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GUIDE 2022

SUPPLY CHAINS

Keeping up with the pace

Perfecting Governance

IN ASSOCIATION WITH:

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Acknowledgements

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About Airmic
The leading UK association for everyone who has a responsibility for risk management and insurance in their organisation, Airmic has over 450 corporate members and more than 1,500 individual members. Individual members are from all sectors and include company secretaries, finance directors, and internal auditors, as well as risk and insurance professionals. Airmic supports members through learning and research; a diverse programme of events; developing and encouraging good practice; and lobbying on subjects that directly affect our members and their professions. Above all, we provide a platform for professionals to stay in touch, to communicate with each other, and to share ideas and information.

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CONTENTS

01 Introduction

Geopolitical conflicts, weather events, Brexit, labour shortages, the pandemic, port delays and power outages have kept supply chain disruptions firmly in the news. These supposed 'once-in-a-generation' events have taken place with increasing frequency and the impact on supply chains has been significant. Manufacturers have faced silicon chip shortages. Parents have struggled to find baby food. Hospitals have run out of respirators and personal protective equipment. In a global economy, any one of a myriad of sudden and serious supply chain interruptions with an equally disparate number of different causes can have catastrophic consequences on an organisation's ability to deliver to its customers.

How do board members identify and maintain oversight of the mission-critical elements of the organisation's supply chain whilst maintaining oversight of the immediate challenges faced by the organisation and ensuring it is developing a longer-term strategy to build resilience? What part does, should or can technology play in this planning?

At the same time, a steady stream of reports about unsafe working conditions, unsanitary food production facilities, unsustainable farming and fishing practices, and environmentally harmful extraction of energy and raw materials have placed an often unwelcome focus on the sustainability of supply chains. Also, regulators, lawmakers, consumers, employees, investors and activists are asking ever more difficult questions. New laws and regulations are being imposed, and existing ones are being repurposed, to enhance the personal accountability and liability risks faced by directors serving on the boards of organisations at the top of these supply chains.

"The challenge faced by directors in discharging their non-delegable duty to supervise a company's affairs is especially acute when it comes to mission-critical elements of the supply chain. That is due to a web of increasingly complex and unpredictable risks including geopolitical, cyber-related and reputational. This guide offers directors an opportunity to stand back and re-examine some basic but important questions."

Francis Kean – Partner, Financial Lines, McGill and Partners

01 INTRODUCTION

> "Supply chains are adapting and reshaping in response to the fast changing and volatile world we operate in. Boards are considering the risks associated with their supply chains and closely examining the cost benefits of current practice and changes which might be required to meet the purpose and strategic objectives of the organisations they govern."
>
> *Julia Graham – CEO, Airmic*

A good example is the European Commission proposals presented in February 2023 for a law on corporate sustainability obligations – the Corporate Sustainability Due Diligence Directive (CSDD). The law aims to oblige organisations to carefully manage social and environmental impacts throughout their supply chains, including their own business operations. It goes well beyond existing legislation at national level. In most cases, national law has a focus on specific human rights violations, such as in the UK where it is aimed at modern slavery or in the Netherlands where it targets child labour. The only European national legislation with a cross-sectoral approach is thought to be France's 2017 law on the duty of vigilance, which has far-reaching requirements.

The aim of this paper is to provide a toolkit to assist directors in understanding and keeping pace with this fast-changing and increasingly complex landscape of supply chain challenges. It takes the form of 12 questions designed to break the diverse set of issues down into a manageable series of topics. The list is not exhaustive and the answers to each question will vary tremendously depending on the size, maturity and nature of the organisation's operations. Nevertheless, in response to each question, we identify a range of issues which are likely to be relevant.

We also consider how well the insurance industry is responding to the supply chain challenges faced by organisations in providing relevant and meaningful solutions. There are signs that with appropriate expert input and advice, insurers are willing to take a more holistic and bespoke cross-class approach (encompassing property and business interruption, liability, marine cargo and cyber risk) to the challenges faced by large organisations. Greater data sets and more sophisticated techniques, including parametric solutions, are beginning to offer solutions to respond to rapidly changing needs.

1

How can I gain confidence, when I ask internally about supply chain exposures for the organisation, that there is a common understanding of the breadth of the issues raised among those responsible within the organisation for addressing it?

