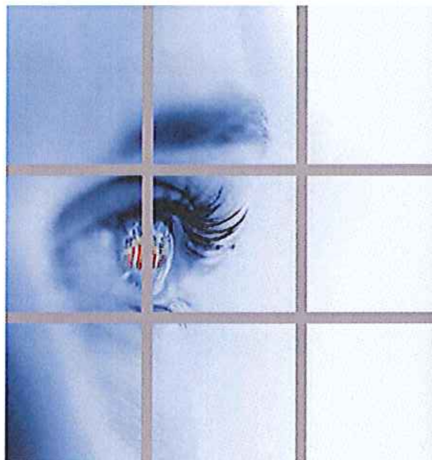


Shropshire County Council

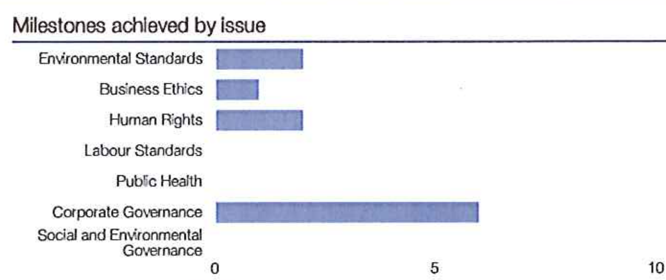
Responsible Ownership Activity Report Q3 2013

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	21
Milestones achieved	11
Countries covered	1

Milestones achieved by issue



Companies engaged by country

Companies engaged by issue**

* ***reo***® is currently applied to £82.8 billion (€96.7 billion / $125.6 billion) of assets as at 30 June 2013

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

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r(e)o® viewpoint

Juan Salazar, Associate Director, Governance and Sustainable Investment August 2013

Safety in the world's most dangerous industry

Background

Mining is arguably the world's most dangerous profession. The International Labour Organization estimates that one percent of the world's workers are involved in mining yet it accounts for eight percent of the fatal accidents.

Workplace safety in the mining industry is critical to successful and sustainable mine management. It also functions as an important indicator of corporate management quality. We believe poor safety performance in the form of recurring and serious safety incidents:

- Increases costs and production disruptions;
- Affects a management's relationship with employees and regulators;
- Harms its public reputation; and
- Threatens a company's license to operate.

Safety incidents usually lead to reductions in productivity that can ultimately affect not only short-, but also long-term performance. For example in May, a tunnel collapse at the Grasberg copper and gold mine in Indonesia killed 28 workers, which forced **Freeport-McMoRan** to shut down operations for more than a month. The stoppage has significantly lowered the mine's output this year, with the company only expected to return to full production in September. Elsewhere, highly controversial mine stoppages by government inspectors in South Africa due to safety concerns in 2011 cost the country's struggling platinum industry 300,000 ounces in lost output. This was worth $500 million or so and amounted to about 5 percent of global production.

The management of safety risks at mining operations is challenging. This is a high-risk industry that involves considerable human labour and machinery operating in challenging environments. This is made more complex by the need to consider issues such as cultural perceptions around safety; employee relations; risk tolerance in society; and different stakeholder expectations. These issues are exacerbated as companies pursue increasingly complex activities such as deep underground mining.

F&C Acts

In 2012, F&C wrote to 38 large and medium-sized mining companies operating mainly in emerging markets. These included **China Shenhua**, **GlencoreXstrata**, **Vedanta Resources** and **Kazakhmys**. The purpose was to introduce them to leading industry practices in the management of workplace safety, and to encourage the implementation of a robust safety culture across the organisation. As part of this engagement project, F&C led an in-depth dialogue on safety issues with a small group of companies selected from this wider group.

In this engagement project, we had a series of recommendations. F&C asked companies to:

1. Develop and publish a dedicated company-wide safety policy;
2. Establish procedures, systems and tools to implement such a policy;
3. Ensure strong and consistent leadership from top management in regard to safety management;
4. Carry out training programmes for staff – including senior executives and contractors – that challenge 'unsafe' behaviours and explore context-specific considerations (e.g. locals' risk tolerance to safety);
5. Set a specific process to investigate and communicate the causes and consequences of safety incidents;
6. Create internal reporting mechanisms for employees and contractors to voice concerns about safety practices and procedures; and
7. Incorporate safety in management performance reviews at all levels in the organisation, and setting an explicit link between safety and pay for senior executives and mine managers.

Analysing the state of play

12 of the 38 companies which we wrote to responded to our engagement. All of these mining companies had in place a group-wide health and safety policy, which generally includes a commitment to achieving 'zero harm'. While there is still work to be done regarding implementation of safety policies, we were encouraged to learn about initiatives that some companies are taking.

