Developing Red Flag Indicators

of

Human Rights Risks in Business Models

Introduction

"'Sustainable business models' are viewed as ways of integrating societal and environmental concerns systemically into the way business is done. However, at present, typical business models are far from sustainable, which is apparent from the issues arising from current business practices. … until the pressures emerging from business models are tackled it is likely that all initiatives aimed at improving labor standards will bring only peripheral improvements."

-Ethical Trading Initiative

Business can be a powerful force for good. Enlightened businesses know that their self-interest in long-term, sustainable success is best served when their activities maximize value for the communities affected by their operations, and minimize harm. However, in 2019 a business that does well by unduly externalizing costs onto others – be they its workforce, supply chain workers, communities round its facilities, consumers or the environment – is at ever-growing risk of infringing laws, alienating customers, losing investors and squandering its social license to operate.

Investors, governments and other stakeholders – and indeed the company itself – have an interest in understanding the full risk profile of a business in order to properly evaluate its prospects for the future. In the context of human rights, the UN Guiding Principles on Business and Human Rights provide that business enterprises should undertake human rights due diligence to identify, prevent, mitigate and account for how they address their adverse human rights impacts. The Guiding Principles make clear that the scale of a company's human rights due diligence will vary in complexity, including based on the nature and context of the business operations.[1]

Developing Red Flag indicators

Human rights due diligence should incorporate an understanding of the impacts associated with the most fundamental elements of how a business is designed and run: in other words, its business model. As part of its Valuing Respect project, Shift is developing a set of Red Flag Indicators as a tool for companies' senior leadership, boards and investors, as well as civil society stakeholders, to distinguish human rights risks that are integral to different features of business

[1] UN Guiding Principles, Principle 17(b).

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models. By their nature, these risks warrant the direct engagement of the company's board, senior leadership and shareholders in the due diligence process, to understand whether and how the business model itself may be enabling or incentivizing negative human rights impacts.

A sustainable business model – in whichever context it operates – is one that is both economically viable and integrates respect for human rights into its core value proposition. The risk features of business models that make up the Red Flag Indicators do not, in and of themselves, necessitate harm to people's enjoyment of their rights. However, they substantially increase that risk. By structuring the risk into the heart of how the business works, it becomes particularly prevalent and therefore likely to represent one or more of the company's **salient human rights issues** (its most severe, potential negative impacts on human rights).[2] Moreover where risks are integral to the business model, it is unlikely that operational-level measures alone can prevent the risk from materializing. Decisions on prevention and mitigation should therefore be made at the highest levels of the company.

Most often, the potential impacts on human rights are unintended and unwanted negative consequences of economic decisions that make sense in their own terms. The company is best served by thoroughly examining, and, where relevant, acknowledging, any business benefits that are flowing to the company from the human rights impacts. In this way, the company functions in a more integrated and enlightened way, where economic thinking is not separated from human rights thinking, and where the company positions itself to respect human rights at its core. In turn, this allows the company to ensure the resilience of value propositions and strategic decisions and demonstrate the credibility of its commitment to respect human rights.

The Red Flag indicators will not be an exhaustive list of all risks associated with all business models; rather, they will cover a range of illustrative examples. They should help spark reflection and enable the identification of any additional red flags relevant to a business or industry that users are examining. Companies may also find it useful to make changes or add to the categorization of business model features, so as to better suit their company's understanding of the components of its own business model.

Some of the Red Flag Indicators being developed will be addressed in whole or in part by laws or regulations in certain jurisdictions. However, companies operate in a context of uneven enactment and enforcement of laws around the world. In order to meet their responsibility to respect human rights, companies should undertake an examination of their business model from a human rights perspective regardless of the ability or willingness of governments to regulate and enforce limits on certain practices in the markets in which they operate. This is particularly pertinent in the case of new and innovative business models, in light of the lag time that often exists before relevant laws and regulations are drafted, enacted and enforced.

[2] For more about salient issues, see "Introduction to Salient Human Rights Issues" at https://www.shiftproject.org/resources/publications/video-introduction-to-salient-human-rights-issues/

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Finally, a key ingredient to addressing impacts on people is accountability. The Red Flag indicators will not attempt to locate or create accountability measures for each of the potential impacts. However, they will clearly signal that there is a human rights risk for which the company holds some direct responsibility, and highlight the relevant questions that senior decisions makers within the company should be asking – and should be asked by their investors and other key stakeholders – in order to instill appropriate accountability for how they are addressed.

Structure of the Red Flag Indicators

There is no singular definition of what constitutes a business model, although some guidance might be found in a company's own disclosures or in legislative definitions[3]. The Red Flag indicators understand features of a business model to include those factors on which its commercial success substantially depend. Drawing from existing literature[4], the indicators will be organized according to a three-part framework comprised of a company's:

a. **Value Proposition**: "what" the company sells and "to whom" it sells. For example:
   - Offering lowest cost goods or services (pursuing a cost leadership strategy over a differentiation strategy) such that it becomes economically challenging for the company and/or suppliers to respect labor rights
   - Manufacturing or selling products that, when overused, can have adverse impacts on human rights

b. **Value Chain**: "how" the company delivers value. For example:
   - Commodities that are priced independently of how those prices affect livelihoods and human rights for local populations
   - Having business partners over whom you have limited operational control

c. **Revenue Model**: "why" the business is profitable. For example:
   - Labor relationships structured to avoid costs that come with formal employment arrangements
   - Marketing to vulnerable populations as a way to overcome market saturation in more socio-economically developed locations.

In practice, it can be challenging to strictly delineate between features that are part of the business model and those that are operational choices or practices. For the purposes of the Red Flags, where a particular business feature exists but the commercial success of the business would not be substantially affected by its removal or alteration, it is unlikely to be inherent to the business model. Conversely, where a particular way of doing business is so incorporated into the DNA of the business or the industry that abandoning it would affect the commercial success of the business, there is a strong case for considering it as part of the business model.

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For each Red Flag Indicator we are developing an illustrative list of specific manifestations of it. We are also developing supporting material that sets out more fully the nature of the human right risks, their wider implications for the business, and measures that can be taken to mitigate them. They are intended to help users move from identifying the red flag to identifying how companies can address them in their human rights due diligence. The supporting material will address the following factors:

- Heightened risk factors
- Potential effect on people
- Who is affected
- Rights affected
- Higher risk industries/ sectors/ geographies
- Risks to the company
- Guiding Principles analysis (Relationship to impact)
- Example questions to ask
- Mitigation examples
- Tools/Further Information

With regards specifically to mitigation examples, we note that current mitigation practices with respect to the Red Flags will be at different levels of maturity; moreover there will be some issues for which there are not yet leading practices with demonstrated success in addressing the negative impact on people. As practices evolve, these resources can be updated accordingly.

Consultation on the Red Flag Indicators

The Valuing Respect project team is currently testing initial drafts of the Red Flag Indicators with various stakeholder groups. We will publish a more developed draft on the project portal in Q4 of 2019 for wider stakeholder feedback. We welcome interest from anyone who would like to be directly involved in discussions of the indicators.

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