Shropshire County Council

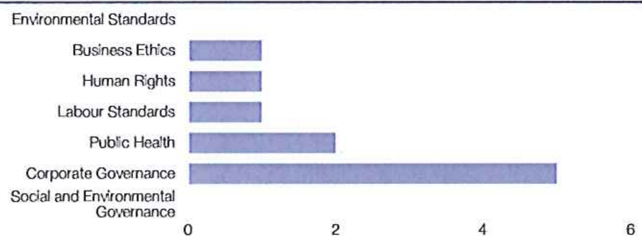
# Responsible Ownership Activity Report Q1 2013

The purpose of the ***reo***® (responsible engagement overlay)* service is to engage with companies held in portfolios with a view to promoting the adoption of better environmental, social and governance (ESG) practices. The ***reo***® approach focuses on enhancing long-term investment performance by making companies more commercially successful through safer, cleaner, and more accountable operations that are better positioned to deal with ESG risks and opportunities. Through a combination of constructive dialogue and active share voting, ***reo***® works to drive behavioural change with companies, and records successful outcomes as 'milestones' – changes in corporate policies or behaviour following intervention.

## Companies engaged this quarter

| | |
|---|---|
| Companies engaged | 39 |
| Milestones achieved | 10 |
| Countries covered | 1 |

Milestones achieved by issue




Companies engaged by country

Companies engaged by issue**

* ***reo***® is currently applied to £91.0 billion (€112.1 billion / $147.9 billion) of assets as at 31 December 2012

** Companies may have been engaged on more than one issue.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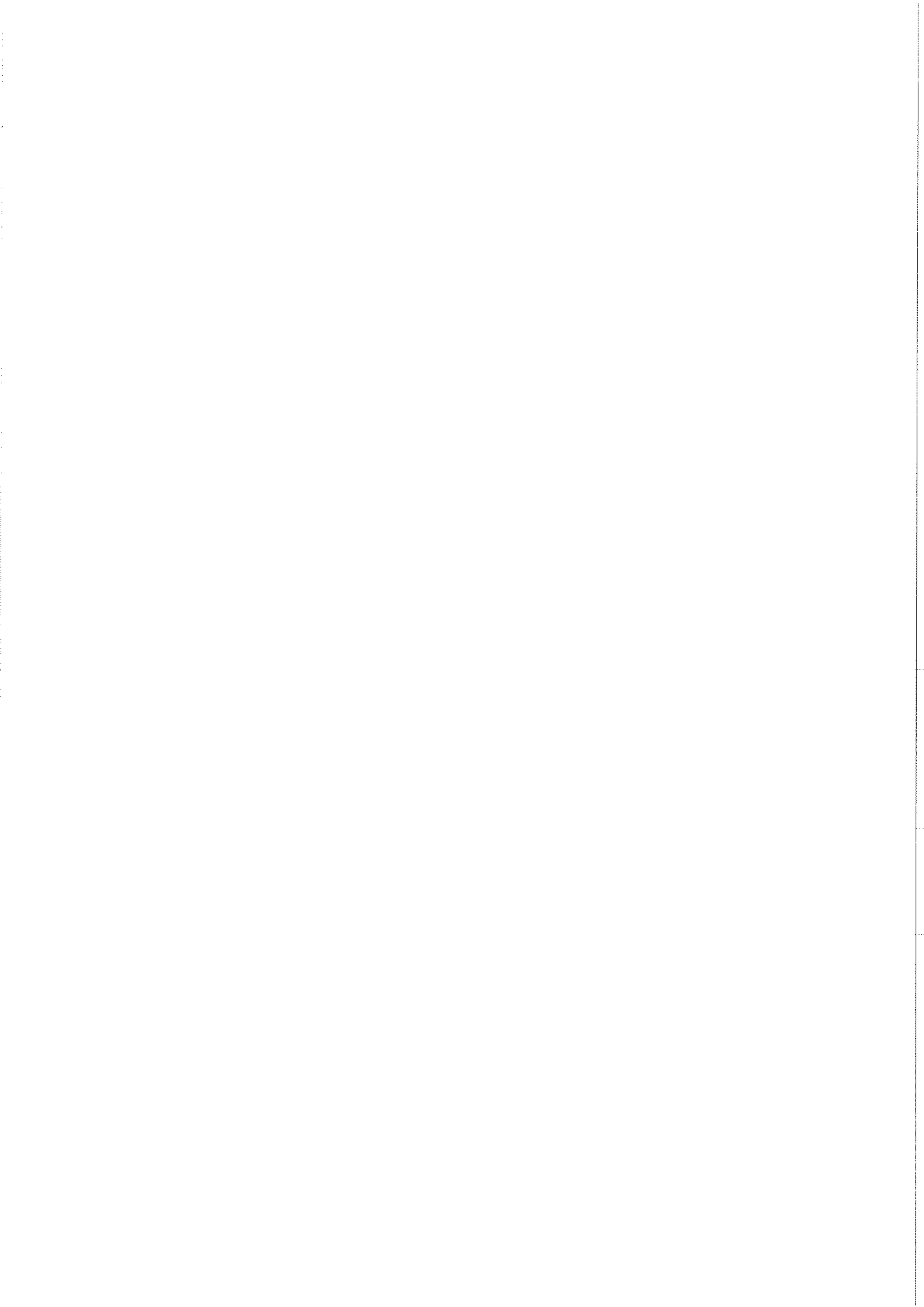

