BUSINESS MODEL RED FLAGS

A TOOL FOR FINANCIAL INSTITUTIONS TO EVALUATE HUMAN RIGHTS RISKS IN PORTFOLIO COMPANIES' BUSINESS MODELS

*Shift*

THE CHALLENGE

INVESTORS AND LENDERS MAY BE MISSING A KEY SOURCE OF RISK IN THEIR PORTFOLIOS, AS WELL AS THE OPPORTUNITY FOR MORE SOPHISTICATED, EFFECTIVE ENGAGEMENT. A BUSINESS MODEL LENS CAN HELP.

Investors and lenders traditionally **assess risks to people** by focusing on geographic and industry risk. In some cases, that can create **blind spots** in their portfolios, by missing key risks to people that are hardwired into a company's **business model**. This is particularly relevant for companies operating across sectors, trying new or adapted business models, and/or operating in sectors that traditionally escape social scrutiny: for instance, a company with positive environmental contributions that may nonetheless be wired in ways that create risks to people.

Business model risks to people can be present even in companies that score well in traditional assessments of human rights policies and processes. And when business model risks are unaddressed by companies, their operational, reputational and even financial success can be threatened, in turn posing risks for investors and lenders.

When it comes to **engagement** with portfolio companies, too often conversations focus on a single controversy and policies or operational-level processes designed to address it. Without a robust consideration of whether the **business model might be a root cause**, the investor or lender **misses the opportunity** to discuss with the company the commercial drivers that might be behind an incident and the on-going risk they might represent. There is also a missed opportunity to connect the dots to **other companies in the portfolio with similar business model features** that risk similar issues.
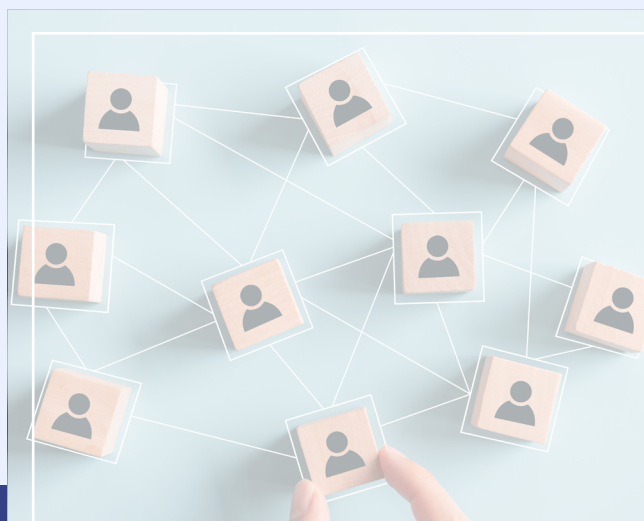
WHY A BUSINESS MODEL ANALYSIS?

By understanding how business models can fuel the conditions that result in harms to people, financial institutions can complement industry or company-specific risks, better understand the potential scale of risks and set a foundation for more insightful dialogue with companies.

Including business model risks as a dimension of analysis is not designed to generate a priori exclusions. As noted below, **the Red Flags can support investors and lenders** in prioritizing certain companies for further scrutiny across large portfolios and in developing more meaningful engagement strategies. Evidence that company leaders have created mitigation strategies to address risks to people embedded in their business model is a strong signal of commitment to responsible conduct.

A business model-level analysis can also help lenders and investors address the engagement challenges by having a more robust and effective engagement with portfolio companies on:

⊙ The commercial drivers that may be leading to harm,

⊙ The way a company's strategy or business model could incentivize or facilitate harm,

⊙ Whether the harm may be hard-wired into a company's business model, thus making it likelier to recur across a company's operations or in other parts of the portfolio.

As with any situation in which investors and lenders are connected to harms that are directly linked to their products or services by their business relationships (including portfolio companies), divestment may be appropriate where the investor/lender has tried, but proven unable to exercise sufficient influence with the portfolio company to mitigate the harm. This step will be particularly important in the case of severe human rights impacts.

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THE 24 RED FLAGS

The Business Model Red Flags (BMRF) are an interactive menu of twenty-four ways in which companies' business models can carry inherent risks to people's rights.

Each Red Flag is supported by a guidance document and focuses on three features of a business model:

VALUE PROPOSITION	THE VALUE CHAIN	THE COST STRUCTURE & REVENUE MODEL
What the company offers and **to whom**	**How** the company delivers **value**	**How** the business model is **profitable**

Speed in developing products or services, or delivering projects, with risks to health and safety.

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HIGH-LEVEL DECISION MAKING

RISK TO PEOPLE

RISK TO THE BUSINESS

UNGPs & SDGs ANALYSIS

TAKING ACTION

Such as:

• Setting extremely abridged timelines for product development in order to meet launch dates or to be first to market, for example, when undertaking rapid product development in the tech sector, leading to workers working excessive hours

• Requiring excessive speeds for the manufacture or processing of goods such as meat & poultry or other fast-moving consumer goods, impacting the safety or other working conditions of workers

• Requiring speed from workers to meet commitments made to clients, such as providing round-the-clock responsiveness to client requests in legal advice, management consultancy or other client services, affecting the family life of workers

• Providing or changing orders to suppliers with insufficient lead time for capacity planning, impacting the health, safety and wages of supply chain workers

• Placing excessive pressure on suppliers for speed in production in the lead up to events, or to meet seasonal demand, such as in the harvesting of seasonal agricultural commodities

• Expediting R&D for new or updated products/services to market, leaving insufficient time to test for potential impacts on users/customers

• Delivering construction projects with unattainable schedules or particularly inflexible deadlines (e.g. associated with large sporting events)

HIGHER RISK SECTORS

• Apparel
• Companies with labor-intensive production lines, such as beef, pork and poultry processing plants
• Tech, including start-ups pursuing rapid growth
• Fast-moving consumer goods
• Food and beverage companies
• Toy companies
• Law firms
• Management consultants, PR firms, advertising agencies, accounting firms and other client services industries
• Construction, including in the context of particularly time-bound projects such as mega sporting events

The Flags are organized into the following four levels:

LEVEL 1: OVERVIEW FOR LEADERS.

