Response to consultation on the Draft Report on Minimum Safeguards (Platform on Sustainable Finance)

From Morningstar Sustainalytics

Submitted via EU Survey

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Executive summary

Sustainable investing and understanding sustainable business practices are integral to Morningstar's mission of empowering investor success.

In our response to the draft report, we mainly draw from the experience of our subsidiary, Morningstar Sustainalytics, which offers a Taxonomy solution supporting both investors (portfolios) and corporates (green bonds).

We welcome the opportunity to comment on the proposed clarification on the Minimum Safeguards (MS) and would like to focus our feedback on three elements of the draft report:

1) Human Rights criteria
2) Corruption, taxation and competition law
3) Application of the criteria to bonds

We appreciate the need to converge interpretations made on the core component of the regulation such as the MS and believe that this should achieved in a way that preserves both the usability and credibility of the EU Taxonomy.

On the one hand, we note that the first criterion proposed (due diligence processes in place) could exclude many issuers with revenues aligned with the climate-related TSC and would therefore be challenging from a usability perspective because, in the current state of the economy, aligned revenues are very scarce. This may also rule stop many green bond issuers from using the EU Green Bond standard. From a broader policy perspective, this is not desirable given the need to fund activities related to climate change mitigation and adaption and that the EU SF Action Plan is reliant on the EU Taxonomy being an effective tool.

On the other hand, the other criteria are insufficient in our view to provide insights on the actual risk of MS violations by an entity. This does not correspond to current market practice and investors will most likely not wait for the manifestation of these proxies to divest. This may raise some credibility issues for the EU Taxonomy.

We would therefore suggest to phase in step 1 of the process of human rights due diligence (i.e. adopting and embedding a commitment to HRDD into policies and procedures), strengthening the assessment criteria with step 2 to 4 over time and including controversies as a proxy for the actual outcome of the processes related to human rights, corruption, taxation and competition law, which are widely used by investors.

We would also like to point out that for external verifiers of green bonds issued by banks, the individual assessment of the entities receiving the loans poses a time-consuming and challenging undertaking, and recommend instead to allow for an assessment of the due diligence process of the bank to ensure that the loan recipients are aligned with the MS.

1. Human Rights criteria

Overall, we welcome the focus on HRDD and note that with CSRD and CSDD reporting will likely increase and become more robust (but this will take at least several years and will not necessarily improve disclosure beyond EU companies).

Regarding **the first criterion**, while we agree with the intention of the criterion, we are concerned that many companies (in particular SMEs) do not (yet) report with sufficient detail to make a sound assessment. Often companies provide general descriptions and commitments. If we would follow the suggested interpretation on Criterion 1 by making an assessment of whether the undertaking has the due diligence procedures that span all of the six steps contained in the OECD Due Diligence Guidance, most companies meeting the TSC will not comply with the MS and therefore will not eligible for Taxonomy alignment reporting and the EU GB standard.

This is problematic, because the number of companies with any alignment with the Taxonomy Climate objectives is already very low at the moment, due to the state of to the economy. Reducing that number even further by applying stringent MS rules, risks hindering the traction of the EU Taxonomy as a tool to drive capital flows towards sustainable investments.

We therefore recommend using a phased approach of the 6 HRDD steps (i.e. adopting and embedding a commitment to HRDD into policies and procedures) and a calibration according to the size and footprint of issuers.

Regarding **the second criterion**, while we understand the focus on BHRRC, NCP and court cases to identify cases where HRDD is not adequately implemented to create consistency and due to their public availability, we do believe that these assessments lead to gaps in flagging actual negative impact that companies are involved in (and which therefore indicate an inadequate HRDD implementation).

The report states that data on breaches should be generated from **sources with a high level of independence and impartiality**. As an ESG data provider we dedicate a lot of effort to identifying and vetting sources. We therefore recommend that breaches and (allegations of) violations can be assessed using a broad variety of reliable sources beyond the BHRRC and NCP sources mentioned in the report in order to avoid a strong bias against companies who receive a lot of scrutiny by the BHRRC and NCP complaints. In principle any credible allegation made should be in scope, even if it is not reported by the BHRRC or filed at a NCP. Below, we will explain why we believe the focus on BHRRC, NCP and court cases will lead to gaps in flagging actual negative impact of companies.