# reo® viewpoint

Mirza Baig, Senior Advisor, Governance and Sustainable Investment February 2013

# Revamping India's corporate governance regime

In January 2013, F&C responded to a detailed public consultation paper published by the Securities & Exchange Board of India (SEBI) on proposed revisions to the corporate governance requirements for Indian listed companies. Reeling from the shock of the $2 billion accounting scandal at Satyam Computer Services in 2009, Indian regulators have responded with a plethora of initiatives over the last few years to rebuild investor confidence in the country's capital markets. These measures included the publication of the Ministry of Corporate Affairs' Voluntary Principles, the Godrej Committee's Guiding Principles of Corporate Governance and the expected passing of the Companies Bill, 2012 into law.

These were welcome developments but, because the standards and recommendations were developed in parallel, the result was a somewhat disjointed governance regime. Consequently, the SEBI proposals seek to create a more coherent and progressive corporate governance framework, with the aim of re-establishing India as a destination of choice for international investors.

## F&C's consultation response

As long-term investors in India, F&C's detailed response to the SEBI consultation drew from its experiences in India along with best practice from over 50 markets worldwide in which F&C exercises its voting rights and undertakes targeted governance engagement. Although the SEBI document contained 31 separate proposals, F&C focused on the 10 areas which it believed to be of most interest and importance to international investors. The key points emphasised by F&C in its submission were as follows:

### Succession Planning

Long-term investors often have time horizons which extend beyond the average tenure of an executive or non-executive board member. These investors evaluate corporate boards on their current skills and experience, but also on their ability to evolve over time and continue generating sustainable returns in the future. This necessitates an orderly succession plan for both the executive management team as well as for non-executive directors, with a particular focus on the key positions of chairman and chief executive.

The relative merits and risks of internal versus external appointments should be assessed against an objective set of criteria based upon the requirements of the role as well as the culture and commercial context of the business. How candidates are identified, evaluated and selected should be publicly disclosed.

Succession planning is of greater importance in family-controlled businesses where uncertainty over the seniority and suitability of family members can cast a shadow over the long-term future of the company. This is a matter of particular significance within India. The nomination committee should seek to identify the members of the family who are best suited to assume greater responsibility based upon their skills and experience, and communicate this to the market where possible. If suitable family members are not identified then the company's succession should take into consideration external professional managers.

### 'Reliance' on Succession Planning

The very public spat between Mukesh and Anil Ambani following the death of their father ultimately resulted in the break-up of the Reliance Group, in a deal brokered by their mother. As the brothers continued to air their differences in public, it appeared that minority shareholder interests came a distant second to family considerations. F&C has been engaging with **Reliance Industries** since 2008 to ensure that uncertainty over succession is not continued through to the next generation. Unfortunately, apart from a few notable exceptions such as the **Tata Group**, the lack of a formal and transparent succession process is symptomatic of family-controlled businesses which dominate the Indian market.

