

**May 2010**

## **F&C's Financial Sector Voting**

In light of the catastrophic nature of the global financial crisis that erupted in late 2008, F&C's Governance & Sustainable Investment (GSI) team established a framework for voting at the AGMs of financial services companies that were materially affected. Client and public interest in our voting activity in this sector has remained very strong, and we therefore have documented our considered, pragmatic approach to voting and engaging with banks in these still-fluid market conditions.

### **What is the endgame?**

As an investor, F&C attaches high importance to a healthy and sustainable financial system. This is important not only for our investments in the equities and bonds of banks themselves, but also to ensure that other investee companies are in a position to receive the financing that will allow for long-term growth and value creation. The lessons of the recent financial crisis speak to the need for fundamental, not incremental, reform in the financial sector to assure the emergency of a stable, sustainable global economic system. This has resulted in F&C undertaking engagement at both the public policy level and with individual financial institutions to raise these themes.<sup>1</sup>

The systemic nature of the financial system requires coordination at an international level. While reforms ultimately need to take place within each individual institution, these will not be successful unless they are taken up broadly, in a wide range of jurisdictions. F&C supports the regulatory reforms recommended by the International Monetary Fund (IMF) to ensure higher customised capital requirements, particularly in those banks that are of systemic importance to the financial system. Banks regarded as "too big to fail" pose a threat of moral hazard and create a contingent liability on the public finances of many governments. We welcome moves to raise capital and liquidity requirements, as these constitute a critical first step in ensuring that banks be better positioned to withstand future financial downturns.

At the individual bank level, we believe there is scope for reform across a range of issues, including board effectiveness, risk management and remuneration. While remuneration is only a part of the equation, it is a key component in that it establishes the framework of incentives for bank executives and individual business decisions. In this regard, we support the G20 recommendations for reform of bank remuneration, and we encourage banks to embrace publicly the G20 recommendations and to become engaged with the evolving debate about bank regulation and reform.

### **How F&C assesses individual banks**

- Almost all financial services firms have experienced substantial losses, either as a direct result of the sub-prime meltdown, or due to the ensuing credit freeze, global recession, loss of investor confidence and market freefall that struck in 2009. However, while some institutions have suffered catastrophic losses, others have navigated challenging times more successfully, preserving greater value than competitors.

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<sup>1</sup> See F&C's submission to the UK's Walker Review and F&C's letter to U.S. Senators Christopher Dodd and Richard Shelby with regard to the "Restoring American Financial Stability Act of 2010" at [www.fandc.com/publicpolicy](http://www.fandc.com/publicpolicy).

- As always, F&C's primary focus is on the protection of investor value at individual companies held in client portfolios. However, one major lesson of this crisis has been the significance of systemic weaknesses in driving down value at otherwise sound businesses. Our voting activity therefore also seeks to promote better governance standards across the sector as a whole, in recognition of the need to reconcile near-term competitiveness with the long-term sustainability of the economy as a whole.
- In casting its votes, F&C considers both a company's immediate past performance and its future prospects. Votes are an important tool to indicate dissatisfaction with past performance and poor decisions, but we also consider how well positioned a bank is to weather volatile and uncertain markets.
- F&C votes at major financial holdings on a case-by-case basis. However, there are certain matters of fundamental principle where, absent unique circumstances, we take a consistent position across all companies, in the belief that shareholders must take a firm stand against anti-shareholder *precedents* being set in a time of crisis. This applies, for example, in the case of restrictions on shareholder rights in capital raisings. While the "new" market environment may have created a sense that "old rules" had to be suspended, we consider it essential that our votes signal to boards across the market that certain practices remain unacceptable.
- Emergency government intervention in the banking system substantially altered the balance of power and decision-making authority at certain institutions, bringing to the fore considerations of both shareholder value and public interest. Companies with significant government stakes require a different kind of analysis to understand how states may influence strategy, operations and relations with other investors. To this end, although F&C appreciates the need for state-controlled banks to be answerable to their government owners, its voting will continue to reflect its assessment of what is in the long-term interest of its clients.

