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Tackling modern slavery through finance

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This paper looks at the impact of modern slavery risks in investment management, what the industry can do to combat it and the approach JANA takes to ensure their investment managers are considering the risks within client portfolios.

The history of slavery and investments

Financial instruments were utilised many centuries ago to support transatlantic trade for items such as sugar, cotton and most tragically, slaves. Merchants found the trade across the Atlantic, while lucrative, was slow and unreliable. As a solution, they issued credit notes that could travel relatively quickly and safely across the seas in exchange for the 'goods' such as slaves. In addition, plantation owners borrowed money to finance their expansion by using slaves as collateral.

Fast forward a few hundred years and while such practices would be deemed as outrageous, 'modern' forms of slavery still exist in various forms along operational and supply chains.

Some have claimed that slavery was a key element in developing financial markets, such as the evolution of banking practices in both the US and the UK. Others, such as the Lichtenstein Initiative for Finance Against Slavery and Trafficking Others (FAST), will assert that it was the innovations of the financial sector that led to the eventual abolishment of slavery in the 1830s. What can be concluded is that the financial sector has an obligation to help combat modern slavery.

Contrary to some market commentary that questions if modern slavery still exists, modern slavery has an estimated worth of US$150 billion each year and occurs in every region of the world according to the International Labour Organization (ILO). The ILO estimated that on any given day in 2016, there were 40.3 million victims of modern slavery globally, of which 71% were women and girls.

Walk Free, a global organisation established by the Minderoo Foundation with a mission to end modern slavery, estimated that there were up to 15,000 victims living in Australia. Figure 1 on the next page highlights some of the key findings of research conducted by the ILO and Walk Free.

The drive to tackle modern slavery through investments

The Responsible Investment Association Australasia (RIAA) in its research: *From Values to Riches Charting consumer attitudes and demand for responsible investing in Australia*, November 2017, surveyed a small group of Australians to ascertain their interests and engagement for social and environmental issues when making decisions on their investments in superannuation and other financial products. RIAA found that 92% of the respondents expected their superannuation or other investments to be invested responsibly and ethically.

In addition, 62% responded that human rights violations were among the top three things they wanted to avoid in their investments.

Modern slavery features in the Sustainable Development Goals (SDGs) under the 2030 Agenda, which was agreed to by 193 member states at the United Nations Sustainable Development Summit in 2015. It is a commitment to eradicate poverty and achieve a sustainable world by 2030 and beyond, with human well-being and a healthy planet at its core.

Of the 17 SDGs, goal number eight is Decent Work and Economic Growth with over 10 specific underlying targets. Target 8.7 aims to:

Take immediate and effective measures to eradicate forced labour, end modern slavery and human trafficking and secure the prohibition and elimination of the worst forms of child labour, including recruitment and use of child soldiers, and by 2025 end child labour in all its forms.

The efforts of the European Union to direct private capital into sustainable finance can be seen in their Sustainable Finance Disclosure Regulation (SFDR) that utilised the SDGs as a foundation to establish and measure sustainable outcomes for investments. We can therefore expect an increased focus on private capital and investments on tackling sustainability issues such as modern slavery. Investment managers and asset owners have a significantly influential role in how global capital can be utilised to confront modern slavery risks. Increasing awareness and knowledge of modern slavery should lead to change and an allocation of capital in effective ways.

The objective of the *Commonwealth Modern Slavery Act 2018* (Slavery Act) is to reduce the "risk to people" rather than the risk to the value of investments. Notwithstanding, modern slavery risks can have impacts on reputation/brand and cause disruptions to business operations and productivity. All these can have material financial implications and therefore companies will need to manage these risks with appropriate policies and strategies.

It can be expected that companies that manage ESG risks such as modern slavery are likely to deliver better social and financial outcomes in the long run. It is also in the best interests of investors to address modern slavery risks given the overall benefits of the eradication of modern slavery through strengthened social systems on which capital markets and their investments rely.

Regulation of modern slavery in investments

The Slavery Act requires impacted entities to report on their operations and supply chains.

Thus, where an investment manager forms part of a reporting entity's supply chain as an external manager such as for an Australian reporting entity, that entity must outline how it is working with the external manager to assess the nature of the investments and ensure that the manager considers modern slavery risks when managing investments on their behalf. Consequently, most Australian managers have undertaken an assessment of modern slavery risk exposure across their investment portfolios.

The Global Slavery Index developed by Walk Free estimated that US$354 billion at-risk products are imported by G20 countries. The industries identified as having the highest supply chain risks to modern slavery are agriculture and fishing, apparel, industry construction and building materials, mining and electronics.

Modern slavery is also a risk in relation to the lending, investing, advisory and financing activities of financial services companies.

The challenge with identifying modern slavery risks in portfolios arises due to the far-reaching and complex nature of supply chains across varying sectors. It is important to keep these unique characteristics in mind when assessing modern slavery risks within each asset class exposure, and thus managing expectations of what to expect when assessing the practices of each manager. Having said that, where analysis is possible, the best practice managers are expected to go beyond a tier 1 analysis of their supply chains in analysing and combatting modern slavery risks.