Supply chain management is the handling of the entire sequence of processes involved in the production and distribution of goods or services to end users. In a large organisation, the responsibility for this is likely to be diffuse and shared among multiple functions, including technical, procurement, legal and risk, some of which may themselves be outsourced and all of which will look at this complex issue with their own particular focus. On top of this, it is almost certain that a large organisation will be seeking to manage the environmental, social and governance (ESG) issues which supply chains throw up. If you are to exercise effective oversight of these multiple functions, transparency and communication are key. Does the organisation have an overall supply chain framework in place? Where does responsibility for its implementation sit and how is success measured?

"Brexit, Covid-19 and now the growing economic challenges are creating more supply chain challenges than ever before."

Richard James – Head of Risk, Nuclear Transport Solutions

2 Are the risks to the supply chain considered at a macro level based both on external factors as well as on the organisation's own suppliers?

Given the unprecedented pace of world events, external factors warrant closer and more constant monitoring than ever. How well resourced is the organisation to perform this function? To what extent are potential catalysts to supply chain disruption such as future pandemics factored into this process? High-level external factors which could harm an organisation's supply chain, depending on the nature of its operations include:

a. **Political** – Here the location of the organisation's customers, suppliers and the raw materials on which it and/or they rely matter. It is not simply political change and upheaval in these countries which is important, but also swings towards trade tariffs and barriers and protectionism, which can pose threats.

b. **Economic** – In 2022, we have seen some of the most extreme and adverse fluctuations in exchange rates ever to have affected the UK, as well as inflationary pressures provoked by the conflict in Ukraine and wider uncertainty, and a lack of confidence as to economic outlook.

c. **Social** – With the power of social media to amplify reaction to ethical concerns as to the organisation's conscience with respect to issues such as modern slavery and child labour in the supply chain, trouble can emerge from a clear blue sky.

d. **Technological** – Given the interconnectedness of organisations, the impact of software failure or power outage on a particular supplier could very quickly have serious knock-on consequences for the organisation.

e. **Natural disasters** – The increasingly severe impacts of global warming on climate and weather patterns can have significant impacts on an organisation's operations. The Thai floods in 2011, for example, had a huge impact on the global technology companies which had used the country as a core manufacturing base.

"There is a need to consider the macro environment to truly understand your supply chain risk."

Richard James – Head of Risk, Nuclear Transport Solutions

3 How do I identify the elements of the supply chain which, if they were to fail, would have the most severe impact on the organisation's ability to continue to deliver its core products or services?

An exercise to identify the organisation's key suppliers both by volume and by profit is a key component of operational risk management and will therefore almost certainly have been performed. Does the exercise also extend to a consideration of the organisation's main sources of profit, i.e. its key customers, with a view to the protection of the organisation's delivery promises to them in the event of supply chain disruption? Is the output from the exercise monitored on an ongoing basis or is it simply updated annually? Are you satisfied that the exercise is carried out by an appropriately qualified team coordinating input from finance, IT, operations and risk management?

> "Organisations need to consider conventional outsourcing models and stress test these to ensure they are positioned to respond to change with agility, as part of enterprise-wide good operational resilience practice."
>
> *Julia Graham - CEO, Airmic*

4 How do I satisfy myself that appropriate contingency plans are in place should there be a critical failure in the organisation's supply chain?

The task of assessing risk within the supply chain will be delegated downwards from the board and perhaps outsourced as is permitted, for example, by the Financial Conduct Authority in the UK. How is board oversight maintained in these cases? There can be a tendency to look inwards at an organisation's capabilities and its risks instead of looking at the whole value chain.

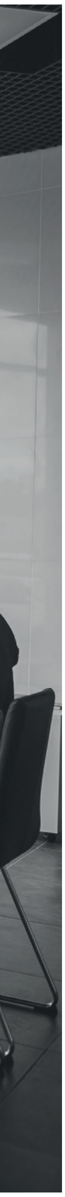
Most organisations will have in place crisis management plans addressing contingencies in the event of key supplier failure. These may range from the release of additional funds for more expensive temporary replacements to possible short-term support from third-party providers or even from competitors. Relevant questions which directors may wish to ask include:

- How are contingency plans kept up to date?
- Do the plans address not simply sudden and total disruption to the supply chain but also gradual but also gradual and potentially equally serious shortages in critical components?
- Is there sufficient linkage between the management of relevant risks and the need to secure the organisation's mission-critical objectives.
- Is the focus too internal?