### Mandatory Rotation of Audit Partners

A series of accounting related scandals across the region has served to undermine investor confidence in the integrity of financial statements. F&C believes the focus of much-needed reform should be on audit quality and reporting. The independence of auditors is a critical step in this process; hence we support the mandatory rotation of lead audit partners and external audit firms. However, evidence from other jurisdictions where mandatory rotation has been prescribed, such as in China, has had a mixed result on audit quality due to a perceived drop in quality during the transition period. Therefore, the optimal period and process for auditor rotation should be kept under review by SEBI to ensure the ultimate objective of enhancing audit quality is achieved.

The responsibilities and duties of the audit committee in overseeing the auditing process should also be emphasised. The audit committee is responsible for the appointment of auditors and the oversight of their work, and hence are the primary safeguard of audit quality. When selecting an external auditor, the committee should take into account the auditing needs of the business, the governance of the audit firm, its capacity, skills and experience, audit approach, and independence from management. After selecting an audit partner, the audit committee should then work closely with the external auditor to oversee allocated resources, the audit plan, access to information, data testing, and the manner in which any areas of difference are resolved with management. The details of this process should be made available for public scrutiny through disclosures in the audit committee report. F&C believes that a strong and engaged audit committee is likely to have a greater impact on audit quality than auditor rotation alone.

F&C Investments

### Related-Party Transactions

Many companies are involved in material related-party transactions, which represent a significant risk for minority shareholders. Akzo Nobel India's acquisition of three unlisted subsidiaries in 2012 was one such example of a potentially value destroying related-party transaction. On that occasion 45% of non-promoter shareholders voted against these transactions – representing a key landmark for shareholder activism in India.

F&C considers this risk is mitigated to some extent through the establishment of fully independent and strong audit committees, whose responsibility it is to ensure that such transactions are conducted at fair market value. Therefore, any guidance on the oversight of related-party transactions should acknowledge the critical role of audit committees and ensure they are empowered through access to information, external advice, pre-approval authority and the legal emphasis of their fiduciary responsibilities.

F&C strongly supports the requirement for shareholder approval of significant divestments in subsidiaries, continuous disclosure of material related-party transactions, and the approval of such transactions by a 'majority of the minority' of shareholders. We also recommend that each company be required to disclose any shareholdings that its controlling shareholders may have in other companies or investment vehicles that have a material interest in the company.

### Controlling Shareholders & Royalty

Over the past few months there has been a growing trend of multinational corporations demanding more royalty payments from listed subsidiaries in India. The highest profile case involved **Unilever** which increased royalties to 3.15% of net sales, triggering a 3% drop in **Hindustan Unilever's** share price. As such, royalty payments have served as an acid test of the manner in which boards are willing to defend the interest of minorities in the face of pressure from the controlling shareholder.

In the case of **Holcim** and **Ambuja Cements**, F&C voted against proposals to approve a royalty of 1% of sales. However, under the current regime, interested parties are permitted to vote on related-party transactions. Given **Holcim's** 50.6% stake in **Ambuja Cements**, the vote became largely ceremonial. New SEBI proposals to empower audit committees to oversee related-party transactions and require transactions to be approved by 'a majority of the minority' shareholders should ensure future decisions on matters such as royalty payments are fully transparent and fair.

### Investor Code

F&C considers the role of active institutional investors to be central within an efficient and progressive governance regime. SEBI is proposing the establishment of a new investor code broadly consistent with the UK Stewardship Code, of which F&C is a signatory and an active proponent. However, we note that institutional investors' commitment to the UK Code has been borne out of a deep-rooted conviction in the value of good governance coupled with an increased scrutiny of their practices by their clients, the asset owners.

