Responsible Outsourcing - What should we learn from Bangladesh?

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Three Inconvenient Truths

The tragedy in Dhaka has brought out the campaigners and media complaining about western consumer habits, low prices, globalisation and irresponsible retailers and brands. But three inconvenient truths are often passed by in the quest to blame the west.

- *Firstly*, the blame for this tragedy, as with most in emerging economies, lies fairy and squarely with the building/factory owner and the authorities. The ease with which the owner could bypass official permitting procedures betrays a common lack of enforcement in many emerging economies - through a combination of corruption and cultural attitudes. This can result in painfully inefficient bureaucracy, delaying permission for the simplest of tasks which could improve safety. On the other hand, a 'nod and a wink' in the right place can allow a structure to be built which even a student could have rejected on basic design criteria.

- *Secondly*, the emotive focus on garment brands is misleading. Nearly everything we buy now has some component sourced from emerging economies. But how often do we hear calls to boycott goods from China (or even cars made from Chinese steel) because the electricity in their factories comes from coal fired power stations, the coal for which kills thousands every year – China's coal mining fatality rate is ten times higher than in OECD countries. And here again we find the invisible hand of corruption is behind the human tragedies. A study in the Harvard Business Review found that 'politically connected' companies had fatality rates five times higher than other companies – because local government officials often have an economic interest in a mine and are more interested in profit than safety

- *Thirdly*, this problem will never be solved by changing western consumer habits alone, nor by increasing prices. In fact, the western consumer habit, much as one may contest its virtues on social and environmental grounds, has been the driving force behind economic growth that has take hundreds of millions out of poverty. Charging consumers higher prices would most likely fatten the wallets of the few (shareholders, factory owners, corrupt officials) but leave safety of workers in the hands of poorly trained, under resourced and often corrupt departments for permitting, inspection and enforcement. BP took the flack for Deepwater Horizon, but it wouldn't have happened if the US authorities had been regulating the offshore industry properly. Ultimately, Bangladesh is suffering from the same disorder.

Is it possible to Re-Engineer Responsible Sourcing?

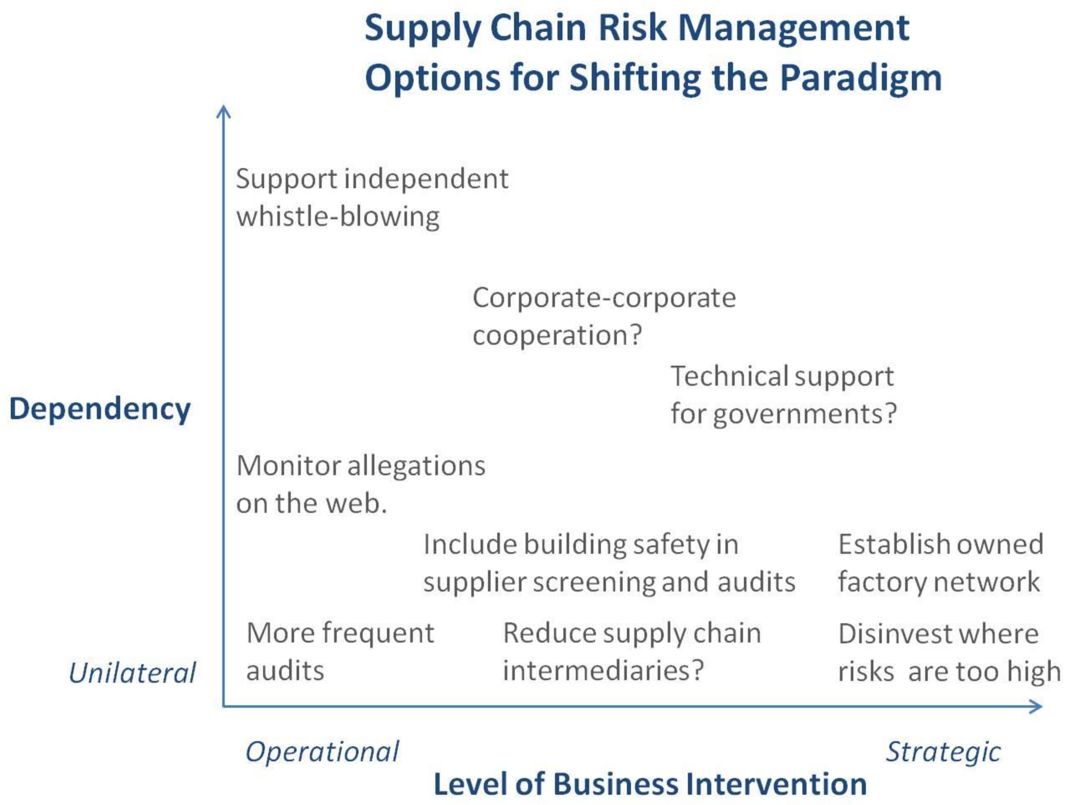
Nevertheless, for investment managers and supply chain managers, this is just the latest of a growing number of tragedies which are causing more than the odd headache at corporate HQs – Bangladesh fires, China suicides, Philippines child labour and on it goes. What, if anything, can or should be done to reduce the significant reputational and other business risks which accompany emerging economy investment? Can we re-engineer the responsible sourcing model?

