Association of British Insurers

Revisions to the UK Stewardship Code

The ABI's response to the FRC's consultation document

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

ANNEX

Questions for Consultation

General comments

Members broadly consider the Code as a whole to be well-structured, balanced and clear. However, there are some specific areas where ABI members are concerned that changes are close to failing the second test governing the proposed changes; that they should not fundamentally impact investors' stewardship activities or be unnecessarily prescriptive.

Members consider that the extension of the principles of the Code to cover overseas investments needs to be reconsidered. Although the revised Code only invites adopters to report on their practices we are concerned that the existence and implication of the language infers this to be in some way best-practice or an informal requirement. Members have highlighted concern over the FRC potentially extending its remit beyond UK-listed companies. While the ABI has conveyed support for Codes for Institutional Investors in different markets it is important that, if such Codes are considered appropriate, they are developed taking account of the nature of local markets. We therefore believe that any further development of Codes should be encouraged at a national level and any form of extra-territorial oversight must be avoided.

Furthermore, the extension of the principles of the Code to cover debt securities needs to be implemented with care. Members agree that companies are well advised to consider the views and expectations of debt investors as this will assist them in raising capital on cost-effective terms, as well as retain access to the debt market. However, holders of debt securities do not have rights that are analogous to those of shareholders which bring corresponding responsibilities that the Stewardship Code has naturally been concerned with. Although the revised Code only invites early adopters to report on their practices we are concerned that the inference of best-practice is somewhat premature. This would translate to a fundamental change to the operation of stewardship activities and therefore we believe a more in depth discussion is required before it can be considered a best practice requirement under the Code.

Finally, members are concerned that the change in wording under principle 2 from "robust" to "effective" may have a material negative unintended consequence in regard to meeting the AAF 01/06 standard. The AAF 01/06 Working Party has noted that there would be a consequential increase to the burden of proof required to demonstrate compliance. The implication is that this change is likely to significantly increase the burden and cost of the process, and may result in prescriptive requirements in documenting activities.

The definition of stewardship

We welcome the added clarification of what is meant by stewardship. The Stewardship Code should not be, or be seen to be, an invitation to micro-manage companies. Therefore, we particularly welcome the balance conveyed between the

primary responsibility of the board in overseeing the actions of management and the responsibility of investors in overseeing the board's fulfilment of its responsibilities. However, we do believe that activities that scrutinise and question, rather than direct, company matters such as strategy, performance, risk and corporate governance, will in the long run serve to promote the success of companies. We believe that the introductory section and guidance to principle 1 encapsulate this balance of approach well.

We also welcome the broadening of issues over which investors should be engaging in company dialogue. Engagement should be on-going and not limited to last minute discussions pertaining to specific proxy voting items. More meaningful dialogue on fundamental issues such as strategy, risk appetite, and performance can only work to aid investor understanding, and, hopefully, better contextualise corporate governance and remuneration practices.

However, we believe that investor stewardship should also include dialogue on the board's capital management and financing decisions. It is important that the balance between retained earnings, shareholder returns, employee pay-outs and capital investments into the business continue to be in the long-term interests of investors. Likewise, it is important that companies' access to capital markets is undertaken in an appropriate manner and in consultation with shareholders. The FRC should consider including this aspect of stewardship in the Code.

The roles of asset owners and asset managers

Although an oversimplification of the commercial reality of many investment companies - some of which may be part owner part manager - this clarification of roles is considered helpful and should serve to improve the functioning of the different stewardship roles within the investment chain. Enhancing the relationship between asset owners' and asset managers' so that it better takes account of stewardship responsibilities is a central component in building an effective coalition of engaged investors. We therefore support the clarification of asset owners' responsibility in this regard.

However, perhaps further guidance on what this ought to entail would be more instructive to the asset owners that are new to the concept of stewardship. We think the FRC should consider expanding paragraph seven within 'Application of the Code' to provide further guidance on the types of ways asset owners' should feasibly be applying the Code principles. This is particularly important in regard to the suggestion of holding to account their asset managers.