5

How does the organisation decide, with respect to key suppliers, how far down their supply chain to assess the supply chain risks faced by them? Is it necessary to look all the way back to the relevant raw materials?

There is no easy answer to this question. Many organisations have little idea as to the full length and complexity of their supply chains and, indeed, it may be impractical to conduct such an exercise. This may be why, in a survey conducted by EY of 200 senior-level supply chain executives in late 2020, visibility in the supply chain was seen as the key priority over the next three years. A shift from linear supply chains to more integrated networks may be part of the answer. And technology is a key enabler of this, with devices or sensors (part of the Internet of Things) able to provide valuable data as to both the location and the condition of goods in the supply chain. A distinction needs to be drawn between utilising digital technologies and creating autonomous digitised supply chains which require connected technologies across planning, procurement, manufacturing and logistics. Does the organisation have a strategy to become digital?



6 To what extent, if at all, does the organisation consider supply chain risk collaboratively with its key suppliers? Or is this purely an internal-facing exercise?

In the event of the serious disruption of a key supplier's ability to deliver mission-critical components or services, a collaborative approach to problem-solving based on mutual trust and common goals is likely to yield better solutions for the organisation than the threat of litigation. To what extent does the organisation invite its key suppliers to be involved in its contingency and disaster recovery planning to propose workable solutions to avoid or minimise disruption? Has the organisation sought to integrate its key suppliers into its contingency and disaster recovery planning to the extent appropriate? Digital technologies can also facilitate virtual collaboration through the increased use of automation and investment in artificial intelligence and machine learning. To what extent do these technologies form part of the organisation's supply chain strategy or framework?

7. How is the risk assessment of IT outage, cyberattack and data breach integrated with the organisation's approach to supply chain?

The organisation's own internal IT security policies and procedures can be used as a base to set minimum controls and business continuity standards for key suppliers (see the second in this series of Airmic Boardroom Guides). Larger organisations with their own information security teams and threat intelligence capabilities also have a role to play in monitoring trends and events that might cause disruptions in the supply chain. They may also operate a formal cyber supply chain risk management process (C-SCRM) involving the identification, assessment and mitigation of the risks associated with the distributed and interconnected nature of ICT/OT product and service supply chains, covering the entire life cycle of a system (including design, development, distribution, deployment, acquisition, maintenance and destruction). If not, how are these risks monitored and assessed?

It is worth noting when considering cyber and technology risk that the supply chain not only encompasses physical suppliers, but also any and all technology vendors whose products and services are relied on to run the organisation's IT/OT network.