## 2009 Voting Overview

2009 saw F&C vote against, or abstain on, the reelection of certain board nominees it considered had failed in their fiduciary obligation to deliver appropriate strategic direction and prudent risk oversight. These votes reflected a clear call for accountability. Votes against individual directors were specific and targeted in order to avoid contributing to widespread destabilisation of any one board. Votes against directors focused on committee chairmen and the CEO, where they were up for election. Our opposition was not extended to all members of committees unless there were egregious considerations. Moreover, given 2008's extraordinary circumstances, we made exceptions to our policies to underscore our support for competent boards that had performed well during the crisis.

### **At companies that sustained enormous losses, we expected significant board changes, and strived to register our concerns about performance:**

- We expected to see new independent directors and refreshment of the audit, risk and remuneration committees. We voted against the chairman of the nominating committee, the senior independent director/lead director and/or the independent chairman at poorly-performing companies presenting the same roster of unsuccessful directors serving on the same committees. If these individuals were not standing for election, we signalled our concern by voting against another member of the nominating committee, or a long-standing director.
- We abstained on the Report & Accounts to communicate deep reservations about the management of the business, the effectiveness of board oversight and the wisdom of past strategic decisions. In the US or other

markets, where the report & accounts were not subject to a shareholder vote, we used our director votes to signal concern over serious strategic missteps.

**At companies most deeply and materially affected by the crisis, we held executive management to account:**

- At banks where management change had not already occurred, we considered a vote against the CEO if there was poor execution of strategy (e.g. extensive losses, capital mismanagement, poorly-judged acquisitions, etc.) Such a decision took into account the best long-term interests of the company, such as avoiding further destabilization, evidence that the CEO remained the most effective leader, etc.
- Where we supported the CEO (for reasons above) but had concerns, we commented on the ballot and in our follow-up letter.

**At companies where there was evidence of poor risk management and oversight (e.g. extensive write-downs and losses; inadequate due diligence in acquisitions), we challenged the performance of the appropriate committee:**

- We voted against the chairman of the audit committees or the committee explicitly tasked with risk management (e.g. finance & risk committees).
- In cases where we wished to send a stronger message, we also voted against long-standing members of the audit or other committees if they constituted the majority of these committees and/or there was no evidence of new appointments.
- We commented on the appointment of the auditors where we had concerns about their role in assessing risk exposure, but did not consider the auditors as primarily responsible for poor risk management.

**Where companies disregarded shareholder rights in capital raisings, we acted to prevent the erosion of shareholder rights:**

While strictly following the letter of regulatory standards, a number of emergency capital raisings consistently violated its spirit by offering investors “false choices”. The crisis emboldened banks to offer deals that were seriously dilutive to existing shareholders but, if rejected, carried such punitive terms that shareholders essentially had no choice but to approve them.

- We voted against the independent chairmen or the senior independent directors/lead directors on boards where shareholder rights were violated and capital raisings were poorly structured and executed.
- At extraordinary general meetings, we abstained on or voted against such transactions.

**Where remuneration contributed to excessive risk-taking, we challenged overly short-term pay practices that did not align pay with long-term performance:**

Our voting focused on available data relating to past performance and strategy, but also considered any proposed revisions to future plans. While we recognise that no individual bank can single-handedly drive reform through its own actions, we believe that sector-wide structural reform is essential, and therefore that all banks should take visible steps to contribute to such a transformation in the industry’s culture and standard practices. We therefore used our votes to signal our desire for change and to empower independent directors to play their part in reforming pay practices across the industry as a whole.

- We voted against remuneration committee chairmen at banks that rewarded failure or that did not sufficiently tie pay to performance in 2008.

## **2010 Voting Outlook**

For many financial services firms, 2009 was a transition year. Although still severe in the early part of 2009, the financial crisis eased as the year evolved – in no small part thanks to governments bailing out individual banks and providing liquidity to the system as a whole. Every financial institution benefited, directly or indirectly, from this governmental support, which meanwhile drove a sharp rise in public sector indebtedness in many of the countries

most affected by the bailouts. Some financial institutions continued to post substantial losses in 2009, while others have returned to profitability. Share prices at many banks have also rebounded, offsetting some of the substantial losses that resulted in 2008.

Against this backdrop of still-fragile recovery, it is imperative that the lessons learned from the financial crisis not be forgotten. In order to resist a potential drift back to pre-crisis “business as usual” practices, F&C will use its voice and its vote to give a strong signal to financial institutions to continue their positive efforts to redress the corporate governance deficiencies of the past.

