reo® viewpoint

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All eyes on the Mexican exchange

If proof were needed that sustainability is rising up the agenda in emerging markets, the proliferation of specialist stock market indices provides it. Countries following the lead of South Africa's pioneering Sustainability Index include Korea, Brazil, and most recently China, which announced the creation of a Sustainable Development Industry Index.

Next on the agenda is Mexico, whose stock exchange, the Bolsa Mexicana de Valores (BMV), is set to publish its own sustainability index in the Autumn. Elsewhere in the world, the development of such indices has proven a spur for improvements to environmental, social and governance (ESG) management by companies keen to earn the kudos of index membership; will the same prove true in Mexico?

A visit to the country by F&C in late 2010 revealed that even ahead of its publication, the process of putting the index together was serving as a catalyst for action. However, with standards lagging many other emerging markets, there is still a long way to travel.

Mexican governance – Caveat emptor

Whilst some individual companies are demonstrating good practice, in general ESG risk management practices in Mexico have not kept pace with progress in other emerging markets. Too many companies still view ESG management as a matter of basic legal compliance, rather than understanding it as a part of sound risk management.

Key issues facing investors in Mexico include:

- The continuing influence of controlling shareholders and family owners;
- The prevalence of share structures that effectively disenfranchise minority shareholders;
- Patchy management of worker safety, and tempestuous – even violent – union relations;
- Potentially costly social risks, such as resistance from communities and indigenous groups to local projects; and
- Wasteful energy and water consumption, reflecting inadequate environmental regulation.

The stock exchange acts...

F&C took these and other concerns to the **BMV**, itself a listed company, urging it to play a leadership role in 'mainstreaming' the concept of good sustainability practice amongst its issuer clients. We therefore strongly supported the development of the Sustainability Index, highlighting the ways in which Brazil's Novo Mercado and South Africa's Johannesburg Stock Exchange had achieved success in lending credibility to sound sustainability practice.

But the BMV is not getting an easy ride: many of the companies we spoke to were apprehensive, with concerns about the quality and fairness of the evaluation process. Despite an original planned launch by mid-2011, the index's debut slipped to Autumn of this year, as regulators contended with reams of new ESG data and a nervous client base.

...and companies respond

Despite the delays, the creation of the index is already proving a valuable catalyst, as companies have had to generate data on their ESG management processes, many for the first time. During our visit, we encouraged companies including **Desarolladora Homex**, the lower-income homebuilder, to publish the information they assembled in their annual corporate sustainability report.

We expect the publication of the index to lead to a wave of new and improved ESG disclosure – initially driven by the better performers, but over time attracting other players.

Pressing Walmex on supply chain risks

With its parent Wal-Mart in the front line of demands for disclosure on ESG issues, **Wal-Mart de México y Centroamérica (Walmex)**, its 69%-controlled affiliate, might be expected to be a front-runner inclusion in for the new index. But Latin America's largest retailer and private employer has faced a range of controversies, including criticism in 2008 and 2009 over alleged abuse of the system of using teenagers as unpaid volunteer packers working in stores for tips.

In our discussions, we focused particularly on labour standards and on oversight of the company's complex supply chain. Walmex had already taken action on issues such as hours of work and parental permission around its student work programmes, in line with industry standards. However, room for improvement remained in ensuring that these policies are followed in practice. We urged the company to adopt formal systems and incentive schemes to encourage store managers to take labour standards seriously. We also recommended that the company disclose summary results of its whistleblowing system, so as to demonstrate both to staff and to the public that violations of basic labour standards, including non-discrimination, are taken seriously by the company and dealt with appropriately.

As with any major retailer, Walmex also faces significant supply chain risks – particularly as it sources 86% of its products from domestic suppliers, many of which are poorly regulated. After repeated controversies and persistent engagement by F&C, Walmex has developed a new management approach that includes comprehensive inspections of social practices in its textile supply chain (where risks are highest), as well as supplier performance reporting. But gaps remain, and we urged the company to implement some of the techniques that its US parent company uses – for instance, training buyers in responsible purchasing practices.

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Labour headaches at Grupo Mexico

Labour unrest is a common problem for the mining sector, but rarely does it reach the extremes experienced by **Grupo Mexico**, Mexican-based owner of major copper operations in both Peru and Mexico. Grupo Mexico suffered a three-year standoff with one powerful union that occupied and effectively shut down its Cananea mine in Northern Mexico. Meanwhile, the company also faced a court battle with US labour unions over allegations of poor worker safety practices, which is blocking its acquisition of US copper miner **Asarco**.