Leadership

Boards and senior executive teams are getting increasingly involved in workplace safety discussions. The boards of GlencoreXstrata and Kazakhmys are, for example, playing a larger role in overseeing the implementation of safety initiatives that include external reviews of safety practices at selected operations, strengthening safety governance frameworks, and improving communications between employees and mine supervisors. Other companies such as **Fresnillo, Newcrest Mining** and Vedanta have launched group-wide, CEO-led comprehensive reviews of their safety management practices. Preliminary results from some of these reviews have pointed at the importance of involving workers and their representatives in the safety decision-making process.

F&C Investments

Training

Workers' attitudes towards safety are largely shaped by their own cultural background, as well as by the prevailing organisational culture. Companies are therefore rethinking their approaches to training and communication, focusing more on behavioural change while concurrently addressing likely causes of at-risk behaviour. **Gold Fields** is rolling out a group-wide behavioural safety programme to encourage solidarity between supervisors and crews. It also deploys "enhanced safety alarm" questionnaires to help crews analyse behaviours leading to actual safety incidents.

Process safety

Companies are undertaking efforts to strengthen safety management controls in order to ensure that process hazards are correctly identified, understood and controlled to prevent process-related accidents from occurring. One of the main risks workers in underground mines face is fall of ground, i.e. rocks falling from the 'roof' of the mine. To better tackle risks related to falls of ground, **Grupo México** recently launched a project to improve the stability of mines. The key feature of the project involves re-shaping flat roofs at underground chambers into vaulted roofs, which are less prone to cracks in the rock.

The world's most dangerous occupation?

Some of the hazards miners face include:

- **Gas explosions:** Resulting largely from a build-up of methane gas in coal mines. Good ventilation of the work area is essential to prevent pockets of gas forming, as is monitoring of electrical equipment for sparks that can trigger explosions. To complicate matters deeper coal seams have higher methane content due to higher pressure. In 2010, 29 were killed at an explosion in a **Massey Energy** mine in West Virginia, the highest death toll from a US mine incident in 40 years.
- **Falls of ground and cave-ins:** Two of the most common of all underground mining accidents, these occur mainly when the walls and ceilings of underground mineshafts have not been properly secured, or as a result of subsidence.
- **Chemical leaks:** Chemicals are used widely, such as cyanide in gold mining. Accidents occur when the chemicals are not securely stored and safety procedures are not followed correctly. In 2000, a cyanide storage leak at a Romanian gold mine into the Somes River polluted drinking water supplies for millions of Europeans and killed large amounts of fish.
- **Flooding:** Breaching underground reservoirs of water, including build ups in abandoned mines, has led to incidents including the 2010 Wangjialing mine flood in China that killed 38.
- **Electrocution:** Heavy electrical equipment such as drills and industrial machines poses dangers for mining teams.
- **Vehicles:** Giant trucks and other vehicles is a cause for accidents, including fatal ones.

Next steps

While the companies we contacted are at different stages in their journey to ensure a safe workplace and achieve a 'zero harm' objective, safety seems to be squarely placed at, or at least close to, the top of the risk management agenda. We were encouraged by the actions most companies are taking to improve their safety practices and creating a robust safety governance framework. Challenges do remain, particularly around the extensive use of contract workers mining companies make. This presents significant challenges given the different backgrounds and approaches contractors have and the temporary nature of contract work. Going forward, we plan to revisit this and other topics with a number of selected companies, as well as to check on the progress of their safety-related initiatives.

We will also continue to look closely at the issue of safety across the industry by engaging with leading companies and organisations such as the International Council of Metals and Mining (ICMM). From our past discussions with the ICMM and with companies such as **Anglo American**, Freeport-McMoRan and **Rio Tinto** we have learnt about the shape of the debate going forward. Topics that are being increasingly discussed among sector leaders include the implementation and use of leading performance indicators, the use of data analytics to gain insight into causal factors and improve safety outcomes, focus on training and communications that address overall employee wellbeing, and investments in automated drilling and excavation technology. This will inform our future engagement with both leading companies and those lagging behind.

For clients with access to F&C's ***reo***® Partner Portal, please access detailed confidential reports of engagement and milestones with specific companies from this project by using the search function.

If you would like further details on the information in this note, please contact your ***reo***® client director.

