, AND TRACEABILITY HAVE A HIGH POTENTIAL FOR REDUCING THE E&S SUPPLY CHAIN RISKS OF IFC'S CLIENTS IF THEY ARE UNDERSTOOD AND USED APPROPRIATELY IN RELATION TO IFC'S OWN STANDARDS.

If there are relevant E&S risks in the client's supply chain, IFC should work with the client in all stages of the project cycle to analyze and reduce those risks to acceptable levels, as defined by IFC's policies and Performance Standards (see Supply Chain Memos A and B). Part of this risk analysis, if utilized appropriately, can include the use of voluntary standards set by industry organizations and multistakeholder platforms, and the associated certification and traceability systems used by IFC clients:

- **Voluntary Standards:** Many voluntary standards that focus on environmental and social responsibility have been developed for forest and agro commodities (timber, palm oil, soy, aquaculture, etc.), minerals and mining, and textiles/clothing. They contain environmental and social criteria that may be similar to the requirements in IFC's Performance Standards. Many of the best-known voluntary standards have been developed or are owned by multistakeholder membership organizations (roundtables) with strong industry and civil society representation.
- **Certification:** Certification systems owned by or working on behalf of voluntary standards organizations produce—on the basis of their audit and inspection rules and methodologies—certificates that claim to guarantee compliance with the social and environmental requirements set by the voluntary standard. IFC clients may opt to source some inputs from certified sources only, thereby potentially reducing E&S risks in their supply chains.
- **Traceability:** Traceability is an important method for reducing E&S risks in supply chains. Traceability is suitable when the buyer of a certain input needs a guarantee that this input is coming only from acceptable sources. Most certification systems based on voluntary standards contain options for certifying traceability along the supply chain, most often called “chain-of-custody” (CoC) certification, with different degrees of traceability precision, ranging from Identity Preserved (IP) Certification to less precise systems, such as Mass Balance. IFC clients that require a high degree of traceability of their suppliers may be in a stronger position to significantly reduce their supply chain-related risks.

While voluntary standards, certification, and traceability have a high potential for reducing client E&S supply chain risks and contributing to a general market push toward sustainability, this can occur only to the extent that the standards are sufficiently high, certification systems effectively exclude noncompliance with standards, and traceability systems allow commodity or product flows to be accurately followed through complex supply chains. There is no certainty that this will be the case. Much depends not only on the standards themselves, but on the quality of implementing certification and traceability systems, including the quality and credibility of certification/verification and the auditing methods used to assess compliance.

OBSERVATIONS

Within IFC, there are staff members with high level of expertise on topics associated with voluntary standards, certification, and traceability. Nevertheless, on the basis of CAO compliance cases and interviews with IFC staff, CAO notes that nonspecialist staff members lack sufficient understanding of both the possibilities and the limitations of using voluntary standards, certification, and traceability systems. Specifically in relation to these staff, CAO has observed that:

1. Staff may incorrectly assume that IFC requirements are automatically covered by voluntary certification systems.

On many supply chain issues, voluntary standards and related certification systems set equal or even higher standards than IFC. However, requirements related to other issues, depending on the voluntary standard used, may be entirely or partly missing, or lower.

2. Expectations that certification can effectively manage environmental and social risks related to supply chains may be too high.

While certification on the basis of voluntary standards systems is an indication of potentially reduced E&S risks, it is not a guarantee of compliance with IFC's own policy requirements. Certification systems may not sufficiently guarantee compliance with their own voluntary standards and/or the standards may not be sufficiently high. In CAO's experience, this may not be fully understood throughout the IFC organization. Emphasis should be placed on IFC's own responsibility for assessing E&S risks, even in situations where the client's supplies/supply chains have been successfully certified.

3. Staff have limited understanding of what membership in voluntary standard organizations indicates about a client's environmental and social performance with regard to its supply chain.

Through their membership in organizations that set voluntary standards, such as the Roundtable on Sustainable Palm Oil (RSPO) or Forest Stewardship Council (FSC), companies may signal their commitment to environmental and social sustainability. CAO has observed that it is not sufficiently understood by all IFC staff that such membership does not necessarily reduce a client's supply chain E&S risks to acceptable levels. Even if the standard organization obliges its members to eventually certify all operations, members may still have several operations that are not yet certified. Roundtable membership is a first indication of commitment, but on its own does not allow for conclusions to be drawn about a client's performance.

4. There is a limited understanding among staff on the benefits and limitations of traceability and chain-of-custody (CoC) certification.

