Corporate Governance and Stewardship
Financial Reporting Council
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Aviva Investors' response to the FRC's proposed revisions to the UK Stewardship Code

About Aviva Investors

Aviva Investors is the global asset management business of Aviva plc, managing assets in excess of £331 billion[1] across a range of equity, fixed income, multi-asset, real estate and alternative strategies. We operate in the United Kingdom, Europe, North America, and select Asian markets.

Aviva Investors recognises and embraces our duty to act as responsible long-term stewards of our clients' assets. We maintain a deep conviction that environmental, social and governance (ESG) factors can have a material impact on investment returns and client outcomes, and that being a responsible financial actor means our investment approach must support, and not undermine, the long-term sustainability of capital markets, economies and society.

Summary

We welcome the opportunity to provide comment on the revamped UK Stewardship Code. The introduction of the code in 2010 was a ground-breaking initiative which fundamentally redefined the responsibilities of asset managers and owners and helped to strengthen the global standing of the UK capital market. Following the rewriting of the UK Corporate Governance Code in 2018, we believe it is appropriate for the Stewardship Code to be subject to a fundamental review and update.

We are broadly supportive of the key objectives behind the revised code, in particular the intention to refocus the code on outcomes, expand the scope beyond equities, engage the

[1] As at 31st December 2018

broader investment value chain, and include environmental, social and governance considerations within stewardship obligations. While the new code represents a step change improvement on the existing framework, we consider there is significant scope for further enhancements.

We have provided comment on 10 distinct areas where we believe there is an opportunity for the FRC to strengthen the code, clarify expectations upon signatories, and create a more robust framework to realise the stewardship code's objectives. Our response includes recommendations in the following key areas:

Definition – reframe definition to clarify the extent to which the pursuit of generating value for the economy and society is deemed a standalone objective for stewardship and how this may impact the discharging of fiduciary responsibilities to clients.

Expanding stewardship beyond equities – guidance should outline a framework for managers to define standalone policy statements summarising how institutional level stewardship commitments are translated and adapted for distinct asset classes.

Incorporating ESG – provisions and guidance should require signatories to define specific objectives behind their ESG approach and frame stewardship policies and reporting accordingly.

Outcome orientated reporting – code should add an additional principle with associated provisions and guidance focused on reporting. FRC should consider endorsing the IA Stewardship Reporting framework to guide signatories' disclosures.

Building a market for stewardship – the principle, provisions and guidance for service providers should be expanded to explicitly reference and engage the sell-side recognising their critical role in the long-term allocation of capital.

Governance and audit – provide additional guidance for signatories to fully embed stewardship policies within firm-wide internal controls procedures and introduce spot audits to monitor the consistency between public statements and internal firm practices.

We would welcome an opportunity to engage and elaborate further on both our key recommendations and detailed comments below.

Detailed comments and recommendations

1. Definition of Stewardship

We note the proposed revised definition of stewardship outlined below.

'Stewardship is the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities.'

We agree that while the previous definition helped initially crystalize the concept of stewardship, the interpretation of key responsibilities and activities encapsulated by the term have evolved considerably in the intervening period. Therefore, it is appropriate to revise and expand the definition of stewardship to capture and promote more progressive behaviours amongst market participants.

We are supportive of the inclusion of asset allocation within the revised definition as this is a central component of delivering sustainable markets and client outcomes. However, we are concerned that the reference to 'sustainable value for the economy and society' may give rise to confusion. We firmly believe that over the long-term, the success of companies, economies and society are interdependent. Furthermore, investors have a responsibility to allocate and manage capital in a manner that, in general, promotes a thriving and sustainable economy and society. Nevertheless, we are concerned that the definition proposed may be interpreted as obliging economic growth or social welfare as a standalone objective of stewardship activities. In specific circumstances this could result in conflicting goals and undermine the discharging of fiduciary responsibilities to clients. We strongly encourage the FRC to revisit this definition and clarify the mandate of asset owners and managers when executing their stewardship responsibilities.

We also consider monitoring, engagement and the accountability of issuers to be a core element of Stewardship rather than an example activity as indicated in the proposed definition.

2. Purpose, Strategy and Values

We are strong supporters of the inclusion of purpose, strategy and values within the principles, and believe that it is appropriate for expectations upon companies contained in the corporate governance code be mirrored in the stewardship code. Organisational culture is critical to shaping and guiding behaviours and this must be grounded in a clear purpose and set of values. However, we consider that the language of the principle misrepresents the directional relationship between purpose, strategy and stewardship. Purpose and strategy must always come first and a firm's approach to stewardship would be derived accordingly rather than the other way round. An investment firm established to contribute towards social impact would have a very different approach to stewardship compared with a traditional hedge fund. Similarly smaller firms may limit stewardship activities to passive monitoring rather than active engagement in accordance with their purpose and strategy.