⊙ **Higher Risk Sectors** in which the Red Flag feature is most prevalent.

⊙ **Key Questions for Leaders** to ask or be asked to aid decisions about whether further action is needed.

LEVEL 2: RISK ANALYSIS.

⊙ **Risks to People:** the key human rights risks associated with this Red Flag, absent appropriate mitigation efforts.

⊙ **Risks to the business:** evidence of legal, financial, operational, and reputational risks that can arise because of companies not addressing the Red Flag.

LEVEL 3: UNGPs AND SDGs ANALYSIS.

⊙ **What the UNGPs say,** with reference to how companies might be involved with the adverse human rights impacts associated with the Red Flag.

⊙ **Possible Contributions to the Sustainable Development Goals** that can be achieved with effective mitigation or removal of the Red Flag.

LEVEL 4: RESOURCES FOR TAKING ACTION.

⊙ **Due diligence lines of inquiry** for deeper analysis of the company's impact and how it could effectively mitigate the risks associated with the Red Flag.

⊙ **Mitigation examples** illustrating how companies have in practice sought to reduce the impacts associated with the Red Flag.

⊙ **Alternative model examples** of companies that have either designed or redesigned their business model to function without the risk elements highlighted in the Red Flag.

⊙ Additional **tools** and **resources** to guide further analysis.

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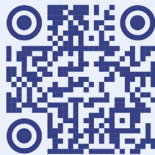
USE CASE SUMMARY

As part of the process to define and develop the indicators in this resource, we engaged extensively with investors and lenders to understand how they are using, or plan to use, the resource.

	BMRFs CAN SUPPORT INVESTORS/LENDERS IN…	EMERGING GOOD PRACTICE EXAMPLE
SCREENING	• Augmenting traditional screening strategies to include signals of awareness and action by a company on its business model risks. • Targeting enhanced due diligence where companies of diverse sectors share similar higher risk features of a business model.	A major institutional investor has used the BMRF resource to enhance its risk-based evaluation of thousands of companies in its investment universe. This was done through combining the red flags with the FactSet RBICs revenue data set that draws on company disclosures to categorize the revenue sources of 45,000 companies. By tagging each of the 24 Red Flags to FactSet's 1,600 revenue classifiers, the investor was able to bolster its methodology for identifying investee companies that are higher risk from a human rights perspective and so merit deeper due diligence.
MAKING ENGAGEMENT WITH COMPANIES MORE PRODUCTIVE AND INSIGHTFUL	Moving beyond predictable engagement interactions (in which the investor is merely referred to a sustainability policy/report or in which discussions center on isolated good practice examples or incidents) towards more insightful and productive discussions on how business leaders recognize and mitigate business model and strategy choices that have inherent risk to people.	• A US asset management firm has made reference to the BMRFs with new companies. It is engaging to mature and evolve their human rights approach and plans to integrate select Red Flags into a bank engagement initiative in 2022. • A European institutional investor selected multiple Red Flags (11, 17 and 23) to inform the organization's dialogue with the delivery and transportation sector. The investor used the Red Flags' **Questions for Leaders**, as well as **Examples of Mitigation Activities** to strengthen internal competence and so external engagement with investee companies.
BUILDING CAPACITY OF RMs/ PORTFOLIO MANAGERS AND ADDING VALUE TO CLIENTS	• Adding to the relationship managers' (RMs) toolkit when discussing social risks with clients, including concrete risks, good practice examples and due diligence suggestions. • Providing a more familiar entry-point for human rights capacity building: RMs are likely to be familiar with interrogating a company's business model as a source of increased risk.	The ESG team at a large European bank has added the BMRF resource to the bank's internal learning tool used by RMs including those that work with mid-sized enterprises. A translated version of the resource, which relates Red Flags to the bank's sector classification system, is available in this tool as well. This helps relationship managers to discuss Red Flags that are relevant for specific activities (for specific sectors) with clients.

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ADDITIONAL POTENTIAL USE CASES IDENTIFIED IN CONSULTATIONS

BMRFs CAN SUPPORT INVESTORS/LENDERS IN…

USING PROXY VOTING MORE EFFECTIVELY

Drafting proxy resolutions that move away from generalized requests for better human rights policies/processes towards requests that demand the attention of boards/executives and actually drive meaningful behavior change.

STRONGER ANALYSIS OF INCIDENTS

Diagnosing whether an incident is an outlier event or a function of a company's business model (or prevailing model in the industry). This can aid investors in both predicting the likelihood of a similar incident recurring and/or engaging portfolio companies with a focus on confronting these internal drivers of negative impacts on people and investment risk.

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ABOUT SHIFT

Shift is the leading center of expertise on the UN Guiding Principles on Business and Human Rights. For over a decade, we've worked with global companies, standard setters and financial institutions to put respect for people's dignity at the center of how business gets done.

Shift is a mission-driven organization, headquartered in New York City.

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ABOUT VALUING RESPECT PROJECT

Valuing Respect Project was a three-year project, led by Shift, to research and co-create better ways of evaluating business respect for human rights. We developed tools and insights that can help both companies and their stakeholders focus their resources on actions that effectively improve outcomes for people. Valuing Respect was generously funded by the Ministry of Foreign Affairs of Finland, the Ministry of Foreign Affairs of Norway and Norges Bank Investment Management.

valuingrespect.org