Despite pushing through the Asarco acquisition and driving the rogue union out of Cananea with the help of government forces in June 2010, the company remains controversial and fresh labour relations problems remain a key risk. F&C has long urged the company to develop a human rights management system, which the company agreed to do. By late 2010, Grupo Mexico had begun the process, although its initial efforts were tilted excessively towards community development and philanthropic projects. We therefore urged the company specifically to frame its policies and systems in terms consistent with key international labour and human rights standards.

Although progress is slow, there is cause for some optimism about Grupo Mexico's commitment to managing other sustainability risks. Late last year, it followed F&C's suggestions to improve reporting on worker safety performance and, importantly, follow more stringent Peruvian mine reclamation and end-of-life standards in all Mexican mines.

Next steps

We will advocate several steps to help companies across the Mexican market move past a basic compliance approach to ESG risk management, including encouraging them to:

1. Meet or exceed the standards established by the BMV's Sustainability Index if they fail to make the cut;
2. Endorse the principles of the UN Global Compact if, like Grupo Mexico and Walmex, they have not yet done so. This would send a clear message to employees and stakeholders about their commitment to international standards like the Universal Declaration of Human Rights and the ILO Core Conventions;
3. Ensure effective relationships with labour unions. This means engaging not only with legally-recognised unions, but, in the fraught Mexican context, also the sometimes illegal parallel unions that attempt to organise workers and disrupt legitimate labour relations; and
4. Fully disclose all these efforts in annual corporate sustainability reports. Disclosure should go beyond an account of philanthropy to detail the companies' policies, management systems and performance indicators for managing ESG issues, and articulate clearly how sustainability and governance drivers are integrated into the companies' core business strategy.

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reo® viewpoint

George Dallas, Director, Corporate Governance

September 2011

F&C's approach to bonds, corporate governance and stewardship

Background

This document is F&C's policy statement on bonds, corporate governance and stewardship. It articulates how F&C approaches engagement on behalf of its reo® clients that have requested engagement on their corporate bond holdings. This document has been sent to all companies in these clients' corporate bond portfolios. It frames how long-term creditors and shareholders have similar, but not identical, interests with regard to corporate governance, and outlines F&C's expectations of good governance from the perspective of bondholders. In particular it notes that corporate bondholders have a strong interest in robust governance of ESG (environmental, social and governance) risks as a dimension of overall enterprise risk management, and encourages companies to manage these risks actively to protect their underlying credit quality and financial strength.

Stewardship beyond equities

Investor stewardship is a relevant concept across all asset classes. In particular, the role of corporate creditors in the stewardship process is a growing area of focus. F&C has been engaging companies on behalf of client bond portfolios since 2009, and in its 2010 submission to the Financial Reporting Council (FRC) consultation on the UK Stewardship Code, F&C encouraged the FRC to broaden the purview of investor stewardship to include creditors as well as shareholders[1]. This reflects the recognition that a company's bondholders and other creditors benefit from good corporate governance – and share many common interests with shareholders in promoting healthy governance practices. It is also the case that creditors can bolster investor stewardship by significantly increasing the assets under management represented by active engagement.

Creditors and shareholders: common ground

While shareholders and creditors can have different, and sometimes conflicting, perspectives on a company's governance, there is also a significant overlap of interests that supports engagement on behalf of all key financial stakeholders. A fundamental premise here is that long-term shareholders and creditors have a similar interest in the long-term sustainability of the firm.

While individual corporate bonds are issued and (usually) repaid, companies typically refinance maturing debt. As such, debt, like equity, forms a permanent part of a company's capital structure. Long-term creditors want sustainable financial performance to generate cash flows for debt service and to maintain their credit quality (and hence control the cost of debt). Long-term shareholders also want sustainable financial performance to allow for earnings growth, dividend payments, capital retention and capital appreciation.

While creditors' main rights and protections come in the rights as outlined in individual debt issues, they can have an interest in influencing companies to be healthy over the long term and not allow their credit quality to deteriorate materially. They can have influence over companies – beyond the rights as outlined in individual debt agreements – to the extent that companies want to maintain a loyal base of creditors ready and willing to provide cost-effective debt capital.