It is important that they heed the comply-or-explain nature of the Code and understand that there will be many different approaches to stewardship practices in the market place. We consider it important that such discussions form part of the normal client interaction, rather than be reported on in a compliance statement by the asset owners. For example, it would be entirely counterproductive for asset owners' to be "naming and shaming" those investment managers they had conducted robust engagements with around their particular stewardship approaches. A more constructive approach would be to guide as to the type of questions the asset owners should be considering as part of their normal client interactions.

For example:

- should there be consideration to including stewardship practices formally within investment agreements?
- should they form part of the competitive tendering process?
- should there be structured annual review of the mandated asset managers' stewardship practices?

We consider this to be an important way of ensuring a market based solution to improved stewardship. Client interaction of this nature provides a natural incentive for the asset managers to demonstrate the competence and rigour of their in-house stewardship practice. It will help reward those that have been effective in implementing the principles of stewardship in the management of their investments. Those asset managers with less developed stewardship practices may also feel a natural pull to improve in a bid to avoid laggard status, particularly in the context of hard fought contractual tender processes.

Conflicts of interest policies

Two separate reports[1][2] on the implementation of the Stewardship Code have highlighted concern over the effectiveness of conflicts of interest policies for both identifying and managing potential conflicts. A handful of asset managers still restrict disclosure in their compliance statement to either a statement that the recommendation of the proxy voting service shall take precedence or a generic statement that they shall act in the best interests of their clients. Little is detailed on the matters that may arise to cause a conflict and how such conflicts are mitigated in practice.

To augment a move away from boiler plate disclosure we are generally supportive of attempts to encourage more informative language. It is important that such statements detail potential conflicts as they relate to the practicalities of day to day stewardship activities. Therefore for compliance statements to be effective it is important that they describe the specific ways in which conflicts may arise in view of the nature of the organisation.

While signatories will be unable to document every single example of potential and actual conflicts it would be informative for there to be a single example of how the various different conflicts are controlled for and mitigated. For some investment companies this will mean explanations on an institutional, individual and group level. If relevant and appropriate some explanation at each level would be best practice.

We therefore particularly welcome the guidance statement that notes that the policy should address how matters are handled when the interests of clients or beneficiaries differ. The issue of conflicts of interest may be an area where further guidance could be provided for asset owners. Perhaps there would be further benefit in alluding to the responsibility of the asset owner in overseeing the effective operation of the conflicts of interest policies of its mandated asset managers.

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[1] The FRC's 'Developments in Corporate Governance' report - http://www.frc.org.uk/images/uploaded/documents/Developments%20in%20Corporate%20Governance%2020101 17.pdf

[2] Fairpensions: Stewardship in the spotlight, 2010. http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf

Collective engagement

We are happy with the proposed wording and do not have any improvements to suggest.

The role and use of service providers and other voting advisory services

We consider it important that statements in relation to how proxy advisers are used provide the necessary information to assess the quality of signatories' stewardship activities. Therefore, it is essential that such statements detail the extent to which they use, rely upon and follow the recommendations of proxy advisers. We welcome the proposed changes particularly in the context of demonstrating that in the UK such services are used to inform, rather than replace, investor stewardship activities. As the consultation paper rightly points out this is important given the enhanced focus on the role proxy advisors play in the EU.

Improved disclosures here should also serve to better equip asset owners' to be more discerning, if they so wished to be, on the merits of their potential and or mandated asset managers' stewardship practices. This is another area that provides a natural incentive for the asset managers to demonstrate the competence and rigour of their in-house stewardship practice.

Finally, we welcome the new emphasis on the important role of service providers in promoting and facilitating stewardship across different parts of the investment chain.