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F&C Investments

r(e)o® viewpoint

George Dallas, Director, Corporate Governance and Yo Takatsuki,
Senior Analyst, Governance and Sustainable Investment

September 2013

Bank Pay 2013: Progress, but not out of the woods

The aftermath of the global economic crisis brought acute scrutiny to remuneration of executives in financial institutions. Heightened visibility of very high bank pay in the light of the pain inflicted by the banking crisis on the global economy, prompted growing discontent, and, in many cases, moral outrage at a broader societal level – arguably more so in Europe than the US. This sense of injustice, which politicians and the media have fanned, has barely calmed in the five years since the collapse of **Lehman Brothers.** In part this reflects the fact that the banking industry has been scandal prone, with incidents such as Libor manipulation and sanctions busting. Either way pay continues to be an issue casting a shadow over the reputation of banks.

Investors in bank shares and bonds, as well as industry regulators, are now focusing more intently on how remuneration structures in banks may have created incentives for unduly risky behaviour – and in turn threatened individual bank solvency and financial system stability. F&C has a long track record of engagement with major financial institutions around the world which stretches back before the 2008 financial crisis. We have seen gradual progress along a range of issues which we have focused our dialogue on. Engagement asks have included:

- Improving alignment between pay and performance
- Establishing appropriate performance metrics which curb risky behaviour
- Increasing emphasis on equity-based (rather than cash) incentive plans
- Extending vesting periods
- Striking a better balance between the employee bonus pool and shareholder dividends
- Introducing clawback and malus provisions
- Being prepared to justify generous and large awards – especially when the bank has not generated a risk-adjusted return on capital.

Following on from a series of scandals in recent years, we are also now increasingly encouraging ethical performance to be factored explicitly into the remuneration assessment of senior executives at banks. While the direction of travel is broadly positive, F&C nevertheless believes that major concerns remain with regard to bank pay – particularly given that in 2013 many remuneration committees granted significant awards for what we considered poor or sub-par performance.

F&C engagement: joining up pay, risk and ethics

In 2013, in light of the visible, and costly, compliance breaches and regulatory violations that many banks experienced relating to incidents including product mis-selling (**Lloyds, Royal Bank of Scotland**), money laundering (**HSBC, Standard Chartered**) and Libor rate manipulation (**Barclays, UBS**), as well as incidents that reflected a failure of internal controls such as **JPMorgan Chase**'s trading losses, F&C's engagement evolved further to focus on encouraging banks to more formally link remuneration, risk management and business ethics. This reflects our recognition that appropriate ethics, culture and values in the banking sector are fundamental to the long-term sustainability both of individual banks and the financial system more broadly.

So far this year, F&C has communicated its expectations and voting policies on bank remuneration and corporate governance to the 60 largest banks in Europe, North America and Asia. F&C research also identified banks with weaknesses in its pay practices and we held one-to-one remuneration consultations with a number of high risk banks including: **Goldman Sachs, Deutsche Bank,** and Barclays.

Improvements come, albeit slowly

Compared with prior years, in 2013 F&C saw more fruits of past engagement. We believe pressure from investors, regulators and other stakeholders has led to improvements in bank pay plans. As highlighted earlier, we are seeing longer-term deferrals of incentive pay awards, more equity-based pay, and less in the form of cash bonuses. Specific examples include Barclays reducing the size of its bonus pool despite higher levels of absolute profits, the exercise of clawback provisions relating to payment protection insurance mis-selling at Lloyds and the introduction of improved, risk-related performance conditions at both **Citigroup** and Unicredit.

Importantly, we are also seeing culture and values featuring more prominently as a component of remuneration outcomes. HSBC and Standard Chartered, for example, both take into consideration ethical conduct as a precondition to the receipt of individual incentive awards. Changes of this nature are positive, and in general we believe that pay in banks is much better structured and governed now than in the years preceding the financial crisis.

2013 – how F&C voted

In spite of these positive trends, F&C still considers any celebration as premature. This is reflected in how we voted bank executive remuneration plans at Annual General Meetings (AGMs) in 2013. F&C did not support remuneration plans at not a single major US or European bank. The reasons for these voting actions varied, and were inevitably bank-specific.

F&C Investments

However, both in Europe and in the US a common theme in our votes against management was the awarding of significant bonuses to executives in years when many banks' financial performance did not cover their cost of capital and when many banks suffered significant losses or fines due to regulatory or compliance breaches. Particularly in the US there were multiple cases where we had concerns about the vagueness of performance conditions and the considerable discretion that remuneration committees continue to have to make generous awards even if the bank's performance was poor or lacklustre. The absolute size of award – also known as quantum – also remains a concern as well, particularly in the US, though it is fair to say that the issue of quantum in the US is a concern for all companies generally, not just for banks.