We encourage managers to think of three linked chains –supply, value and risk. We think of supply chain as physical production and logistical transfer of goods. This supply chain can create value all along it as well as risks. Unless a supply chain continues to create value all along it (win-win-win) it will not be sustainable – when one link breaks, other links are exposed and threatened. Fundamental to analysing this is to be aware of and to quantify the various risks for each partner in the chain. Unfortunately, this has not been a universally understood principal, which is why supply chains are often not sustainable, either commercially, socially or environmentally. So any changes to supply chains aimed at reducing risks must also consider the operational implications and the coincidental impacts on value creation *along the chain*.

A number of themes are emerging:

- *More frequent audits*
- *Include building safety in supplier screening and audit*
- *Monitor allegations*
- *Support independent whistle-blowing*
- *Corporate-corporate cooperation*
- *Reduce supply chain intermediaries?*
- *Technical support for governments*
- *Take ownership of factories*
- *Disinvest where risks are too high*

Each of these requires different levels of investment wit different types of benefit, which will vary quite significantly between companies. Two key factors are *the level of business intervention* and the *dependency* on other stakeholders. The diagram below provides a semi-quantitative illustration of how these options might compare on this basis.



So, for example, increasing the frequency of audits is a very operational level intervention which can largely be implemented unilaterally – although suppliers will not be very happy with the prospect. Supporting industry-wide whistle-blowing networks would also be an operational level initiative, but would require the involvement and cooperation of many stakeholders, not least the acceptance of government authorities. Extending technical support for government departments (for example, to improve inspection and auditing capabilities) would be a more strategic intervention, with longer term benefits.

These options are outlined below.

More frequent audits

Some have already suggested more frequent auditing as the simplest way both to check on compliance and to re-enforce expectations, values, good working practices and relationships. Those who have been involved in supply chain audit programmes over the last 15 years know that this is not the answer.

Most emerging economy factories have become very astute at passing compliance audits through careful preparation, often involving forged permits, fabricated operational records, paid-off regulators, well briefed employees and cooperative arrangements with sub-contractors. Between audits there is typically no assurance of compliance. Furthermore, many retailers and brands tolerate all but the most serious non-compliances being identified repeatedly over many audits – to avoid the business costs and potential interruptions of delisting. Besides, many factories are already audited many times every month and would any significant increase would threaten productivity. This option would most likely increase costs to both supplier and customer with little or no improvement in assurance.

Include building safety in supplier screening and audit

It is surprising that this aspect of risk has not been a standard element of factory due diligence and compliance audits. It is self-evident to anyone who has visited industrial regions of emerging economies that most buildings are badly designed, built with low-cost materials and poorly maintained. For fire safety alone it would be prudent to make a physical assessment (not just a permit document check) – the recent collapse in Dhaka should elevate this to the top of the list for 'corrective actions' for retailers and brands.

Monitor allegations

Very few companies attempt to keep track of their suppliers' performance between audits. Traditionally, the reason has been lack of information. But increasingly, via the web, it is possible to build a picture of supplier performance in areas such as environmental pollution, health and safety, labour conditions, governance and operational control. Accidents, pollution, employee dissatisfaction, community grievances, corruption and other allegations of malpractice are invariably reported on the web by NGOs, community groups, and employees. This can provide improved supplier risk profiles and early warning of potential disasters if cumulative data are analysed over a number of years. The costs can be a fraction of auditing, e.g. less than US $20 per company for annual monitoring (see www.investassure.net).

Support independent whistle-blowing

An extension of the web monitoring concept is to use whistle blowing as a mechanism to facilitate employee reporting of poor labour conditions or other concerns about the working environment or employer responsibility. This has been standard practice within western corporates for decades. But there have been recent attempts in Asia to establish sector-wide programmes, sponsored by groups of corporates and run by independent NGOs. Unfortunately, there has been a lukewarm response by some governments to public whistle blowing. For example, inspired by *http://www.ipaidabribe.com/* in India, *www.ibribery.com* in China, drew 200,000 unique visitors in two weeks. Its anonymous posts mentioned officials who demanded luxury cars and villas; police officers who needed inducements not to issue traffic tickets; and doctors receiving cash under the table to ensure safe surgical procedures. But censors blocked access to the site for people inside China.