Therefore, although we support the initiative to establish a similar code for Indian domestic investors, it is vital that institutional investors seek to comply with the spirit rather than just the letter of the code for it to have any meaningful impact on behaviour. The importance of this can be seen by the unsatisfactory disclosures made by mutual funds with respect to their voting policy and record following the mandatory disclosure requirements implemented previously by SEBI.

F&C recommends that SEBI appoint a working group of major domestic institutional investors to debate the value, viability and potential framework of an institutional investor code. This should include a discussion on the value of good corporate governance practices in protecting and enhancing long-term investment returns; assessment of current working practices and capacity; identification of the key areas of conflict of interest; an appropriate client reporting framework; and the establishment of an independent body to oversee the application of the code.

Beyond the additional responsibilities placed upon investment managers, it is vital that SEBI reaches out to asset owners through pension fund trustees and financial advisors and consultants. Greater appreciation of the importance of good governance practices within the investment mandate selection process will likely prove to be the greatest catalyst for embedding responsible investment practices within the industry.

### Conclusion

Indian governance standards have gone backwards in recent years according to the Asian Corporate Governance Association's bi-annual ranking of Asian markets. The SEBI initiative, which will seek to update the Indian listing standards later this year, is a welcome development with the potential to re-instate India as a leader in the region alongside Singapore. However, the success of the new governance regime will hinge upon whether the spirit of the revised listing standards as well as the form is embraced by both companies and institutional investors. The jury is still out on this count.

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F&C Investments

r(e)o® viewpoint

George Dallas, Director, Corporate Governance

March 2013

# Banks 2013: Taking a broader view of risk

The banking sector continues to be an important area of focus for F&C's clients, who are investors in bank equity and debt. There remains a long list of concerns about the industry. These relate to the ongoing effects of the recent financial crisis, irresponsible practices such as the mis-selling of financial services and products, compliance and ethical failures that have resulted in significant regulatory fines, as well as the ongoing issue of bankers' pay. The issue of bank pay in particular has elevated to the realm of political and social debate, particularly in Europe, where the European Union (EU) has recently agreed on a provocative legislative proposal to cap bank bonuses (see box on next page).

Ahead of the upcoming voting season, we have written to the chairmen of over 50 major global financial institutions to provide guidance on F&C's banking sector voting policies. The letter was sent with this Viewpoint report, to underscore our key concerns about the sector and to guide F&C's engagement with banks in 2013.

## A marathon, not a sprint

To paraphrase the 19th century German politician Count von Metternich, when the banking system sneezes the global economy catches a cold. This reflects the reality that investors are exposed to the health of the banking sector in a wide variety of ways, beyond just their direct holdings of debt and equity securities of banks. The 'real' (non-financial) economy requires a healthy banking system to provide banking services and loans to businesses and individual customers. We also must also take into account the impact of the banking system on public sector finances. More than five years from the onset of the global financial crisis in 2007, many sovereign governments – and as a result, individual taxpayers – continue to feel the effect of bailing out the financial system. In the US, UK and across the Eurozone, this has resulted in higher state debt burdens, austerity in government spending, more taxes and lower credit quality on many sovereign bonds. Even for banks that do not have explicit state ownership, we believe moral hazard – the potential for governments to serve as a financial backstop for the banking sector – is not likely to go away entirely, even though regulatory reforms have been implemented in many jurisdictions to make the banking system stronger and more self-sufficient.

The banking sector is arguably unique in its degree of systemic importance to the wider economy, and F&C believes this has major implications on how we should assess bank performance and governance. Banks should prioritise financial strength and long-term stability over short-term profit maximisation through inappropriate risk taking. While this should be true of all companies in which we invest, this is particularly important for banks, given their confidence, sensitivity and the contingent liability that the sector poses to the economy. In this context we welcome the initiative of several banks, Deutsche Bank for example, to reduce their return on equity targets to levels that are more sustainable and less susceptible to inducing unintended and destabilising consequences. We also believe that banks must focus on risk-adjusted economic profitability, and if they do employ return on equity metrics as key performance indicators these should be complemented with a publicly disclosed cost of equity calculation.