Bank	Country	Vote	Rationale
Banco Santander	Spain	Abstain	Significant CEO bonus for a year the bank did not cover cost of capital
Barclays	UK	Against	Aggregate bonus rewards to staff excessive relative to performance
Citigroup	USA	Abstain	Considerable improvements but equity awards need stronger link to clear performance targets
Credit Suisse	Switzerland	Against	Employee bonus pool remained barely unchanged despite another sharp fall in annual profitability
Deutsche Bank	Germany	Against	Significant improvements in remuneration structure and disclosures going forward, but for 2012 bonus payments were too high relative to company performance
Goldman Sachs	USA	Against	Long-term concerns remain about highly discretionary and very generous nature of awards
HSBC	UK	Against	High level of bonus to executives for a year the bank paid susbtantial regulatory fines
JPMorgan Chase	USA	Against	Plan is overly discretionary, lack of clear performance conditions for equity awards
Royal Bank of Scotland	UK	Abstain	CEO forfeited bonus, but large awards to CFO despite bank posting losses and incurring fines
UBS	Switzerland	Against	Rising bonuses against a background of losses and deteriorating profitability

2014 and beyond

The political reaction against bank pay in Europe resulting in Capital Requirements Directive IV (CRD IV) – a legislative initiative to cap bank bonuses at 100% of base salary – is an important regulatory development. F&C believes that how banks respond to this regulation will be one of the key issues in 2014. As this legislation stands to potentially put European banks at a competitive disadvantage relative to non-European banks in terms of attracting and paying for top managerial talent, we are concerned that this regulation could result in significantly higher levels of fixed pay (salary) and in banks seeking novel ways to beat the system. These could involve tactics such as the creation of "allowances" that are on paper categorised as a part of base salary, but which in effect act as another form of bonus payment.

F&C believes that if banks choose to only follow the letter of this regulation, and not the spirit in which it was established, they could be setting themselves for further regulatory scrutiny and public disapproval. In 2014, we will be closely monitoring how European banks confront this bonus cap issue, and if we observe that banks are taking inappropriate steps to circumvent the legislation we will be prepared to challenge such practices in our engagement and voting.

In conclusion, we see some positive developments in bank pay, which we hope will put F&C in a position to support bank remuneration structures next year. But the proof will lie not only in improved pay structures, but also in the discipline of bank remuneration committees to exercise appropriate discretion in the application of pay awards. This will continue to be an important theme in F&C's engagement with banks.

Case study: Deutsche Bank

F&C has actively engaged with Deutsche Bank over many years on themes relating to governance, remuneration and sustainability. Deutsche Bank had a significant shareholder vote against its pay plan in 2010, yet failed to put its plan to a shareholder vote in 2011 – which gave rise to F&C voting against the discharge of liability of its supervisory board members. To its credit Deutsche Bank did put its remuneration plan to an advisory shareholder vote in 2012, as well as in 2013. However, F&C voted against the bank's pay plan in both 2012 and 2013, reflecting in part our concerns about a disproportionate emphasis on Returns on Equity as a driving performance criterion – a metric that F&C believes can promote risky behaviour and does not reflect well the highly leveraged nature of financial institutions. We also questioned the award of significant bonuses to its co-chief executives in 2012, in a year when the bank's net income had significantly declined.

In late 2012 F&C led an investor delegation of German ***reo***® clients to meet with Deutsche Bank officials to discuss its approach to corporate governance and sustainability. This included a discussion on remuneration, and F&C followed up this meeting with a letter addressed to the independent committee that Deutsche Bank had appointed to review its remuneration structure. In this letter we stressed the importance of a remuneration structure that encouraged prudent financial management, reflected risk adjusted performance and placed emphasis on appropriate behaviours regarding culture and values. F&C was pleased to see that the new compensation structure put in to place for its management board members addressed many of our concerns. We believe the compensation architecture is much improved.

The removal of the Return on Equity (RoE) metric in the annual bonus award, and its replacement by a range of metrics relating to capital, costs, risk-adjusted income and culture, is a welcome step forward. We also noted positively that the new long-term share award programme no longer relies solely on relative total shareholder return, and that culture and client relations will also feature as guiding metrics. We agree that linking these factors to compensation makes sense, though we also note that potentially high incentive rewards can relate to metrics which can be subjective by nature. We encourage transparency on how the remuneration committee assesses and weights employee and cultural Key Performance Indicators (KPIs). These are factors we will assess when we next vote on the Deutsche Bank remuneration plan. But it is encouraging to see this evolution, and we hope that this improved structure will be matched with appropriate use of discretion by the bank's remuneration committee.

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