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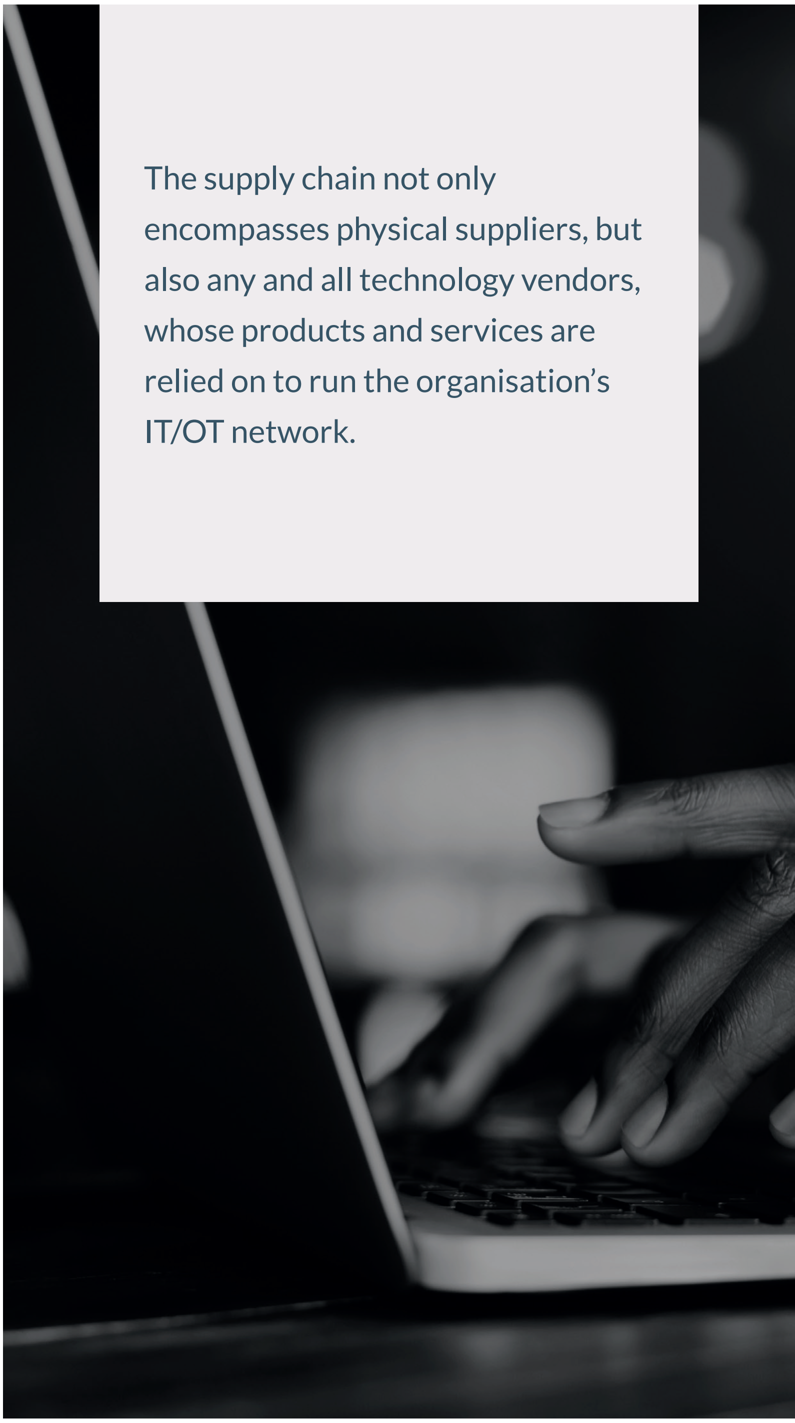
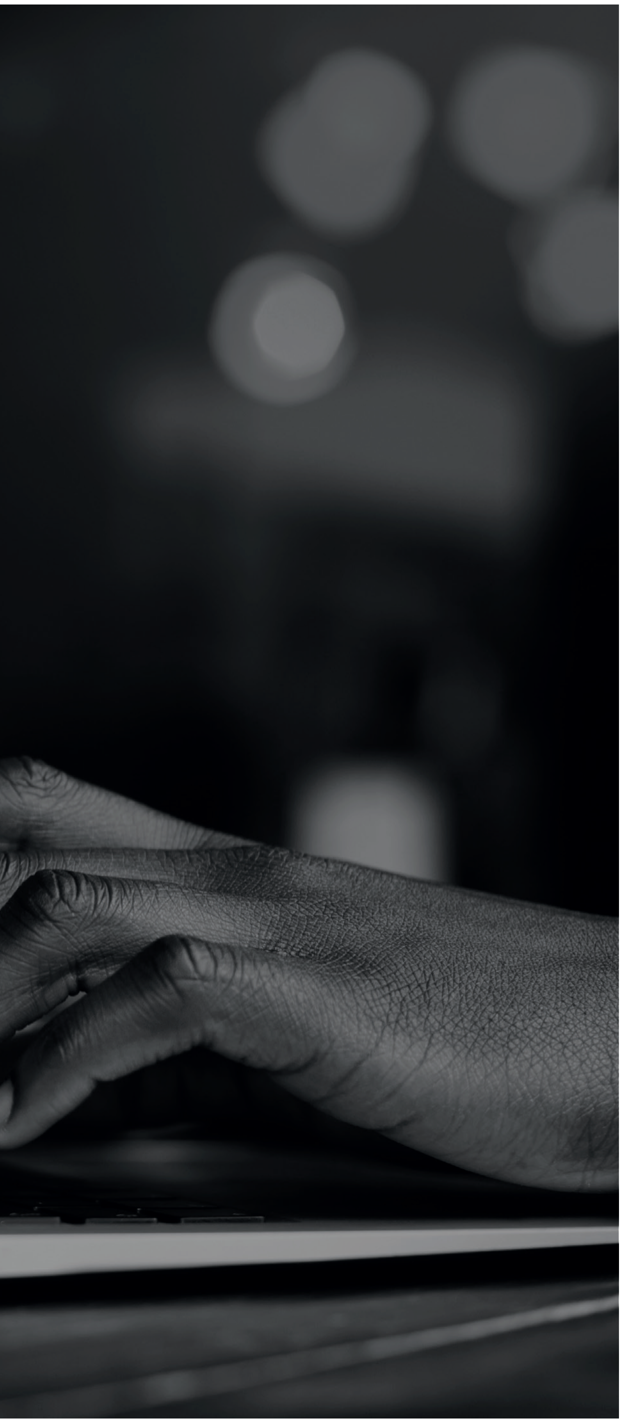