**EU bank bonus cap – Will it work?**

In March, the Council of the EU endorsed the proposal of the European Parliament to cap the bonuses of Member States' banks to a ratio of 1:1 fixed to variable remuneration. This can be raised to 2:1 if supported by a supermajority of shareholders – and possibly a bit higher if banks pay 25% of the bonus deferred for at least five years and in the form of financial instruments that can be cancelled in the event of a crisis. This legislative development is expected to be applied beginning in 2014, and has created considerable controversy, particularly in London, Europe's leading financial centre.

The intent behind this proposal is to bring bank pay under control and to discourage unduly risky behaviour by financial institutions that might be incentivised by the carrot of very large bonus awards. Implementation of this bonus cap should enforce greater restraint on bank pay, and can serve to dampen deeply embedded cultural expectations within banks about entitlements for levels of pay that many bank remuneration committees have not been able to keep in proper check.

F&C recognises that these efforts made by regulators have potential to bring bank pay under greater control. However we are also wary of legislative initiatives to control pay in the private sector. We are concerned this proposal may lead to unintended or undesirable consequences. Concerns include:

- Potential for significant base salary increases to minimise the reduction in total pay. This could add to the fixed charge expense base of banks and reduce their financial flexibility.
- Marginalisation of performance criteria that currently serve as variable pay incentives. We fear remuneration committees of European banks may be more inclined to grant the full 100% (or 200%) bonus payouts to bank executives to remain competitive against banks that do not face these pay caps. We believe there will be a temptation for committees to exercise less rigour in assessing performance standards of executives. This is coming at a time when F&C and other investors are encouraging greater scrutiny on bonuses, especially at banks whose returns do not cover their cost of risk-adjusted capital.
- Creation of a non-level playing field, in particular for European banks active in capital markets. The risk of talent flight to banks in North America and Asia, where such remuneration controls will not be in place, could become greater. Retail and commercial banks are less likely to be affected from this aspect.

F&C Investments

At the same time equity investors certainly want banks to be profitable and to cover their cost of capital. Fixed income investors will want to seek security from banks maintaining their credit quality and from their position in the capital structure hierarchy. But in this environment of rising regulatory capital requirements and 'bail-in' senior bank debt, it can be a challenge for banks to be attractive to private sector equity and debt investment. This is a difficult balance to achieve, but it is essential to do so, since a banking system that is not attractive to debt and equity investors poses an ultimate threat to economic stability. We believe part of the answer is that a lower risk business model – and higher quality of earnings – should also result in a lower cost of debt and equity capital and thereby improve economic profitability. In terms of financial theory this suggests we should be seeking to improve investibility in the banking sector by reducing its volatility or 'beta'.

## Ethics as a business imperative

Banks have been consistently on the back foot in recent years with regard to public opinion. If anything, levels of trust continued to deteriorate in 2012, as the 'shareholder spring' evolved into a 'summer horribilis', when a spate of compliance breaches and ethical violations by banks surfaced in a range of areas including money laundering, LIBOR manipulation, insider dealing, government sanction busting and irresponsible marketing practices. Banks and investors are seeing clearly that reputational risk is real, and can result in significant fines, damage to brand equity, threats to operational licenses, as well as forced changes in executive management and board members.

It is clear that there is urgency for banks to rebuild trust and address increasingly high societal concerns and expectations. The chairman of a major UK bank said to us that revelation of his bank's past compliance breaches were 'truly shocking' and he recognised a real need to try to 'future proof' the bank from further scandals. A prominent continental European bank has made explicit reference to banking's 'fractured relationship with society' and to the need for culture change in the sector. It is positive to see that in several cases bank managements and boards are seeking to address these issues; indeed, banks such as **Barclays** and **HSBC** have publicly embarked on reviews of internal culture and values. Yet, while culture change is a critical part of the solution, it can be easy to prescribe from above, but it can be very difficult to bring about on the shop floor.

To address this, bank boards and executive management must first set the right tone in terms of a code of conduct and appropriate behaviour. This requires an unambiguous top down focus on shared values and on a business model which recognises that long-term performance is only sustainable by delivering responsible financial services to customers. This must be matched by corporate-wide communications and employee training, as well as robust control and compliance systems.