### **Director elections**

We note that in 2009, many executive teams and boards were reconfigured and strengthened to address weaknesses and past poor performance. Greater attention has been focused on risk management, while the emergency capital raisings that had sharply diluted shareholders in the latter part of 2008 largely came to an end by 2009. Consequently, F&C’s 2010 voting on director nominations will shift away from removing individuals associated with poor risk management and shareholder rights abuses. **However, we will continue to identify and vote against those directors still on boards who should be held accountable for the failings of bank governance leading up to the crisis.**

### **Remuneration**

In 2010, F&C’s voting will focus on continuing to reinforce board competence, independence and balance, while ensuring that remuneration and risk control policies have been strengthened to avert a recurrence of the recent crisis. Indeed, in the aftermath of the crisis, **remuneration will remain a particular area of focus.**

In light of the stronger results reported by many banks in the latter part of 2009, F&C is concerned that many financial institutions will seek to reward executives for financial performance that was driven just as much by government support as it was by the banks’ own performance. A key focus will be high short-term bonus awards, and the extent to which remuneration committees have exercised discretion to award these for 2009 performance particularly given the extraordinary losses and rising indebtedness suffered by shareholders and the tax-paying public.

While F&C recognises that banks need to attract, retain and motivate high-quality executive talent, we believe the most appropriate way to do this in the current environment is through long-term incentive awards. As a result, **while our voting will resist generous short-term bonus awards, we will tend to support longer-term incentive awards that are properly structured.**

In particular:

- **We will vote against remuneration reports that include one or more of the following features:**
  - Significant bonus awards that were granted for 2009 performance for banks still in recovery mode and where the beneficial conditions brought by government bailouts provided much of the foundation for improving performance;
  - Poor disclosure of performance conditions (relating to awards for outgoing as well as incoming management);
  - Over-reliance on single performance targets that may be open to manipulation;
  - Performance periods encouraging excessive risk-taking over short-term horizons;
  - Inappropriate balance between base/variable pay and short/long-term awards;
  - Rewards for failure.

- **We will look for evidence of changes in remuneration philosophy and practice** to prevent excessive focus on the short term and to encourage closer links to appropriate risk levels. Indicators may include:
  - Multiple performance metrics incorporating risk-adjusted returns on capital;
  - Extended performance periods, beyond 3 years, for long-term incentive arrangements, that provide a true reflection of sustained performance;
  - Where companies choose to increase base pay as a result of extended performance periods, the expected value of total compensation should not increase;
  - Scaling back of annual awards of restricted shares and options to reflect depressed share prices. Maintaining maximum awards as a percentage of salary may result in excessive dilution and may lead to significant windfalls for management when the markets bounce back;
  - Additional holding periods for share awards beyond the associated performance period;
  - Introducing longer-term view to annual cash awards. Evidence might include using deferred shares in place of all or some cash or building a clawback mechanism (e.g. escrow account, etc...)
  - Metrics that evaluate relative performance versus peers (e.g. TSR linked to sector performance);
  - Evidence of the company's commitment to a consistent performance-driven group-wide remuneration strategy beyond top executives;
  - Enhanced disclosure (e.g. in bands) of the remuneration of individuals below board level who materially impact the company;
  - Commentary on how risk-adjusted returns are factored into remuneration (e.g. dialogue between the remuneration and the audit, risk or compliance functions).

**In markets where we cannot vote directly on remuneration plans:**

- We will support shareholder proposals calling for investors to have a "say on pay"
- We will evaluate other shareholder proposals about compensation based on the merits of the proposals and according to our standing policy for voting shareholder resolutions.

**Board and management accountability: F&C's commitment to investor accountability**

This framework has informed F&C's voting activity and has been implemented on a case-by-case basis across major financial services holdings and after close consideration of individual circumstances. In all cases where we abstain or vote against management recommendations, we send a letter explaining our vote to the company and its board.

Proxy voting is only one tool used by F&C to encourage better practices in the financial services sector. Our ongoing engagement through direct dialogue with management, through numerous international governance networks, and with regulators are equally important for influencing successful outcomes at companies held in our clients' portfolios.