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INSIGHTS

ACTIVE STEWARDSHIP
IN FINANCIAL SERVICES

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“THE CONCEPT OF ‘ACTIVE STEWARDSHIP’ WAS FIRST INTRODUCED IN THE UNITED KINGDOM IN 2010 WHEN THE COUNTRY’S FINANCIAL REPORTING COUNCIL INTRODUCED THE UK STEWARDSHIP CODE.”

– Mariela Vargova, Ph.D.

Active **Stewardship**

Nine years ago, in mid-March, Bear Stearns, which in 2007 traded at over $125 per share, was sold to J.P. Morgan for $10 per share in a transaction that many mark as the beginning of, what we now know as, the Global Financial Crisis of 2008. While it is said that the passage of time heals all wounds, the disastrous contagion across the global financial landscape, the collapse of numerous large financial institutions and the loss of public trust in the financial services sector remains on the minds of many. Whether it was opaque counterparty exposure, excessive leverage, insufficient risk management, or a lack of corporate transparency, we now know that these factors in combination led to the near collapse of the entire global financial system. While the financial markets have moved well beyond that terrible day in March of 2008, the public trust of a very large sector of the global economy is still severely marred due to continued bad behavior, lack of corporate transparency, accountability and proper risk management, as well as risky business practices.

Accountability & **Reflection**

As the Governor of the Bank of England Mark Carney said in 2015, the "crisis and its aftermath laid bare that many of our markets didn't live up to these standards" of transparency, responsibility and accountability, and warned that until markets regain those qualities they cannot retain their social license to operate.[1]

The crisis also underscored the lack of effective shareholder scrutiny of boards of directors and senior management on essential corporate governance issues such as risk management, corporate strategy, independence and long-term value creation.[2] To overcome these shortcomings, the global investment community took on the role of "active stewardship" in capital markets. It started to adopt stewardship codes to engage with companies in seeking to improve business practices and disclosures. These efforts were focused on seeking major reforms towards financial stability and greater corporate responsibility.

2010: **Active Stewardship is Born**

The concept of "active stewardship" was first introduced in the United Kingdom in 2010 when the country's Financial Reporting Council introduced the UK Stewardship Code.[3] According to the code, stewardship means that investors are expected to proactively engage with companies on issues of strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.[4]

In January 2017, a group of U.S. and international institutional investors with combined assets of $17 trillion followed suit and launched the first U.S. Stewardship Code.

The adoption of stewardship codes in many national markets highlights a new set of responsibilities for shareholders. By signing on, institutional investors commit to closely monitor their companies and to use their voting power to improve corporate behavior. As fiduciaries, investors also commit to be more transparent about their own activities to their clients and other stakeholders.

Today, active stewardship includes many environmental, social and governance (ESG) issues that are priorities for those investing with a sustainability mindset. As fiduciaries, we at Rockefeller & Co. seek to engage with boards of directors and senior management on ESG issues to identify potential long-term business risks and encourage opportunities such as management quality and ethics, human capital and labor issues, climate change and low carbon economy. We believe that such engagements can have a long-lasting impact both on business profitability and competitive advantage.

Beyond the potential long-term investment growth and sustainability benefits of implementing these engagement activities, institutional investors are leading the efforts to rebuild trust in public markets after the financial crisis, starting where the issues were most apparent – the financial services sector.

Embracing Change: **Financial Services Sector**

Borne out of the trauma from 2008 and a new stricter regulatory environment, financial services companies were the first to face this new level of shareholder scrutiny and engagement.

Wall Street came under pressure by regulators and society to take significant steps to change its corporate governance guidelines, business practices and culture.

It may come as a surprise to learn that several large banks led the reform efforts in 2010 by reviewing their business standards and ethics codes and implementing

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employee trainings on new values and culture.

One of the largest banks significantly improved public disclosures by adopting new policies and processes on ethics, and publicly committing to high-quality practices to ensure financial stability and economic opportunity.[5] At the core of these efforts was the goal to be client-oriented, with accountability to stakeholders and regulators alike.

It was in the areas of risk management and board oversight that banks made the most visible changes. They created risk committees at the board level and implemented company-wide risk management programs. For example, we saw how a leading bank in the U.S. also established a new position of Chief Risk Officer reporting to the board and tasked with ensuring that incentive programs in the organization do not encourage excessive or unnecessary risk-taking.[6]

One of the largest banks also showed corporate leadership by publicly acknowledging responsibility for unethical practices and recognizing past mistakes.[7] They shifted their focus to identify and monitor "material risk-taking" in their organization and increased managerial oversight. Other banks publicly committed to seeking responsible business growth and to conduct their business in a more transparent way.[8]

A New Course **for Financials**

Banks and insurance companies play a vital role in our financial system, providing savings, financing, investment, and payment services to consumers and businesses of all sizes. Our modern economy requires a stable, trustworthy, and efficient financial services industry to function and grow. Active stewardship can serve a role in maintaining a strong financial system.

