

**Responsible Shareholding**  
Investing for Value,  
Engaging for  
Change





# Introduction to Responsible Shareholding

Our Investment Management team aims to maximise the value of our customers' investments. The Responsible Shareholding team within Investment Management also ensures our customers' money is helping to build a more sustainable future for us all.

Responsible Shareholding implements our ground breaking Ethical Engagement Policy across all the companies in which we invest. Company performance on corporate governance and social, ethical and environmental management is analysed to identify where good or bad management of an issue may impact upon share price, and to identify where a company's practices conflict with our customers' ethics.

This information is then used to engage with the company via meetings, letters and company Annual General Meetings encouraging them to adopt best practice. It is also used to inform the investment process for all our funds.

## How does Co-operative Insurance decide what is 'Responsible'?

We don't – our customers do! Customers were asked what issues they care most about and the results were used to create a new, customer driven Ethical Engagement Policy, launched in June 2005. This is applied across all the companies in which we invest. Co-operative Insurance is the first UK insurance company to do this.

Since 1999, a dedicated Responsible Shareholding team has been pursuing our customers' expectations of good corporate behaviour.

## How does Responsible Shareholding implement the Ethical Engagement Policy?

- **Research.** Before any action is taken, every issue is thoroughly researched by our analysts.
- **AGMs.** We exercise our voting rights at the general meetings of all our UK and overseas investee companies and challenge them on a range of issues.
- **Communicating with companies.** We communicate with companies on specific issues, voicing our concerns and representing our customers' values.
- **Risk assessment.** We assess the governance and social, ethical and environmental risks to which companies are exposed and feed this information into our investments team.

An overhead photograph of a business meeting. Four people are seated around a white table. A man in a grey suit is leaning over the table, shaking hands with a woman in a light-colored blouse. Another man in a grey suit is looking at a document on the table. A woman in a grey suit is also looking at a document. There are several black folders and pens on the table.

# Our Approach to Engagement

Our Ethical Engagement Policy means that we use our influence over companies, as shareholders, to encourage them to adopt the highest standards in corporate responsibility. Where necessary, we exert pressure, and offer help to the companies we invest in to change for the better. Responsible Shareholding works both to protect our customers' investments and champion their values by challenging companies to improve.

The Policy provides the basis for our engagement with a range of companies on individual issues. The resulting engagement projects all aim to:

**PROTECT** our customers' investments

**CHAMPION** customers' expectations of corporate behaviour

**CHALLENGE** those companies not promoting customers' financial interests and values to change.

## The Engagement Process:

- **identifying areas of improvement for individual companies and groups of companies affected by similar issues** – this involves in-house research, external consultation and written requests to companies for information
- **making recommendations for changes in policy and/or behaviour** – such as defining models of best practice
- **supporting management to implement change** – for example, facilitating contact between management and relevant external organisations
- **monitoring performance against best practice and policy commitments** – a key aspect of this stage is encouraging full public disclosure of material information
- **attending company AGMs to raise questions and gain direct access to senior management and non-executive directors**
- **using our vote at AGMs to signal support or concern on a specific issue** – each time we do not support the board, we write to the company to explain our position
- **through collaboration with like-minded investors** – we believe that where possible institutional investors should work together from a position of collective strength.



# Make Haste **Slowly**

## Brand Danger

In China, factory workers often work 12 or 13 hour days, seven days a week.

UK companies that buy low-cost goods at the expense of Chinese workers' health, safety and welfare are exposing their brands to unnecessary business risks.

That's the message of a report sponsored by Co-operative Insurance, working together with ethical trading consultancy Impactt.

## Changing Over Time

The report promotes a new approach to improving labour practices, focused on change over time rather than simple audit compliance, and shows it can have a positive impact for workers, suppliers and purchasers.

Impactt worked with 11 purchasing companies and their local partners over a period of three years to test the theory that by improving a factory's productivity, HR management and internal communications, working conditions can be improved and hours gradually reduced, whilst still maintaining wage levels.

During the project most factories saw increased productivity, improved quality, reduced hours, increasing pay and reduced worker turnover.

We have contacted 120 international companies in which we invest to highlight the report and provide practical support for companies to incorporate changes throughout their supply chains.



# Palm Oil – Pressed for Change

You wouldn't think that by buying a packet of crisps or a new lipstick you were contributing to climate change and the threat of orang-utans becoming extinct. But that's what happens when you buy anything containing palm oil, UNLESS the company producing the product sources palm oil sustainably.