The report states that more work needs to be done to **identify companies which have finally been convicted in certain types of court cases on labour law or on human rights.** For (national) court cases, there are issues around accessibility, and whether remedy is available to victims is very dependent on the jurisdiction and subject to interpretation (e.g. settlements). There might also be some interpretation issue in certain country where the rule of law is weak and where court cases can be politically motivated. A final conviction in a court can also drag on over years. Therefore, there is a risk that a company can be considered MS aligned although there is indication that the HRDD approach of a company is not sufficient. In addition, in many jurisdictions companies are not facing risk of conviction for breaches of labour laws or human rights.

The report further suggests looking at the OECD National Contact Points (whether it has accepted a case, and if an undertaking refuses to engage with the party which has initiated the complaint procedure) or whether the Business and Human Rights Resource Centre (BHRRC) has taken up an allegation.

- **National Contact Points**: the OECD National Contact Points are only effectively functioning in a few developed countries (e.g. victims of human rights abuses from least developed countries face accessibility hurdles) and its proceedings take place behind closed doors rendering it ineffective for ESG data providers to analyze. In addition, the relevance of NCPs is highly dependent on how they are funded/organized by the state. It is likely that (at this moment) only a fraction of cases is brought to NCPs.

- **BHRRC**: we note that it is not comprehensively covering all allegations made since it is triggered by a subset of NGO sources and not all allegations are captured. In addition, a sole focus on a company's response to BHRRC allegations, not taking into consideration the quality of the response, risks that companies may avoid MS non-alignment by solely responding to the BHRRC allegations (but not actually taking these seriously – which is an important cornerstone of the UNGP HRDD approach).

We suggest leveraging (norms-based) controversy research in context of the MS assessment methodology which also assesses whether companies are remediating the issue. This can also be done through a flag (potential breach or similar) but there should be a place for a clear indication to investors that a company is involved in negative impacts, especially if these are severe. We would also recommend requiring more reporting from companies on whether and how they are engaging with stakeholders on providing remedies.

The report suggest that a status of non-compliance should be upheld until the company has proven, for example through an external audit, that its human rights and labour rights processes have been improved in a way that a repeat of violations is unlikely. However, as an ESG data provider we observe that in many instances audits are not a reliable tool to assess whether a repetition of a violation is likely. Instead, we would suggest to include a time frame in this criterion in which a company is not faced with similar alleged violations or controversies for a sustained period of time.

Sovereigns: We are also concerned regarding the proxies suggested for assessing sovereigns/sub-sovereigns. We agree that NHRI's play a crucial role in the promotion of human rights within a country. However, we see this proxy by itself as insufficient to assess alignment of a sovereign/sub-sovereign with MS as it could still include states that have not ratified major human rights conventions and/or are involved in severe human rights violations, including some that are alleged to be involved in crimes against humanity. The GANHRI indicator has countries in its list marked as A or B that are known to be involved in serious human rights violations. We recommend to complement the NHRI proxy with other proxies such as ratification of major human rights treaties and some sort of "criteria 2" – that would flag countries that are considered to be involved in egregious human rights violations.

2. Corruption, taxation and competition law

We recommend clarifying under which conditions '*processes have been improved in a way that a repetition of breaches is unlikely'*. Presumably, most companies that are in breach, adopt internal procedures and processes soon after convictions/controversies.

Further clarification is of particular importance in relation to the applicability of the MS to green bonds. We see certain sectors in the green bond space where several issuers have been subject to conviction for corruption, taxation or competition law breaches. A lack of clear guidance can lead to differences in interpretation as to when an entity can be considered aligned again.
We would suggest to include a time frame in this criterion in which a company is not faced with similar alleged violations or controversies for a sustained period of time.

3. **Application of the MS to bonds**

The draft mentions that banks issuing bonds that finance activities under TR, "the bank is not the undertaking carrying out the activity, but the entity receiving the loan or other form of financing is the "undertaking carrying out the activity" and should meet the respective criteria for companies or for sub-sovereigns." We would like to point out that the individual assessment of the entities receiving the loans poses a time-consuming and challenging undertaking for an external reviewer, particularly given that the loan book of banks can comprise a high number of different recipients of loans in different locations. Assessing individually all recipients of loans financed under a bond can have a significant impact on the timelines of the bond assessment and may pose barriers for banks on sharing details of their clients. Given the complexity to assess each recipient of the loans financed, we recommend instead allowing an assessment of the due diligence process of the bank to ensure alignment of the loan recipients with the MS.

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Should you wish to discuss these and other comments, please do not hesitate to contact either of us as indicated below.

Sincerely,

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