Stock lending

We consider the first sentence retained from the previous iteration that - investors should seek to vote all shares held - is a cornerstone ownership principle. However, stock that is on loan is no longer "held" in the sense of legal ownership powers, despite the economic ownership being retained. Furthermore, the large asset managers will have a diverse range of investment mandates in operation for asset owner clients with differing investment objectives; and therefore activities in this regard will seek to reflect client agreements and preferences.

Recalling stock can be a burdensome process and investors will typically undertake a cost benefit analysis of the merits of any recall in view of its clients' interests and the time costs associated with the administrative process. This said further transparency on the approaches adopted would be of benefit to the functioning of the stewardship chain. It is important though that the Stewardship Code is not inferring a preferred approach but is asking signatories to disclose their policy. Effective stewardship requires assessment of the costs and benefits of recalling stock to vote against the loss of income on lent stock that this entails. It is the

ultimate interests of those on whose behalf investments are held that matters in this regard.

Other asset classes and scope

The extension of the principles of the Code to cover debt securities needs to be implemented with care. We support the recognition of the importance of providers of long-term debt finance to achieving the success of the company. The relationship between debt holders and the company is, though, quite different from that between shareholders and the company of which they collectively comprise the 'ownership interest'. It is a matter of law that the Annual Report is addressed to the shareholders. As such they themselves will have a natural interest in informative reporting on the contribution of debt capital to the financing needs of the company which will be relevant to the valuation of the company's equity.

Holders of debt securities do not have rights that are analogous to those of shareholders which bring corresponding responsibilities that the Stewardship Code has naturally been concerned with. Their relationship with the company should be constructive but is in essence contractual and the rights and protections that they enjoy are vis a vis the company. Companies are well advised to consider the views and expectations of debt investors as this will assist them over time in raising capital on cost-effective terms. For the investment institutions owning such securities their stewardship responsibilities on behalf of savers, policyholders and other ultimate beneficiaries is in turn to maximise sustainable value from their investments.

The advent of bail-in of debt for financial sector companies, and the emergence of the concept of contingent capital instruments as loss-absorbing capital for regulated financial entities, has the potential to complicate this analysis. If debt holders are exposed to equity-type risks they are entitled to have views as to the appropriateness of governance and the risk appetite of the issuing entity and there is a legitimate question as to whether and, if so, at what stage and in what way they might be afforded rights. However, we do not think it can be right that debt holders in their capacity as such can be regarded as owing responsibilities or duties to companies.

These are important considerations for institutional investors considering stewardship activities across different asset classes and therefore it is important that the revised Code only invites those adopting such practices to make reference to them, rather than making it a requirement or inferring best-practice views not necessarily shared. We believe a more in depth discussion is required before it can be considered a best practice requirement under the Code to undertake stewardship activities in relation to debt securities.

Members have expressed concern over the FRC extending its remit beyond UK-listed companies. While the ABI has conveyed support for Codes for Institutional Investors in different markets it is important that, if such Codes are considered appropriate, they are developed taking account of the nature of local markets. For example, European markets vary in terms of the nature of share ownership, some being characterised by a dispersed shareholder model whilst others have large bloc shareholders pre-dominating. We therefore believe that any further development of Codes should be encouraged at a national level and forms of extra-territorial oversight must be avoided. In order for there to be efficient cross border investment,

and so as not to place excessive administrative or regulatory burden on institutional investors, Codes will need to be based around a common set of values.

Furthermore, clarity around the scope of stewardship activities across different funds under management, for example for overseas investments, may be difficult to present in the narrative of a compliance statement given the complexity of such arrangements at global asset management companies. Different investment mandates will have different requirements, some directed purely by the asset owner's corporate governance policy, some will be executed by separate responsible investment advisers e.g. engagement overlay services, some undertaken purely by the asset manager and some a blend of each. Cumulatively, asset managers may find it difficult to convey in a clear way each of these different approaches in such disclosure given the range of mandates under management. The complexity here also indicates the possibility of double-counting engagement work; which is something that risks the credibility of the system, particularly in relation to the free-rider problem.