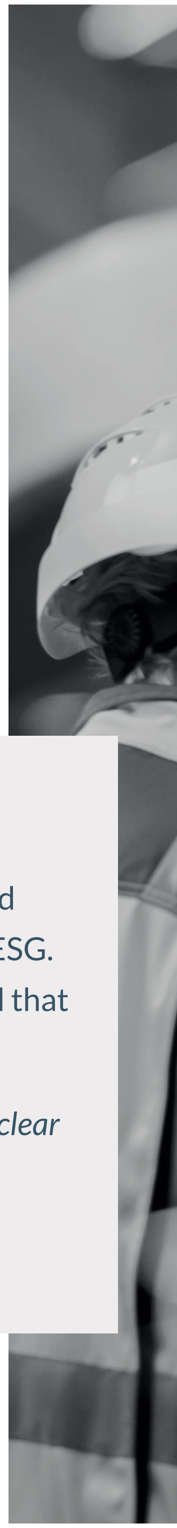
8 How do I gain an understanding in those jurisdictions in which the organisation operates of the extent to which it may be held legally accountable for the behaviours of its suppliers and subcontractors?

This is a challenging question for any organisation with large and complex supply chains. By way of example, since 2018, Articles 28 and 29 of the General Data Protection Regulation (GDPR) have required data controllers to manage the processing of personal data throughout their supply chains. Organisations are required to identify new suppliers of data processing services and assess whether their security controls are equal to or greater than those of the organisation. From 1 January 2023, a new Supply Chain Act will come into force in Germany requiring large organisations to conduct supply chain due diligence to identify, prevent and address human rights and environmental abuses within their direct suppliers' operations. Looking ahead, at EU level, a wide-ranging new Supply Chain Directive has been proposed which would apply across the entire value chain of larger organisations. Additionally, separate legal and regulatory frameworks may also apply in different jurisdictions to organisations within vital sectors such as utilities, healthcare, transport and digital infrastructure. You may wish to seek assurance that the organisation is receiving appropriate and regularly updated legal and other expert advice in this area.

9 To what extent do the organisation's statements and commitments on ESG match those of its key suppliers of goods and services?

At one level, this may be a case of ensuring that the organisation's publicly stated and/or contractual commitments conform to those of its suppliers, but it requires the organisation to take steps to seek to ensure that its key suppliers practise what they preach at least as effectively as the organisation itself does. So, for example, a large clothes retailer employs a structural engineer to visit the factories and workshops of certain of its key suppliers to ensure that they are built and maintained to a standard that adequately protects the workforce. Whilst this kind of cost may be difficult to justify depending on the size of the organisation and the length and complexity of the relevant supply chains, from a board oversight perspective, it is important to ensure that due consideration is given to the feasibility of this type of monitoring of the ESG-related components of the supply chain. The reputational risk to an organisation of serious ethical failings within its supply chain are potentially as severe as the organisation's own failings in this regard. As with the risk of supply chain interruption, visibility is key. With that in mind, how well does the board understand the environmental and social implications of the way the organisation's products are produced and consumed? For example:

- Are labour conditions in the supply chain fair and ethical?
- Have the suppliers provided for their products' recycling or safe disposal?
- What are suppliers' plans to reach net zero carbon emissions? Are they realistic?
- To what extent are operational practices of suppliers driving inclusion and sustainability?