Bank managements should be motivated to pursue best practices, having experienced the consequences of bad behavior long after the Global Financial Crisis. Tighter regulations, enacted in the aftermath of the Global Financial Crisis, including Basel III and the Dodd-Frank Wall Street Reform and Consumer Protection Act, have increased capital requirements and compliance costs for financial institutions. They have also limited aggressive forms of lending and risk-taking.

In addition, banks have also incurred substantial legal penalties for poor conduct ranging from consumer loan servicing, market manipulation, fraudulent activity, and money laundering.

However, while new regulations and legal settlements have placed incremental financial burdens on the financial services industry, banks and insurers have since made substantial progress to comply with new rules and adjusted their business models accordingly. Balance sheets have been reinforced with additional capital and liquidity, and tighter underwriting. While this may limit loan growth, it has also resulted in reduced risk costs in their lending businesses. Banks have added headcount in their compliance and risk control divisions in an effort to monitor and prevent future misconduct.

With a new administration in power in the United States, there is some concern that an aggressive pullback of regulations is imminent. However, we believe that higher quality banks and insurers should remain conservative in maintaining their increased regulatory capital, underwriting standards, and compliance and risk monitoring capabilities, as failing to do so could draw the ire of legislators and regulatory bodies, as well as the general public. This could lead to additional costs through loan losses, further litigation expenses, and even more stringent regulations. We believe that through active stewardship, we can continue to promote responsible practices among these companies.

Going forward, we expect banks and other financial institutions with adjusted business models, that exhibit greater stability in earnings and balance sheet quality to benefit financially in the long run. A reduction of earnings cyclicality should result in higher investor confidence in dividend payouts over time, and financial stocks could see higher valuations as a result. Swedish banks are a prime example. Highly capitalized by global standards, with minimal loan losses in their home market even during economic downturns, Swedish banks have maintained premium valuations (14x to 16x forward earnings, 1.6x to 2x book value) compared to their European peers (many trade at 10x to 12x forward earnings, <1x book value). We believe this represents significant potential upside for long-term investors in the sector.

"OUR MODERN ECONOMY REQUIRES A STABLE, TRUSTWORTHY, AND EFFICIENT FINANCIAL SERVICES INDUSTRY TO FUNCTION AND GROW. ACTIVE STEWARDSHIP CAN SERVE A ROLE IN MAINTAINING A STRONG FINANCIAL SYSTEM."

Doing Our Part at **Rockefeller & Co.**

Over the past several years, the Sustainability & Impact team at Rockefeller & Co. has implemented active stewardship with the financial services sector. On behalf of our clients, we have engaged with boards of directors and senior management, focusing on the following issues:

- **Implementing strategy on long-term financial stability**
- **Improving transparency over business standards, values and culture**
- **Establishing sound risk management systems and processes**
- **Compensation and incentive programs tied to long-term performance**
- **Implementing new employee engagement and trainings**
- **Sustainable finance and climate related investments**
- **Financial inclusion and access to underserved populations**

As engaged investors, we believe we have made significant progress in many of these areas. We worked together with some of the largest banks in the United States in seeking to improve their disclosures over business standards and encouraged them to embrace ESG in their operations and investments. We continue to monitor their progress through regular meetings and communications.

Despite making significant progress in the areas of governing business risk and regulatory compliance, many financial companies continue to be involved in irresponsible business practices. Such behavior can potentially hurt long-term shareholder value and damage their corporate reputation. This is where we believe our active stewardship and constructive shareholder voice can have the most positive impact.

ROCKEFELLER & CO. HISTORY OF CO-FILING SHAREHOLDER RESOLUTIONS IN THE FINANCIAL SERVICES SECTOR AFTER 2008:

2017	**Wells Fargo, Report on Business Standards**
2017	**J.P. Morgan Chase, Proxy Voting**
2015	**Bank of America, Separation of Chair & CEO**
2014	**J.P. Morgan Chase, Report on Business Standards**
2014	**Bank of America, Report on Business Standards**
2014	**Wells Fargo, Report on Business Standards**
2013	**Wells Fargo, Payday Lending**
2012	**Morgan Stanley, Transparency in the Repurchase Markets**
2012	**Bank of America, Internal Controls Related to Mortgage Loan**
2011	**State Street, Separate Chair & CEO**
2011	**Morgan Stanley, Restore Confidence in the Financial System**

Our engagements with the financial services sector are supported by our long-term collaborative work with the Interfaith Center on Corporate Responsibility (ICCR). We also utilize other investor networks such as the UN-backed Principles for Responsible Investment (PRI) and the CERES/Investor Network on Climate Risk (INCR) to engage with companies on sustainability across various sectors.

Finally, the outlook for possible increased deregulation under the new administration could potentially undermine the gains achieved by shareholders through active stewardship and engagements. We believe that institutional investors should be more proactive than ever as stewards of companies and capital markets, and raise their voice in seeking to ensure good governance, accountability and responsible growth.

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[2] http://www.oecd.org/corporate/ca/corporategovernanceprinciples/43056196.pdf
[3] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf
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