Assurance reports

Given that signatories are still able to explain if they were to consider different levels of assurance inappropriate, in light of their business model and approach to stewardship, the change of emphasis is not considered problematic. However, we note that some investment companies' stewardship activities may be audited or verified by virtue of their inclusion in a holding company's sustainability report, and therefore subject to independent verification, albeit not to the AAF 01/06 technical standard. Of course, it remains the responsibility of the signatory to explain why differing standards of verification are suitable in providing sufficient outside scrutiny of the veracity of statements and practices. We agree that the purpose and credibility of obtaining an assurance report is undermined if they are not available for clients and potential clients, and therefore support more formal recognition of this under principle seven.

However, we note that the Institute of Chartered Accountants Stewardship Supplement to AAF 01/06 was developed on the basis of the previous Stewardship Code wording. Therefore, any substantive amendments may result in changes to the nature of the assurance process as well as the burden of proof required in providing an opinion. In this regard, the AAF 01/06 Working Party has noted that the change in wording under principle 2 from "robust" to "effective" would represent a material change to the burden of proof required to demonstrate compliance. The implication is that this change is likely to significantly increase the burden and cost of the process.

Relevance of signatories' statements

Members consider some form of periodic review of policy statements would be sensible as a self-review mechanism for signatories; however, it is considered unnecessarily prescriptive to suggest that this ought to be formally undertaken on an annual basis. It is a matter of reputational importance that practices continue to reflect the stewardship policy outlined within compliance statements. Given the largely on-going nature of members' stewardship practices it was considered more

meaningful to require review of policies when material changes to practices and / or approaches had occurred.

Insider information, acquisitions and sub-underwriting

We welcome the further clarification provided under the guidance to principle three. Although we would note that it is important that part of the guidance – that companies give prior notification before taking investors inside – should be directed towards companies as well. This would form a natural addition to Section E (Relations with Shareholders) of the Corporate Governance Code. Prior agreement is an important principle that should be observed by companies; there is very little an investor can do if taken inside without prior agreement. We have been in receipt of concern from company representatives that guidance on this point is not adequate and, therefore, this may be an opportune time to consider if further guidance could be provided under main principle E.1.

Similarly, as the Stewardship Code has resulted in an increase in investor engagement activities, concerns have been raised over what some investors consider the subjective intersection between corporate governance and market sensitive information. Despite the guidance[i] issued by the FSA pertaining to shareholder engagement and the regulatory regime for market abuse, disclosure of substantial holdings and change in control; there remains a desire for further guidance specifically on the types of corporate governance related discussions that could be considered market sensitive.

Finally, we agree that the FRC should avoid incorporating unduly prescriptive material into the Code. It is disappointing, however, that it has not been considered possible for this reason to include any reference to the specific recommendations made by the IIC in its Rights Issue Fees Inquiry. An underlying theme to the Report is that the views of shareholders can be of particular help to companies in navigating challenging waters around capital raising and also that some of the most useful assistance can be provided through early rather than later dialogue at which point it may be difficult to initiate dialogue.

Arguably either the Stewardship Code or the Corporate Governance Code (in Section E on Relations with Shareholders), or both, would benefit from some reference to the importance of companies making particular use of the advice of shareholders in matters where they are well placed to provide such advice. Rendering assistance in these circumstances to the companies in which they have holdings is also the most obvious way in which shareholders can be responsible owners. We consider this consistent with the sentiments expressed above as regards the appropriate definition of stewardship; the distribution of and access to capital are fundamental areas for shareholder dialogue.

FSA disclosure requirements

We are happy with the proposed wording and do not have any improvements to suggest.

Guidance to Principles 3 and 4

We note, and approve of, the specific reference to considering the quality of the company's reporting. This is central both to the ability of shareholders to exercise their stewardship responsibilities and to the Financial Reporting Council's locus in oversight of governance standards.

[i] http://www.fsa.gov.uk/pubs/other/shareholder_engagement.pdf