



Research Review

**Banks and the Credit Crunch
– where do we go from here?**

November 2008



Provided by: Governance and Sustainable Investment team



Expect excellence

Banks and the credit crunch – where do we go from here?

Over the past 18 months, the banking sector and its investors have experienced a series of seismic shocks. The roots of today's problems lie in the US mortgage market but have spread far and wide throughout the global economy and financial markets. Many commentators, including renowned investor George Soros, believe that the current financial crisis is the worst since the Crash of 1929 and the Great Depression of the 1930s.

It is too soon to gauge how deep or how lasting the damage from this crisis will be – but what is clear is that at its heart lies a fundamental failure of governance. F&C has long believed that a healthy economic system relies on the scrutiny, challenge and debate from active owners seeking to build transparent companies, strong and accountable boards and appropriate incentives.

While there remain many lessons to be learned and much work to be done, throughout the course of this year F&C has been actively engaging many of the world's largest financial institutions on key governance issues and will continue to do so going forward.

Using voting rights to challenge poor practices

During 2008, F&C actively exercised its voting rights on all bank holdings. At the annual general meetings (AGMs) of many of the banks most deeply involved in the credit crisis, we engaged them before the vote to explain what standards F&C expects; we opposed poor governance practices where appropriate, and detailed our concerns on the proxy and communicated them to the companies. Specific actions included:

- **Merrill Lynch:** We voted against the only audit committee member up for election due to the bank's poor performance, the size of its reported losses and concern over its risk controls. We also urged the board to switch to the annual election of directors which would have allowed F&C to vote separately on the chairmen of the finance and audit committees.
- **UBS:** We voted against the chairman and a member of the audit committee over concerns that the magnitude of losses reflected failures in proper risk oversight and control at the committee level.
- **Lehman:** We opposed the chairman of the nominating committee, because the board lacked balance – there were relatively few directors with less than ten years experience and many with multiple board positions. We expressed concern about board independence and objectivity and requested new directors to offer fresh perspectives.
- **Washington Mutual (WaMu):** We voted against the CEO, the chairman of the finance committee and all five members of the compensation committee. We particularly objected to the outrageous steps taken by the compensation committee to protect executive compensation from the costs and losses of the credit crisis and urged the board to restructure performance terms.
- **"Say on pay" resolutions:** We supported all resolutions calling for a UK-style "say on pay" at the large US banks. More broadly, we continued our constructive role in the Working Group on an Advisory Vote on Executive Pay – an investor-company collaboration exploring how a vote might work.

Conducting in-depth engagement to promote change

At many banks, F&C's voting activity has been complemented by in-depth shareholder engagement promoting good governance, effective implementation of strategy, "pay-for-performance", prudent risk management, sustainable banking practices and appropriate transparency and reporting. Over the past 18 months our discussions have included a wide range of global banks as illustrated in the table below:

Barclays (UK)	Bank of America (US)
Bradford & Bingley (UK)	Citigroup (US)
HBOS (UK)	Goldman Sachs (US)
HSBC (UK)	JPMorgan Chase (US)
Royal Bank of Scotland (UK)	Morgan Stanley (US)
Standard Chartered (UK)	Wachovia (US)
BNP Paribas (FR)	Wells Fargo (US)
Credit Suisse (CH)	US Bank (US)
Deutsche Bank (DE)	China Construction Bank (CN)
BBVA (ES)	Industrial & Commercial Bank of China (CN)
Santander (ES)	ICICI Bank (IN)
	Mitsubishi Corporation (JP)

Next steps

With the financial markets in turmoil and new stories breaking every day, it has been almost impossible for banks and investors to look beyond "crisis management." However, F&C will focus on several fundamental themes in its future engagement with banks around the world:

Appropriate Capitalisation

For banks to survive and insulate against future booms and busts, they will have to be better capitalised and less leveraged. F&C has not been prescriptive about how they recapitalise in the current environment, especially in light of increasing regulatory and government intervention.



However, we will look for clear indications that banks employ and maintain appropriate measures that:

- **Shrink their asset base:** through asset sales and by avoiding the temptation to grow for growth's sake.
- **Boost their equity:** through share issuance either to existing and new shareholders. F&C will loosen its dilution prohibitions when new shareholders – including governments and sovereign wealth funds – are brought in. Due to the current environment, the long-term security of a company is paramount. Banks can also retain more equity by suspending or reducing dividend payments to shareholders.

Incentive Structures

The debate over appropriate remuneration is not a new one for financial institutions, and pay-for-performance has been central to F&C's governance engagement for many years. However, the topic has never attracted such scrutiny – or public anger – with frequent attacks on perceived “heads-I-win-tails-I-win” schemes for executives. Politicians around the world, company executives, regulators and shareholders alike, are pointing to flawed incentive structures that exacerbated irrational risk-taking.