We are also concerned that the significance of the stewardship code's role in encouraging long-termism is not sufficiently emphasised. This was a key recommendation of the Kay review in 2012 and we consider the new stewardship code should be bolder in promoting long-termism in both allocation and management of capital.

3. Determination of Asset Allocation

We welcomed the inclusion of asset allocation within the revised definition of stewardship. This is a significant change to the prior definition which focused primarily on post investment monitoring. However, we believe there is an opportunity for the code to elaborate on what is meant by responsible asset allocation as a distinct stewardship activity.

In particular further guidance is required on the extent to which the development of dynamic long-term views of macro, sector, thematic, and company trends, when determining capital allocation, is considered to fall under the umbrella of 'stewardship' and how signatories would be expected to report on this. As part of this process, responsible long-term stewards of capital should be expected to fully integrate social, environmental and governance factors into the formation of forward-looking market outlooks and portfolio risk assessments.

4. Institutional and Strategy Specific Commitments

We agree that it is more efficient and effective to focus overarching stewardship disclosures at an institutional rather than strategy level. Individual firms could potentially have scores of differentiated strategies which will likely give rise to confusing messaging on their core stewardship beliefs and approach. However, we consider there is scope for further clarification within the code, outlining what stewardship means in practice for varying asset classes.

We welcomed the FRC's intention of extending stewardship beyond the realm of equities. However, apart from fleeting references to bondholder voting, the code does not sufficiently draw out the significant opportunities available for signatories to embrace stewardship responsibilities outside of equity mandates.

We would recommend the guidance outline a framework for managers to define standalone policy statements summarising how institutional level stewardship commitments are translated into asset level approaches such as for corporate equity and debt, sovereign, multi-assets, real estate and alternatives. This should include an asset class specific approach to asset allocation, monitoring, and the exercising of influence as owners and/or providers of funding. This is of particular relevance for illiquid asset classes where the importance of responsible stewardship practices is significant due to the longevity of holdings, while the specific stewardship activities will likely be markedly different to the approach adopted for traditional equity strategies.

5. Incorporating ESG Considerations

We have long considered the conspicuous absence of explicit reference to ESG has undermined the credibility of the code in addressing long-termism and responsible management of capital. We are pleased that this has now been addressed to some extent within the proposed revisions.

However, ESG investing can and has been interpreted in a variety of ways by different market participants. We would recommend the code provisions and/or guidance provide clarification on what is expected of signatories based upon the 'objectives' sought behind the factoring of ESG into the investment process. These objectives could include blanket ethical exclusions on certain industries/issuers deemed to be irresponsible, the targeting of defined ESG outcomes, and the integration of ESG considerations primarily to enhance alpha and deliver excess returns.

The ESG objectives adopted by asset owners and managers will determine the appropriate stewardship approach, activities and measures of progress and success. This in turn will allow for more meaningful reporting and differentiation of investors' commitment to ESG.

An objective driven approach to ESG will also provide greater clarity on how 'materiality' is defined, the spectrum of ESG topics addressed, and the importance of market reform based activities in delivering long-term client outcomes.

6. Outcome Orientated Reporting

One of the central recommendations of Sir John Kingman's review into the FRC was that the code needs to have a fundamental shift in approach to ensure 'clear differentiation in excellence in stewardship' driven by a greater focus on outcomes and behaviour rather than boilerplate reporting. We strongly agree with this position as there is limited evidence that the code has driven substantive change in actual investment behaviours amongst a large section of signatories. We believe that this has primarily been as a result of an excessive focus on policy and process.

We welcome the intentions of the FRC to move towards a greater emphasis on outcomes and consider the inclusion of the annual 'Activities and Outcome Report' to be a positive step in this direction. However, we were disappointed that this change in narrative was not subsequently reflected in the body of the code which remains orientated towards policies and procedures. While we understand the reluctance for the code to become overly prescriptive, we consider the lack of any framework, guidance and clear expectations for outcome related reporting to be a serious failing, which could undermine the future credibility and ultimately viability of the code. We would strongly encourage the FRC to add an additional principle with associated provisions and guidance, dedicated to reporting of stewardship activities and outcomes by signatories. The FRC could consider endorsing the Investment Association's Stewardship Reporting Framework as a mechanism of providing guidance on expectations and best practice. Guidance will be of particular importance in helping signatories effectively communicate the extent to which stewardship is systematically embedded within investment processes. This is unlikely to be achieved simply through the communication of limited case studies and engagement numbers.

We also note the FRC's deadline for signatories to publish their first Activities and Outcome Report. The timetable will mean the publication of assessments and tiering of signatories will not be available till midway through 2021. We do not consider this timetable reflects the urgency of the need to act. We encourage the FRC to explore interim solutions to demonstrate progress within a more reasonable timeframe.