Supply chains can be broken down into tiers, based on the closeness of a company to the final product or service. For example, a producer of widgets would have the contracted manufacturing facility as their tier 1 supplier, as that is with whom their biggest commercial relationship is, while their tier 2 supplier would be the business that provides the materials to the tier 1 supplier as a sub-contractor.

While the Slavery Act does not set a minimum requirement for how many tiers of the supply chain must be examined, modern slavery risks are generally found deeper down the supply chain tiers. Managers who are proactive in combatting modern slavery look beyond tiers 1 and 2 and into tiers 3 and 4, where workers could be vulnerable to exploitation. The risks of modern slavery are particularly prevalent at the lower tiers of global supply chains, particularly in developing countries where there is less regulation, oversight and/or enforcement.

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The quote

Modern slavery has an estimated worth of US$150 billion each year and occurs in every region of the world according to the International Labour Organization.

Figure 1. Prevalence of modern slavery

Source: International Labour Organization and Walk Free

The quote

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JANA's approach

JANA recognises that it can influence positive change for the millions of victims of modern slavery by explicitly engaging with managers in relation to how they factor modern slavery risk into their investment process.

Investment managers are expected, at a minimum, comply with the relevant regulations prevailing in the jurisdictions of their operations, understand modern slavery issues and risks and undertake the appropriate measures to combat those risks such as diving deeper into their supply chains. This is done as part of a wider ESG due diligence process when evaluating a manager and their investment strategy.

JANA includes a line of questioning, in relation to modern slavery risk, as part of the overall ESG due diligence process. While the ESG assessment is qualitative in nature, JANA uses a scoring framework, specific to each asset class, to assist the researchers in evaluating managers on a consistent basis and reach an overall assessment for each manager/strategy.

To support their evaluations and engagement, JANA developed a modern slavery questionnaire requiring all investment managers to complete on an annual basis. The questionnaire was developed with the objective of understanding how each manager incorporates modern slavery risks at both the organisational level and as part of their investment activities to ascertain how they integrate, engage and manage modern slavery risks.

The inaugural questionnaire was sent to all investment managers with whom JANA clients have exposures to, based on investment activities over the financial year to 30 June 2020. JANA provided the following observations from a subset of the responses:

- All investment managers domiciled in countries with explicit legislative reporting requirements fulfilled their obligation to produce a modern slavery statement.
- A few investment managers were identified as voluntarily submitting modern slavery statements, despite not being a required reporting entity under the Slavery Act. This is indicative of the importance these managers are placing on the risks of modern slavery and their commitment to combat it.
- A number of investment managers located in jurisdictions not bound by legislation stated their commitment to tackling modern slavery by adhering to the UN Global Compact Principles, which is a call to companies to align their strategies and operations with 10 principles related to human rights, labour, environment and anti-corruption.
- One equity manager developed an internal model to identify the modern slavery exposures of their investee companies. They were able to utilise the information gathered from the data as a tool for engagement where they identified potential modern slavery risks within their investee companies.
- The identification of modern slavery risks is somewhat challenging for some sub-asset classes such as securitised fixed interest and alternatives. While modern slavery risks are not entirely absent from these investments, assessment and identification is challenging. This, however, does not warrant inaction from investment managers.

The questionnaire was recently recirculated to all JANA client-exposed managers for the 2021 financial year. The responses will formulate the questions that will be asked as part of the standard due diligence and assessment. A key role for JANA is to identify those managers that are genuinely committed to adhering to their ESG and modern slavery commitments and engage with those we feel are laggards in this space.

It is challenging to identify modern slavery risks with data alone, this is where engagement is paramount.

Engagement versus divestment

Taking a rigid approach to ESG risks such as modern slavery may result in further harm as opposed to improvement. Some managers may choose to 'de-risk' their portfolios by divesting from investee companies or terminating supplier relationships, where it is difficult to confirm compliance with modern slavery regulations.

However, such divestment may not generally lead to a systemic reduction in modern slavery risks. A better outcome is when engagement leads to the changes that lessen and eventually discontinue the risks encumbered upon the most vulnerable victims of modern slavery. In effect: Engagement that deals with the crux of the issue.

Divestment would be expected to occur when engagement does not lead to any practical changes to address the modern slavery risks. In its *A Blueprint for Mobilizing Finance Against Slavery and Trafficking*, September 2019, FAST suggests that it is most effective to be clear upfront when entering new business relationships about the possibility of divestment should adverse human rights impacts be identified and unaddressed.

This type of engagement would make the possibility of divestment and exclusion more credible. There may also be some situations where the risk is so high that immediate action is warranted. Nevertheless, it must be remembered that in such cases divestment may do little to address the actual risk of modern slavery and could potentially have more far-reaching negative consequences.

Looking ahead

There are consequences that need to be thought about. Is it merely adherence to the regulations or genuine commitment to reduce and eradicate modern slavery and exploitation of human rights?

JANA believes it is important for the finance industry to work cooperatively to administer the changes necessary in combating modern slavery across investment portfolios for the benefit of our broader societies. **FS**