Creditors and shareholders – at least in a going concern context – have something of a symbiotic relationship. They need each other. A shareholder wants the firm to be able to access debt at a cost effective rate to fund long term and short term assets. A creditor wants a company to be able to attract additional equity capital, as required, to strengthen its solvency and financial standing. Indeed, this is called "financial flexibility" in many circles and is a cornerstone to credit analysis.

The legitimacy of the creditor in a stewardship role also reflects the reality that corporate bondholders typically are exposed to the residual risk of the firm in the event of failure; in extremis they can become shareholders even if they do not want to. The recent discussion of "bail-in" for senior bank debt reflects the ultimate fungibility of debt as an asset class on company balance sheets.

Can differing risk preferences be reconciled?

While their interests can differ – particularly as a company approaches insolvency or engages in leveraged transactions – it is the case that both creditors and shareholders want a company that has good corporate governance and good management generally. However, good corporate governance to a creditor may not be entirely the same as good corporate governance to a shareholder. Since creditors have no upside potential and face downside risks, creditors tend to be risk averse. Shareholders, on the other hand, stand to benefit significantly from a risky strategy if it is successful.

So in effect, the preferences of shareholders and creditors can be skewed with regard to risk. But companies cannot and should not avoid taking well-calculated risks to generate adequate returns for equity investors. At the same time, achieving a sustainable and fair balance of risk and reward is what is needed to attract bond investors. Achieving this balance – and ensuring it is well-communicated to both creditors and shareholders – is one aspect of how creditor and shareholder risk preferences might be reconciled.

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[1] See: http://www.fandc.com/FundNets_FileLibrary/file/FRC_Stewardship_Code_April_2010.pdf

What F&C expects from companies as a corporate debtholder

F&C's fixed income engagement focuses on those aspects of governance that reflect a company's overall risk profile – a key concern for creditors. These include:

1. **Clarity on financial policy.** Companies should be transparent to both creditors and shareholders with regard to their financial policies. Particularly with regard to creditors a company's reporting should include a policy statement on the use of debt and the level of credit quality the company wishes to manage itself to. It is not wrong per se for a company to pursue a risky strategy involving debt finance. But this strategy should be clear to both existing and prospective debt investors so that it can be reflected both in pricing and the fundamental investment decision.
2. **Risk management.** The company's risk management and risk governance are fundamental concerns for both creditors and shareholders. This certainly relates to basic internal controls, but also to risk management in the broadest enterprise-wide context – incorporating financial, operational and reputational factors. In this context, environmental, ethical and social factors can present significant risks to the company and its investors. F&C expects corporate debt issuers to take a broad and rigorous approach to risk management, and that the company's board attaches significance to risk management to promote the long-term health and sustainability of the firm. The unfortunate examples of BP in the Gulf of Mexico and Tepco's nuclear meltdown demonstrate that environmental, health and safety risks can significantly affect the interests of both creditors and shareholders.
3. **Board effectiveness.** Bondholders want boards to be aware of creditors' interests, and to demonstrate appropriate regard for maintaining and building the long-term financial health of the firm. Creditors also want strong and effective boards that are able to oversee company management and provide appropriate checks and balances to prevent abuse. For controlled companies creditors want a strong board to protect them from controlling shareholders whose interests may not be aligned with either minority shareholders or creditors.
4. **Audit process.** A particular focus of creditors is a robust audit process, including an independent audit, appropriate accounting policies and high standards of transparency and disclosure in financial reporting.
5. **Remuneration.** Performance metrics reflecting a company's own financial strength and stability can and should be reflected in company incentive structures. Such metrics can include relevant environmental, social and governance metrics and feature as a components of a balanced scorecard guiding annual bonus awards. Or they can also be used as an underpin, or precondition to bonus awards. For example, F&C reached out to many banks globally in 2011 to encourage remuneration committees to establish a credit risk underpin for incentive awards [2]. This is an example of how creditor and shareholder interests can be combined in remuneration consultations with companies.

Not all governance issues have the same relevance for creditor – for example dilution is an important concern for shareholders and typically is not a serious issue for creditors. But in many, if not most, areas of corporate governance the interests – at least on a going concern basis – are complementary.