7. Building a Market for Stewardship

Investment management is essentially a service industry designed to deliver on the needs and expectation of clients. The previous code and various industry reviews placed an excessive focus on the supply of stewardship services without addressing the demand side. This approach meant that an effective incentivisation and accountability mechanism for stewardship activities has not properly emerged. We believe that the revised code's greater emphasis on tackling stewardship responsibilities across the investment value chain coupled with requirements being introduced under the Shareholder Rights Directive II have the potential to be transformative. Ultimately, the awarding, renewal and withdrawing of investment mandates based, to some extent, on an alignment of stewardship objectives, will ensure investment managers are incentivised to develop appropriately resourced and empowered stewardship capabilities. We would encourage the FRC to review and potentially endorse industry initiatives that are seeking to develop model investment mandates that embed stewardship criteria.

We believe that enhanced reporting through the Activities and Outcome report is essential to improved accountability and the refocusing of stewardship on behaviours and impact. However, the goal of achieving 'differentiation in excellence in stewardship' will necessitate better reporting to be coupled with a discerning and informed audience. We believe that there is an opportunity for the FRC to play a more significant role in facilitating increased awareness in the market of existing and emerging stewardship best practice. This could include holding public forums for different managers to present their approach, commissioning and publishing research on particular stewardship topics (e.g. effective escalation), and the development of potential questions to support trustees in assessing managers.

Asset managers could also be encouraged to host their own stewardship seminars where clients and interested stakeholders have an opportunity to review a manager's approach and the delivery of their stewardship commitments.

For the investment chain to function effectively, the market must be 'enabled' to better judge the degree to which stewardship commitments are embedded within the fundamental culture, approach and investment behaviours of a manager and determine the extent to which case studies reported are a fair representation of overall activities across a firm.

8. Advisory Services

Advisory services have a significant impact at each stage of the investment value chain and their inclusion within the scope of the stewardship code is an important and positive development. The more progressive investment consultants are already developing frameworks to evaluate investment managers' stewardship capabilities at an institutional and fund level. However, there is limited evidence that ESG ratings generated through this process have had a material impact on overall manager ratings and selection. We believe this is a critical barrier to overcome for stewardship to play a more central role in capital allocation within the market. We encourage the FRC to develop appropriate provisions and/or guidance outlining expectations for how consultants' recommendations on manager selection and monitoring fully integrate ESG/stewardship ratings.

Beyond proxy advisors and consultants, we do not consider the revised code gives sufficient attention to the significant role played by the sell-side in how capital is allocated by managers. We have long considered that this vital research service is often overly focused on short-term factors and does not give adequate attention to broader ESG considerations outside of traditional financial metrics. This view was validated by the findings of a research report commissioned by Aviva Investors and published in October 2017[2]. We strongly encourage the FRC to fully engage the sell-side in the stewardship debate and ensure the principle, provisions and guidance related to service providers within the code be adaptable and relevant to their business models.

[2] Aviva Investors Investment Research: Time for a brave new world?

9. Audit and Assurance

The objective of the code is to encourage managers to embrace stewardship on a systematic basis and embed responsibilities within core investment processes. Therefore, we think the code would benefit from strengthened language to require signatories to report on the extent to which their internal controls framework reflects its stewardship commitments. It would then be possible to integrate stewardship controls assurance reviews into investment managers' AAF reporting. We would also expect for stewardship related controls and implementation to be within scope of a signatories internal audit program.

We continue to see some merit in the concept of external assurances of signatories' stewardship policies and approach. However, in practice, the assurance program under the existing code has provided limited value due to the skills and experience gap within assurance providers. This issue must be addressed through significant investment within assuring bodies for the value-add to signatories to outweigh the considerable associated costs.

10. Governance of the Code

The governance of the code and signatories is at the heart of the credibility of the code and the delivery of its objectives. We were supportive of the intention behind the initiative to tier signatories. However, in practice, the thresholds chosen were too low, rendering the outcome of the exercise to be of limited value to the market. To deliver meaningful differentiation in stewardship excellence, the FRC must develop a robust set of criteria to determine the level of commitment of signatories and the quality of their execution. This will require the FRC to have sufficient monitoring capacity and technical expertise to make robust and objective judgements. This must be a key consideration when determining budgeting and resourcing needs of the new Audit, Reporting and Governance Authority.

The refreshed tiering approach must also be accompanied by a willingness to police and remove signatories that fail to meet minimum expectations of the code. We would expect such a decision to be preceded by an interim period where the governing authority outlines a set of remedial actions required to maintain signatory status. Should a signatory be unable or unwilling to meet these requirements within a specified timeframe, the governing body should initiate proceedings to remove the signatory status of a firm, and determine an appropriate mechanism to inform the market.

To provide an additional layer of credence to the code we would support the introduction of a formal audit process to evaluate consistency of stewardship statements and practice. This could be achieved through the roll-out of spot audits of signatories. An audit program will both strengthen the integrity of the code while also providing an important feedback mechanism for future updates to provisions and guidance.

We would like to reiterate our support for the positive direction of travel of this review, and trust that our comments are helpful. We would hope that some, if not all, of our suggestions are reflected in the final proposals, which we will review with interest.

Yours sincerely,

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Aviva Investors