While scrutiny over the total amounts of pay for individual executives continues to intensify, we believe that the most critical areas of remuneration include:

- **Long-term value creation:** Should banks adopt deferred bonus payments over several years to help balance short-term and long-term objectives? Should boards require executives to hold onto a portion of equity awards after they vest?
- **Risk-adjusted rewards:** How can reward plans accurately reflect inherent risk and changing economic cycles? How can they guard against driving volumes rather than long-term value?
- **Performance metrics:** Are banks using the right measures to evaluate performance? Should earnings-per-share (EPS) be phased out in favour of risk-adjusted return on capital? What standards will be used to judge executive performance and award (any) cash bonuses in 2008?
- **Rewards for failure:** How can shareholders stop the “rewards-for-failure” culture and modify severance payments? Do boards have the option to “clawback” bonuses that were awarded for “value creation” that morphed into “value destruction”? Will boards have the backbone to utilise clawback provisions and how will it work in practice?
- **Role of the remuneration committee:** Are remuneration committees overly focused on retaining and attracting talent? What leadership role can they play in driving a pragmatic response to heightened scrutiny – and a likely backlash – over pay levels and structure? To what extent can committees influence remuneration strategies beyond the executive team? Will committees build stronger dialogue with investors to improve remuneration plans and promote advisory voting on pay in markets such as the US?
- **Filtering good practice throughout the organisation:** What changes need to be introduced beyond the executive suite to reinforce good practice? How can general employee compensation help rebuild the banking sector?
- **Board leadership:** What immediate steps can boards take to demonstrate a willingness to change pay practices and pre-empt restrictive and prescriptive regulation?

Management Accountability

Significant numbers of bank executives in the US, UK and Continental Europe have already “fallen on their swords” as a result of the credit crisis. To date, F&C has refrained from calling for wholesale board replacement for fear of further destabilising companies. However, we will continue to balance the need for long-term stability with a sharp critique of management strategy and execution, including calling for the removal of executives responsible for significant value destruction. In particular we will be looking for indicators of:

- **Board effectiveness:** including truly independent non-executive directors; checks on a concentration of power in the hands of the Chief Executive, including independent chairmen; evidence of challenging debates on key strategic issues; tangible measures to root out the problems contributing to the current crisis; and substantive evaluation procedures.
- **Strong succession planning:** particularly in light of current turnover risks, the challenge of finding appropriately skilled and experienced replacements and the need to expand the pool of talent from which new leaders can be recruited.
- **Risk management oversight:** by both executive and non-executive teams across existing businesses and acquisitions, including complex financial products, and reinforced by appropriate incentive structures and remuneration.
- **An ability to balance competing interests:** with increased state participation (through capital injections from governments or sovereign wealth funds and heightened influence on board representation), management teams will have to be adept at upholding public interests while creating value for shareholders.

Regulation

In the post-credit crisis “new world”, banks will be subject to increased levels of regulation. For example, the UK's Financial Services Authority (FSA) has already announced plans to force banks to hold more capital if it feels their bonus structures lead staff to take excessive risks. F&C will actively use its influence as significant shareholders and its membership of financial industry bodies to promote “smart” regulation. In particular, we will call for and support regulation that:

- Provides banking systems with **systematic rather than fragmented oversight mechanisms**;
- **Enhances accounting standards** that value risks better, price assets and liabilities more accurately and engender global support;
- Encourages **greater transparency and disclosure**, particularly relating to complex derivatives markets that remain opaque;
- Helps **create a level playing field** by setting good practice standards for the sector, rather than inhibiting competition completely;
- Protects **shareholder rights**, promotes investor participation and enhances enterprise value.

Although the current crisis demands immediate and urgent attention, F&C's engagement will not lose sight of other longer-term risks that have the potential to inflict serious global economic consequences, such as climate change. As such, we will continue to encourage companies to demonstrate a robust approach to dealing not only with today's challenges, but also those that lie beyond.



Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In both 2006 and 2007, F&C were voted winners of the 'Gold Standard' in the Fund Management category. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

Financial strength

Ability to meet and exceed customer expectations

Capability

Outstanding expertise and aptitude as a fund manager

Service

Ability to maintain and grow an effective post-sales relationship

Fair value

Assessing whether customers receive great value for money

Trust

Ability to instil confidence in consumers

As a result, the Gold Standards are one of the hardest, most sought after awards in the financial market place.



WINNER



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We are in an exceptional position to help grow your investments. As a multi-specialist boutique, our talented professionals work in accountable, tightly-knit teams which are supported by first class research, infrastructure and distribution capabilities. Our entrepreneurial culture combined with our rigorous and disciplined approach means we are an ideal choice to manage your investment portfolio.

Our expertise also encompasses a wealth of assets, strategies and regions. From traditional equity, fixed interest and property asset classes to alternative investments such as single strategy hedge funds and fund of hedge funds, we offer tailored, expertly managed investment exposure.

Highlights include:

- **European High Alpha Equities**
- **Asian High Alpha Equities**
- **UK High Alpha Equities**
- **Emerging Market Equities**
- **Governance and Sustainable Investment (GSI)**
- **Liability Driven Investments (LDI)**
- **Private Equity Funds**
- **Emerging Market Debt**
- **Hedge Funds**
- **Global Tactical Asset Allocation (GTAA)**

If you would like further information on our highly competitive range of investment strategies, simply contact the relevant F&C office below.

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