Chain-of-custody (CoC) certification can be a useful instrument for reducing supply chain risks, but the value of CoC certification is not always well understood within IFC. CAO found problematic interpretations among IFC staff about both the need for traceability and the practical barriers against traceability. For example, some staff wrongly assumed that effective risk management would require full traceability for all supplies. In reality, traceability is required for goods from problematic sources only.²

² As noted in the CAO Compliance Investigation report of the IFC Investment in Delta-Wilmar, Complaint 03, March 8, 2016, p. 32: "CAO notes that the IFC Performance Standards do not require full traceability as the basis for supply chain risk analysis or mitigation. Where full traceability is not possible, good international industry practice ("GIIP") would focus instead on forward traceability of CPO from high-risk plantations: i.e. identifying regions or individual plantations that have significant E&S challenges, and then assessing whether product from those high-risk plantations could have been feeding into the client's supply."

RECOMMENDATIONS

1. DEVELOP AN INTERNAL REFERENCE GUIDE FOR STAFF WITHOUT EXPERTISE IN SUPPLY CHAIN ISSUES THAT MAKES THE FOLLOWING KNOWLEDGE READILY ACCESSIBLE: A COMPARISON OF VOLUNTARY STANDARDS TO IFC PERFORMANCE STANDARDS; AN ASSESSMENT OF THE QUALITY AND INTEGRITY OF CERTIFICATION SYSTEMS (AUDITING, ACCREDITATION OF AUDITORS, COMPLAINT PROCEDURES, ETC.); AND AN ASSESSMENT OF THE QUALITY OF SECTORAL AND REGIONAL IMPLEMENTATION OF THE CERTIFICATION SYSTEMS.

- **Activities:** This guide should make use of current and ongoing work within IFC, complemented by external expertise as required, with the goal of centralizing and disseminating knowledge from staff with supply chain expertise to staff who have less knowledge in this area. At a minimum, it should include analysis already completed on certification systems against IFC's E&S Policy and Performance Standards, as well as regular updates by staff with supply chain expertise on the known quality of certification systems and the known quality of implementation of those systems. This guide should take into account certification systems from all IFC sectors and should be regularly updated.
- **Responsibilities:** This work should profit from existing expertise in IFC and from existing practice. For that reason, the work should be carried out with the maximum participation of internal IFC experts, assisted by external experts if needed. The resulting document should be cleared and promoted by senior IFC management.
- **End Result:** A dynamic document that assesses, for each major voluntary standard/certification system, the extent to which certification is a useful tool in assessing a client's supply chain against IFC's Sustainability Framework. This could be developed in tandem with CAO's recommendation for a "thinking steps" tool (highlighted in Supply Chain Memo A) that incorporates relevant resources for staff.

- **Target Audience in IFC:** Investment officers and E&S specialists who are not supply chain experts, as a source of information to support an assessment of their clients' supply chains. As noted in the overview, further specificity on the relevant depth of training for staff should be assessed using the following considerations:
 - Are all E&S and investment staff able to identify the potential for supply chain risk as derived from project and contextual risks?
 - Are all E&S staff able to ensure that the client has incorporated supply chain issues as part of the E&S assessment?
 - Do all E&S staff have the necessary access to appropriate expertise to review the adequacy of the client's assessment on supply chains and to incorporate actions or conditions in the Environmental and Social Action Plan (ESAP), or conditions of disbursement (CoDs)?
 - Do all investment officers have some familiarity with the types of actions and CoDs that might be necessary and appropriate for clients with high-risk supply chains?

2. CONDUCT TRAINING WORKSHOPS ON VOLUNTARY STANDARDS, CERTIFICATION, AND TRACEABILITY SYSTEMS FOR RELEVANT STAFF WHO ARE NOT EXPERTS IN THESE AREAS OF SUPPLY CHAIN RISK ANALYSIS.

- **Activities:** IFC could hold workshops on different topics, such as:
 - Voluntary standards
 - Certification and auditing
 - Traceability.
- **Responsibilities:** To guarantee maximum use of existing knowledge, the workshops could be held by experts within IFC. However, it may also be useful to include representatives of private business and roundtables, both as presenters/trainers and as participants, to bring in fresh ideas and maximize knowledge exchange.

- **End Result:** Better understanding among deal team staff of how to use voluntary standards in promoting compliance with IFC's policies and standards.
- **Target Audience in IFC:** E&S specialists and investment officers. Depending on the subject and the format of the workshop, it may be useful to have separate workshops for these two audiences. There could be general workshops covering all industrial/agricultural sectors or sector-specific workshops.

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