Governance of social, ethical and environmental issues for creditors

Effective management of the risks and opportunities associated with significant social, ethical and environmental issues is an important component of good governance practice for both shareholders and creditors. Companies that ignore such risks may suffer serious damage to their reputation and brand value, as well as litigation and operational risks [3]. Creating a "governance culture" of transparency and accountability that goes beyond mere compliance with codes and legislation is key to addressing these aspects of performance effectively. Well-known scandals illustrate just how important it is for companies to be alert to the business risks inherent in a broad range of issues, such as fraud, bribery and corruption, insider trading, climate change, human rights, labour standards including those in supply chains and the health impacts of products. These risks can impair a company's credit quality.

Specifically, good governance in this area requires [4]:

- Board-level responsibility for significant ESG issues;
- Director training on new or emerging issues;
- Systems to enable the board to identify and assess the risks and opportunities;
- A commitment to open dialogue with stakeholders;
- Formal policies addressing any significant issue;
- Management systems for the effective implementation of these policies;
- Monitoring of the achievement of policy objectives;
- Disclosure of the above within the company's annual report to investors [5].

Can a creditor's perspective enhance long-term thinking?

Active consideration of creditor interests in company engagement might even help investors to address the issue of short-termism that is a concern in many corners. Namely, by taking a "universal investor" approach to a company that encompasses both debt and equity perspectives, unduly risky behaviour that promotes short term gains for shareholders – at the expense of creditors – might be discouraged. At the same time investors should encourage a more balanced/sustainable corporate strategy and financial policy that are better positioned to stand the test of time.

[2] See: http://www.fandc.com/FundNets_FileLibrary/file/co_GSI_reo_viewpoint_February_2011.pdf
[3] F&C's more detailed position on specific issues (e.g. climate change, labour standards, bribery and corruption) can be found at www.fandc.com/governance (see Shareholder Engagement).
[4] This is consistent with the UK Association of British Insurers' Disclosure Guidelines on Socially Responsible Investment (www.abi.org.uk).
[5] This may be supported by more detailed disclosure in a separate Corporate Responsibility or Sustainability report. Where practical, such disclosure should be in line with internationally accepted guidelines such as the Global Reporting Initiative (GRI).

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reo® viewpoint

Mirza Baig, Director

September 2011

The lessons of "India's Enron": Can investors serve as guardians of India Plc?

In May 2011, Indian Asset Management Companies (AMCs) received a stern letter from the Securities and Exchange Board of India (SEBI) demanding to know how they were voting their shares and driving better corporate governance by Indian companies.

Stung by the collapse of Satyam, the high-flying software company that had, despite a stellar board, fallen prey to a $1 billion accounting fraud, SEBI had introduced tough new rules in March 2010 aimed at forcing Indian mutual funds to play their part in holding Indian listed companies to account. In a market where domestic investment institutions have deep historical ties with the companies they own, SEBI challenged them to act as 'conscience-keepers' for the market, arguing that companies would be more likely to uphold high standards of corporate governance if they faced the threat of public opposition by investors. It did this by forcing them publicly to disclose their voting policy and voting record, in line with long-standing practice in the US.

In response, AMCs have begun to post their voting policies and records on their websites. But a closer look suggests that while boxes have been duly ticked, substance has yet to follow form – a fact that has not gone unnoticed by India's lively business media, much less its increasingly impatient regulator. What does this portend for India Plc and the country's close-knit institutional investor community?

The power of television: Mutual Funds tagged as 'Corporate Yes Men'

One year after the introduction of SEBI's new transparency regime, CNBC TV18's popular weekly business talk show, The Firm, ran a special report that shone a spotlight on the record of the country's leading mutual funds. Entitled *"Mutual Funds or Corporate Yes Men?"*, the show painted a critical picture of the industry, and featured F&C's Indian governance expert, who commented as follows on the impact of the reform:

Does governance add value?

While it makes good sense to press AMCs to police corporate performance through more energetic voting, this can only work if they understand why good governance enhances long-term investment returns, and what role investors can and should play to make this happen. If, however, all they see is new costly compliance burdens, the inevitable result is mindless box-ticking and meaningless results. SEBI needs to engage the AMCs to build that understanding.

Companies and shareholders: Who answers to whom?

Indian companies, particularly those supported by a promoter[1] family, have typically viewed their listing as an opportunity for the capital markets to share in their success. However, this has led to some boards seeing their only responsibility to shareholders as generating short-term alpha, whereas the notion of board accountability to shareholders is seen as totally alien. In such an environment, questioning of management by shareholders is frowned upon, while voting against management is considered tantamount to betrayal. Consequently, the fear of having corporate access cut off has led to investors supporting management proposals irrespective of whether they are considered to be in the best interest of minority shareholders. This needs to change.