Nevertheless, this holds great potential and no doubt will increasingly find its way into the armoury of corporate assurance programmes for supply chain managers and investors.

Corporate-corporate cooperation

For nearly a decade now there have been industry funded schemes to share audit and related information between corporate members, e.g. SEDEX, Fair Factories Clearing House. These schemes aim to decrease the costs and business interruption of audit programmes, both for brands and suppliers alike, principally by avoiding repeat audits. Despite a large uptake, there remain many companies who are not comfortable sharing audit reports or relying on a report undertaken for a competitor.

However, there is growing support for the idea of more confidential exchange of specific supplier risk data between corporates who share suppliers and see much to gain from a larger, shared pool of risk data, rather than going it alone. The data could relate to health and safety incidents, employee dissatisfaction, environmental liabilities, or simple governance failings which raise the potential for a serious incident in future. The key to this will be mutual trust and so it's unlikely that large groups will emerge. But managers should consider forming smaller, very focused groups of like minded corporates. With a growing backlash against the apparel retail sector, it would seem that there may be more to gain for the sector as a whole than for any individual company.

Reduce supply chain intermediaries

Whereas some companies maintain close relationships directly with the factories who supply them, many other retailers work through complex tiers of primary, secondary and even tertiary suppliers, who provide a buffer between the retailer and the ultimate supplying factory. This clearly has a number of operational benefits, but it inevitably creates more scope for problems.

'Chinese whispers' syndrome can lead to a dilution or mis-interpretation of retailer ethical policies and requirements. Intermediary 'suppliers' may be less inspired and less effective at communicating ethical requirements, auditing and training factories. Factories, may not feel the same allegiance to the retailer. It can be dramatically harder to know where there are non-compliances in the supply chain. Establishing and monitoring changes to a supply chain risk profile is virtually impossible.

So there is a trade-off to be revisited between supply chain complexity, operational efficiency and risk management.

Technical support for governments

A fundamental challenge in all emerging economies is enforcement. This can be attributed to a combination of lack of manpower, lack of technical training, cultural factors and corruption. Clearly national governments must take the lead in overcoming this challenge. But corporates can play a critical role by contributing technical knowledge and experience to training programmes. This won't reduce risks overnight, but it could be a genuinely valuable element in an altruistic programme of corporate social responsibility.

Take ownership of factories

A more radical option would be to turn back the clock and see brands owning and running their own factories. It's no coincidence that companies like Procter & Gamble, who own and operate more than 130 factories worldwide, have a consistently better record of corporate responsibility than most companies that outsource. Apart from mechanistic factors such as better communications, training and corporate whistle-blowing, the key benefits are cultural. For example, financial incentives to cheat are significantly reduced. Cross-facility audit and productivity teams build co-ownership of risks and accelerate the propagation of operational efficiency gains. Competition between international facilities can provide positive incentives to improve health and safety, environmental performance, etc.

Of course, multi-product retailers can not follow this route. But on the face of it this seems an unlikely route even for brands in the apparel and consumer electronics sectors to follow; it goes against the grain of modern flexible supply chain dynamics and the race to the bottom on price. For many years, very few manufacturers have owned all of the activities along the supply chain. The ability to make rapid and accurate decisions within the supplier network can improve the competitive advantage of manufacturers.

However, there has also been a quiet switch back to more stable supply chains in recent years, in order to build loyalty and more trusting relationships, encouraging co-investment towards a longer-term sustainable win-win. We have also seen some manufacturing coming back to Europe and the USA, to reduce transport costs and to respond to market demand for local produce and more responsible sourcing. So there may well be a possibility that some brands will take steps to reclaim ownership of their supply chains.

Disinvest where risks are too high

It is a very difficult decision to delist a supplier on the grounds of non-compliance with an ethical code. Only recently have we seen examples of famous brands taking this course of action as a remedial measure. No doubt we will see more as the ethical downside of outsourcing continues to be brought to the attention of western consumers.

Nevertheless, wholesale disinvestment from a country, such as Bangladesh, seems fraught with problems and would be judged by most to be politically, economically, commercially and socially ill judged. Deciding not to do business with a militarily controlled dictatorship, such as Burma, is one thing. But when an economy has been growing rapidly on the back of globalisation and western consumer demand it would be arguably irresponsible to leave on the basis of ethical issues which could be put right with the cooperation of government authorities (the export value of the garment industry in Bangladesh has grown from $1 billion in 1985 to $20 billion in 2012, now representing about 75% of exports).

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