Palm oil production has increased massively since the 1990s – much of it from plantations cleared from virgin rainforests.

That's why Co-operative Insurance has been working with Friends of the Earth to raise public awareness and encourage companies to join the Roundtable for Sustainable Palm Oil (RSPO), to develop a globally acceptable definition of sustainable palm oil production and implement management practices that comply with this definition.

Last year we engaged with 56 companies we invest in regarding their use of palm oil – those that have subsequently joined the RSPO include Sainsburys, Marks and Spencer, Tesco, Boots, Northern Foods, Morrisons and BP – demonstrating real impact. We've now managed to persuade all the biggest UK food retailers to join up.

But there is a new threat: a huge new demand for palm oil for biofuels. This has led to the development of an additional project to examine sustainability in the biofuels market.



Palm oil plantation worker ©Helen Buckland

# Biofuels – Eco-friendly or Eco-Disaster?

Biofuels are fuels made from plant, animal or waste material. Ethanol, a petrol substitute, is usually made from sugar beet or corn, whilst bio-diesel is usually produced from vegetable oils, of which palm oil is the cheapest. They have been hailed by some as a way to cut greenhouse gas emissions, and by others as the answer to spiralling crude oil prices. Unfortunately though, some biofuels, as we have seen with palm oil, are far from sustainable.

In theory biofuels are 'carbon neutral' – the carbon released when they are burnt was taken from the atmosphere by the plants as they grew. In reality, however, when rainforest is cleared to make way for new plantations, huge amounts of the greenhouse gas, carbon dioxide, are released.

Moreover, using crops normally grown for food, for fuel instead, creates massive increases in demand and hence large price increases. This is already reflected in world prices for corn and sugar beet.

The use of palm oil as a replacement for crude oil is unsustainable and will cause more problems than it solves.

Co-operative Insurance will encourage oil and energy companies to pursue biofuels with long-term potential for sustainable production, rather than short-term profit at a cost to all our futures.



# Blowing the Trumpet for Wind Power

## CFS Leads the Way

Last year, the Co-operative Financial Services group (including Co-operative Insurance and the Co-operative Bank) demonstrated that environmentally friendly policies and sound business credentials go hand in hand, by signing up to a green energy contract that reduces our carbon emissions and saves money.

## The Ecotricity 'Merchant Wind' Deal

By agreeing to a longer contract, and by having wind turbines constructed for us, Ecotricity was able to guarantee that the electricity they provide is cheaper than normal 'brown' electricity.

The turbines supply 25% of our energy needs and the deal offered a 10% saving on current 'brown' electricity prices for the first 3 years.

## Joined-up Thinking

Co-operative Insurance has shown joined-up thinking on social responsibility by promoting this winning formula to the companies we invest in: 40 of the UK's 150 biggest plcs.

Responses were positive – but highlighted obstacles to be overcome – so we organised a series of roundtable meetings, with household names such as BT and Boots, to hammer out what needs to be done to make wind power more viable and accessible to the widest number of companies.

We will be publishing a report on the roundtable conclusions, with which to lobby Government and other stakeholders and help 'unblock' the road to a vibrant wind energy economy.



# Exposed: Illegal Internet Fur Trade

When Samantha Lacey, a Responsible Shareholding Analyst, set out to research the fur trade, on behalf of the 77% of Co-operative Insurance customers who want to see an end to the trade, she discovered Internet traders using eBay to illegally export furs to the UK disguised as 'gifts'.

Within the fur trade Lynx is the most commonly used endangered species. Under international law, export and import permits are required before a sale is legal – otherwise items are liable for seizure at customs. With Lynx coats selling for up to £10,000 there are big profits to be made.

When Samantha wrote to a company selling a Lynx fur coat on eBay to ask if there were any regulations regarding the purchase, the seller proudly replied that they would mark 'gift' on the box to avoid any customs issue. Other traders were using the same scam.

Responsible Shareholding contacted eBay with their findings and recommendations for improving their customer reporting mechanism and the visibility of their policies.

eBay have stepped up to the challenge by adding a link to their policies pages from the bottom of every listing; adding 'Animal and Wildlife Products' as a type of violation that can be reported; and by promising to add a link from each listing where customers can report policy violations.