But to truly 'future proof' banks from being caught out by dynamically shifting societal expectations, codes of conduct and compliance systems should not just be clinically implemented to tick the right boxes; nor should these be limited simply by what is legal or required by regulation. There must be a broader overarching ethos across the company that staff must avoid behaviour that will be considered unacceptable by society – even if it may be legal. There is a growing need for bank executive management, as well as bank boards, to promote appropriate corporate values. To do so, they need to better understand and deal with a broad and complex stakeholder base. These stakeholders, which reflect civil society, include regulators, governments, politicians, the media, small business and retail customers. Building sensitivity to these stakeholders' interests should work to build a more principles-based approach to bank governance that should better enable banks to make culture change a reality and to navigate through the challenging and often shifting landscape of societal expectations.

## Linking ethics, risk and remuneration

F&C would like to see more evidence of 'joined up thinking' in how banks are managed and governed in terms of ethical performance, risk management and the incentive system for bank executives — as expressed in terms of their remuneration. F&C believes it is important to ensure that inappropriate behaviour has clear financial consequences for bank executives. There must be accountability for past mistakes and violations of agreed risk norms. To do so, the remuneration committees should use clawback mechanisms and reduce variable pay awards — even in scenarios where the bank executives have achieved their financial targets, such as profitability.

For example, many banks have recently incurred significant fines relating to compliance breaches. Even though some of these breaches took place in past years and were caused in many cases by executives who are no longer with the banks, F&C believes that the bank as a whole must remain accountable for past transgressions. This means that regulatory or legal penalties should impact the incentive pool that is distributed to its executives. We believe banks should also develop greater sensitivity to the issue of 'quantum' or absolute levels of pay. The established norms of pay in the financial sector do not necessarily reflect norms in broader society, particularly given ongoing economic challenges and austerity measures in many countries. While investors are prepared to reward bank executives for good performance, remuneration committees should recognise that the public perception of unjustified excessive pay can create long-term reputational damage. This affects the bank's relationship with its customers and other key stakeholders. Benchmarking pay to other financial institutions as a basis of high remuneration awards is increasingly regarded as a feeble justification. The EU initiative to cap bank pay and a recent Swiss referendum on executive remuneration demonstrate that if banks do not proactively address these issues, there is scope for public policy intervention which could have unintended consequences.

### They said...

**"People will wonder why we stay in the EU if it persists in such transparently self-defeating policies. Brussels cannot control the global market for banking talent, Brussels cannot set pay for bankers around the world."**

**Boris Johnson, Mayor of London, 28 February 2013**

### Press quote...

**"If the bosses can't – or won't – do what they should, politicians can help. A bonus cap would make the first-mover disadvantage disappear, by putting everyone in the same, less richly decorated, boat."**

**George Hay, Reuters BreakingViews, 6 March 2013**

## Governance of sustainability issues

Most major banks have developed programmes for addressing their interface with society. These take on various labels, such as sustainability, corporate responsibility, values or citizenship. For the most part we have seen positive developments in this area within the financial services sector in recent years, as it affects both a bank's 'direct' impacts on its employees, its customers and the environment, as well as the 'indirect' impacts through a bank's lending, investment and underwriting activities.

Our experience, however, suggests the urgency with which environmental, social and ethical issues are taken varies from institution to institution. This is particularly true with regard to how sustainability issues are governed at the board level. In some cases we see evidence of active board oversight, taken in the form of sustainability committees focused on these issues. In other cases, we see limited, if any, evidence of how corporate responsibility issues are overseen by the board. While we would encourage boards to consider forming a standing committee to address sustainability issues, we are not prescriptive on this point. F&C wants to better understand how seriously these issues are addressed by the board, especially the extent to which the board 'joins up' thinking on sustainability risks with broader enterprise risk management and remuneration.

## Unfinished business

These areas represent important and challenging areas of focus for the banking sector. F&C acknowledges that many banks are acting positively to address these concerns, and we believe progress is being made. However the marathon is not yet finished. There remains work to do.


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