Conflicts of interests: A chokehold on independent voting

Mutual fund providers in India are typically part of large financial groups whose parent or sister companies have extensive commercial relationships with the very companies whose ballots they must vote. This problem is far from unique to India, but the volume of abstentions on companies facing such conflicts is a testament to the paralysis these conflicts have caused. While eliminating such conflicts is impractical, robust systems and good transparency can help to manage them and protect clients' best interests.

What the ballot box reveals... and doesn't

How India's largest mutual funds voted

A look at the governance policies and voting record of India's 10 largest mutual funds reveals that SEBI's efforts to rewrite the rulebook, however well-intentioned, did not transform behaviour. Rather:

- India's top AMCs have near-identical voting policies that largely refrain from detailing either policy principles or likely voting approaches on specific issues
- Collectively, the 10 AMCs **voted against** management at **fewer than 5 out of over 1000 meetings voted** during the year
- **50% of the AMCs** simply **abstained** from voting **on every resolution** during the year, with the rest showing a similar, if slightly less extreme, pattern
- Some AMC's initially refrained **from identifying the names of companies** in their **vote reports**, as SEBI had not explicitly required this in its guidance.

How F&C voted in India

Although a small player compared with its Indian peers, representing $1.2bn of assets invested in Indian equities, in 2011 F&C voted at 86 shareholder meetings, and abstained or opposed management on 15% of resolutions.

Top 3 reasons for F&C voting against management

- Over-committed directors with poor board attendance
- Lack of qualified and independent directors to oversee strategy, the audit process and internal controls
- Weak disclosure and justification for corporate or capital restructuring.

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[1] A promoter family are typically the founders of a company that oversee its flotation on the stock market while continuing to exert effective control over the publicly listed entity.

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Looking ahead: Joining the dots between good governance, active ownership, efficient markets and value creation

For SEBI's goal of driving genuine governance reform in India to be realised, the following needs to happen:

- **Regulators** should:
  - Focus on ensuring that AMCs live up to their disclosure obligations
  - Encourage dialogue amongst market participants on the value of governance
  - Avoid prescriptive regulation and allow market forces to shape evolving best practice.
- **Companies** should:
  - Consider how better governance, transparency, communication with investors and minority shareholder protections will build investor trust and lower the cost of capital.
- **Institutional Investors** should:
  - Develop detailed governance policies, systems to enable the effective execution of policy, processes for escalation, and active engagement with boards of investee companies
  - Report on their activities so as to allow the market to assess their approach to responsible investment.
- **Business Media** should:
  - Ensure scope of investigative journalism goes beyond cases of fraud and corruption by reporting on stories of mismanagement of shareholder funds, ceremonial and ineffective boards, and the adoption of value-destroying strategies and business practices.
- **Unit Holders and Financial Advisors** should:
  - Be mindful of the short and long-term performance factors that can affect returns, including governance, environmental and social practices
  - Consider their investment managers' approach to active ownership when evaluating their ability to deliver long-term investment returns.

The Indian regulator has, through its proxy voting disclosure directive, thrown the gauntlet to India plc and the close-knit community of financial institutions that back it – but while necessary, this bold step is not sufficient to effect real change. The investment community, public listed companies and ultimately the individuals whose growing pools of savings underpin the financial system need to join the dots between good governance, efficient markets and long-term value creation. This is the foundation of an engaged investor base and ultimately an efficient capital market, around which targeted regulation should be built.

F&C's approach: transparency and tackling conflicts

- Publish Responsible Ownership Principles and Global Operation Voting Guidelines[2]
- Publish India-specific governance guidelines[3]
- Send governance policy to all investee companies
- Invest in dedicated resource of 16 investment professionals responsible for making informed voting decisions on all shareholder meetings
- Send explanatory letters to all companies where F&C votes against management ballot proposals
- Publish full voting record including explanation of any votes cast against management
- Beyond-the-ballot engagement with investee companies covering broad range of environmental, social and governance matters that are material to the business
- Conflicts of interest are overseen by F&C's executive committee, with third-party independent agents used whenever necessary.

[2] Please visit http://www.fandc.com/new/Institutional/Default.aspx?iD=80958 for details of F&C's corporate governance policies and voting record.

[3] F&C has a total of 15 country and region-specific voting policies

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