> "Your reputation can be affected by your supplier's approach to ESG. There is a future need to embed that into your assurance approach."
>
> *Richard James – Head of Risk, Nuclear Transport Solutions*

10 What are the organisation's responsibilities under the Modern Slavery Act, with regard to its supply chains?

Section 54 of the Modern Slavery Act 2015 (MSA) requires that any commercial organisation operating in the UK with a global turnover of £36 million or more must publish a slavery and human trafficking statement each financial year, setting out the steps taken to ensure that there is no human slavery or human trafficking in its business or supply chain.

This includes any limited company or partnership which supplies goods or services. Turnover for the purpose of the MSA includes the income of any subsidiary company, whether in the UK or not.

The term 'supply chain' is not defined in the legislation. The Government guidance document 'Transparency in Supply Chains' says that the term "supply chain" has its "everyday meaning".

"Doing the right thing and showing you care are two of the most important behaviours of any responsible business. Sadly, people and organisations often unknowingly rely on the misery of modern slavery for their success. Be inquisitive, don't walk by. Your reputation will depend upon your behaviour and the behaviour of those you do business with."

John Ludlow – Airmic member, and member of the BS 25700 committee on modern slavery

(BS 25700: Organizational responses to modern slavery - Guidance: www.bsigroup.com/en-GB/standards/bs-25700/)

11 What other forms of insurance could be relevant to supply chain risk?

Product liability cover, as the name suggests, is designed to protect an organisation from third-party property damage or bodily injury caused by products or goods supplied, sold or manufactured. The impact on supply chain pressures to an organisation's exposure to product liability losses can be multifaceted. Reconfigured supply chains could mean an organisation has limited line of sight on due diligence and quality assurance from an outsourced supplier. Navigating territories in which there are reduced levels of manufacturing regulations can also pose product liability challenges. All of this may have an unexpected impact on the quality and safety of a final end-product to a customer.

Closely aligned to product liability is product recall coverage which can also play an important role, offering protection to an organisation in respect of third-party recall and replacement costs, loss of revenue and crisis management costs. The automotive and electronics industries, for example, have recently seen significant increases in recalls within their sectors as they battle supply chain challenges against customer demand.

Cargo and freight insurance, in respect of transport risks in the supply chain, can also be a valuable way both of protecting the organisation's balance sheet and permitting it to reimburse customers or B2B partners for either lost freight or missed delivery deadlines. Depending on the nature of the cause of the disruption, cyber insurance may also help address both third-party liabilities and the organisation's own losses. Finally, D&O insurance could also be a form of last resort insurance in the event that the board has to face claims based on alleged failings in preventing the organisation from suffering serious supply chain related losses. Both of these classes of insurance are covered in the first and second in this series of Airmic Boardroom Guides.

12 To what extent can business interruption insurance provide effective mitigation of the supply chain risk?

Virtually every organisation will have property insurances covering fire, flood and other forms of physical loss or damage. The number of insured perils can vary or be expressed to apply on an all-risks basis. Cover for business interruption as a consequence of such losses impacting an organisation's key suppliers can be included in these policies. It should be noted that a significant limitation on business interruption cover in most policies is the requirement for a link to some form of physical loss suffered by the policyholder. Moreover, the extent of business interruption cover available for the consequences of these types of loss can vary significantly. Key considerations include the length of the period covered, the method by which relevant losses are calculated, whether the cover includes business interruptions suffered by all suppliers (or for example 'first tier' suppliers only) and whether it is provided on a named and/or unnamed basis. There is scope in the global (re)insurance market to tailor bespoke solutions for larger risks. Developments in parametric (re)insurance can potentially be used to index and respond to the impact of an event in an organisation's supply chain even without the traditional physical damage trigger referenced above. However, the availability of information on an organisation's supply chain exposure is critical in terms of developing meaningful coverage and capacity. The question as to the extent of effective balance sheet risk transfer to insurers of supply chain failures is a complex one. Are you satisfied that the organisation has sought appropriate advice and has kept track of developments in this space?

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