Ian Jones, Head of Responsible Investment, said '*Co-operative Insurance is delighted that eBay is seriously addressing ways to tackle these issues.*'



# Introduction to Corporate Governance

In holding shares we take responsibility as part-owners of companies we invest in and look to use this position to gain advantage for our customers. Acting as an owner, rather than as a remote investor, requires that we understand not only the numbers but the way decisions are made – and accounted for.

Shareholders appoint directors to manage the assets of companies on their behalf. Corporate governance allows shareholders to hold those directors to account. Corporate governance is the process by which companies are directed and controlled: the system of checks and balances that help make sure the company is run for the benefit of all stakeholders, not just the directors.

Through voting at all general meetings, and letting companies know the reasons why we vote the way we do, Co-operative Insurance voices concerns over a range of corporate governance issues, such as how much board directors get paid, how much their pay is linked to performance, and which individuals

are appointed to the Board. We liaise with companies on these issues and encourage companies to move towards best practice.

A recent report commissioned by the United Nations Environment Programme concluded that environmental, social and corporate governance issues affect long-term shareholder value – sometimes profoundly. Our experience backs this up; as a general rule, the corporate governance profile of a company is a good indicator of likely investment performance.

When an issue is serious, and the company is not responding to appeals for change, we attend the AGM. We've had a number of high-profile successes. Last year we asked the Board of United Business Media why their departing CEO received a £250,000 bonus for 'ensuring an orderly transition' to his replacement. Would you get a bonus for this? We considered it a waste of our customers' money. The Board, under siege from shareholders, relented and the bonus was handed back.



# First Group

Co-operative Insurance was one of a group of shareholders who filed a resolution requiring the implementation of a human rights labour policy across First Group plc: the UK's largest transport company. This was the first time that a UK institutional investor had co-signed such a resolution.

Shareholder concerns centred around allegations of anti-union practices at the company's US subsidiary, First Student.

Co-operative Insurance chaired a meeting with First Group and other investors to discuss the issues prior to the company's AGM this year. There was a constructive dialogue around implementing a formal human rights policy based on the International Labour Organisation's core principles: a basic set of standards that many shareholders endorse for the companies in which they invest.

At the AGM, Co-operative Insurance's Head of Responsible Investment, Ian Jones, proposed the resolution. Over 21% of votes supported it: a significant result as shareholder resolutions in the UK usually receive less than 10%.

First Group has committed to review all associated activities and procedures that they have in place, and we will continue to work with the company to ensure concerns are resolved.



# Over the Top At The Top – Directors' Pay

Boardroom pay keeps on soaring, year on year, and the gap between the pay of directors and the average worker gets wider and wider. In 2005, Co-operative Insurance launched a campaign to target excess in the boardroom and called upon other financial institutions to join forces with us in voting against bad practice. We regularly scrutinise the remuneration reports and vote at the AGMs of more than 700 leading companies. We abstain or vote against where we consider that pay is excessive, or not linked to appropriate performance targets, or where it just isn't fully disclosed by the company.

Although directors' pay is supposed to be controlled by independent remuneration committees, research by Co-operative Insurance Investment Management has shown that most of these committees are not fully independent. This emphasises the need for shareholders such as Co-operative Insurance to keep monitoring, challenging and using their voting power on new pay awards and bonus schemes.

Directors' pay is important to investors for several reasons. First, it is vital that directors' performance targets, on which some of their pay depends, are challenging and motivate them to deliver the best performance for shareholders. Secondly, there is a real risk to the reputation and brand value of a company when pay differences between the board and staff become too stretched. Also, directors' pay is an expense just like any other; if it is not matched by performance, shareholders pick up the bill – often a substantial one. Finally, investors need the reassurance that the board is primarily looking after shareholders' interests, not just pursuing their own.



# The Dirty Dozen of Directors' Pay

Co-operative Insurance Responsible Shareholding unveils the 'Dirty Dozen' tricks that companies have used to drive up directors' earnings:

<b>1 Tidy desk bonuses</b>	Otherwise known as payments for an orderly handover to your successor. Co-operative Insurance considers this to be a normal part of any employee's duties.
<b>2 Shifting the goal posts</b>	If directors' performance targets are too difficult, replace them with easier ones!
<b>3 Ask and ignore</b>	Where a company claims that it has consulted with major shareholders, whilst not revealing that shareholders had expressed reservations.
<b>4 Mistaking the USA for the world</b>	Excessive payments are often justified by reference to the 'global' market – they mean 'the USA', where excessive directors' earnings are commonplace.
<b>5 The vanishing AGM</b>	Push controversial pay schemes through over the Christmas period then have an AGM just before the August Bank Holiday – with luck, no shareholders will turn up!
<b>6 The extending maximum</b>	Declare a 'maximum' award of options of 250% of salary, but the small print reveals that this can be multiplied by 1.5 for strong performance.
<b>7 Plucking awards from thin air</b>	Otherwise known as granting share options under a share scheme that doesn't exist – then seeking 'approval' when the deed has been done.
<b>8 Bulls-eye every time</b>	Some companies pay out maximum bonuses year in, year out – simply because the performance target is so easy to hit.
<b>9 Sugaring the pill</b>	Make automatic payouts on a takeover so generous that a board could be influenced to accept an offer.
<b>10 A rose by any other name</b>	If you've exceeded your limit on share options, call new awards Share Appreciation Rights.
<b>11 More for me, the same for you</b>	Ratcheting up directors' pay levels well above that of other staff without increasing performance targets.
<b>12 Cashing in</b>	Shareholders demand strict performance targets for share schemes – so pay out more in annual cash bonuses, which don't need shareholder approval.

# Risks and Opportunities



## The Equation for Shareholder Value

At Co-operative Insurance we aim to protect and grow our customers' investments by championing their values.

In today's market an estimated 70% of the market value of the UK's largest companies relates to 'intangible assets' or 'goodwill'. Some of the major risks to goodwill that businesses face relate to their management of corporate governance and social, ethical and environmental (SEE) issues.

Failure to identify and manage SEE risks can lead to loss of consumer confidence and brand value, safety or environmental incidents that result in project delays, refusal of planning permission, litigation, fines or boycotts.

Conversely, companies that manage these issues well benefit from enhanced brand reputation, repeat business and smoother operation with fewer delays. Good management of SEE risks also correlates with general management quality and an ability to foresee risks rather than fire fighting. This all adds to the company's capacity to provide long-term, sustainable returns to investors.

## Measuring SEE Risk

Our team of Responsible Shareholding Analysts identify the key corporate governance and SEE issues most likely to impact upon company value. The company is examined within the context of the approaches taken by other companies in the sector.

Critical SEE issues are identified for each company and the potential impact of each issue is measured. An assessment is made of whether they're transforming risks into opportunities and the efficacy of their structures to identify and manage general SEE risks.

Governance and SEE ratings feed the investment process, enabling assessment of whether risks and opportunities are properly reflected in – or misaligned with – the market price of the stock. This puts our fund managers ahead of the game in stock selection, ongoing stock valuation and portfolio risk analysis.

# Risks and Opportunities in the Construction Sector



Different business sectors face different risks and opportunities in terms of social, ethical and environmental issues. Through examining which factors affect a sector as a whole we can assess which companies are managing these risks well and which are not.

The construction sector is notable for the range of possible impacts, both positive and negative, that it can have on society and the environment.


Construction is a resource-intensive industry for raw materials and for energy. The sector has one of the highest accident and fatality rates. The location and design of construction projects will determine how they impact upon biodiversity and urban regeneration.

All three of the best performers in the sector were house-builders – increasingly demanding regulations have driven improvements.

At the other end of the scale, building products manufacturers are failing to reform poor health and safety and environmental practices that pose large risks.

House-builder Crest Nicholson has the highest percentage (26%) of houses certified under the EcoHomes voluntary best-practice code, closely followed by another of our top three, the Bovis Homes Group. The code is likely to be the basis for future, tightened, building regulations – these two house-builders are already ahead of the game.

The other of our best practice trio, specialist retirement property builders McCarthy and Stone, also rated highly on sustainability issues, particularly provision of public transport, and their effective health and safety systems meant an enviable record of no convictions.



For more information,  
please contact:

**Ian Jones**

Head of Responsible Investment

Co-operative Insurance Society

22nd Floor

Miller Street

Manchester

M60 0AL

0161 903 4045

**[responsibleshareholding@cis.co.uk](mailto:responsibleshareholding@cis.co.uk)**

or visit:

**[www.cis.co.uk](http://www.cis.co.uk)**

Produced October 2006

Co-operative Insurance Society Limited is authorised and regulated by the Financial Services Authority.

Registered in England number 3615R.

Registered Office:

Miller Street, Manchester M60 0AL.

This leaflet is printed using vegetable oil-based inks on 100% recycled fibre.

The paper is made in a totally chlorine-free process.