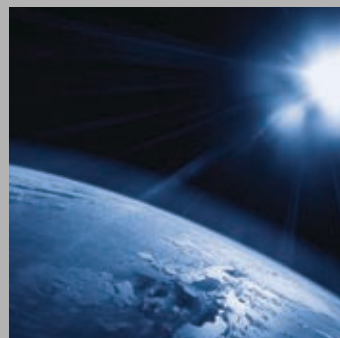
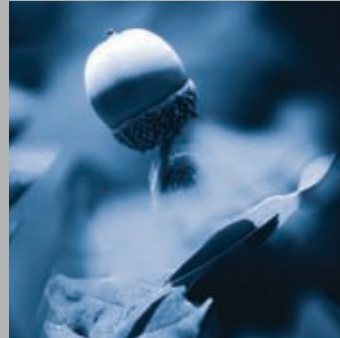
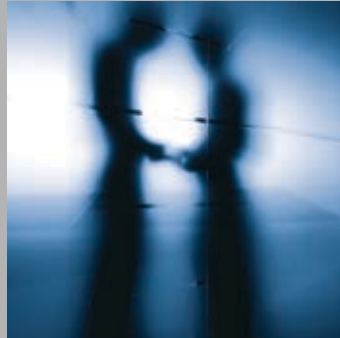


re^o Report

F&C Investments

4th Quarter 2010



In this issue...

- Cancún climate talks: A glimmer of hope?
- Indigenous groups and industrial expansion: Can they co-exist?
- Australia's year of change: Governance and Climate
- The future of Sustainable Property
- Ten-year retrospective on F&C engagement with banks:
 - Is it all about reputation or do ESG factors drive credit quality?
 - 2008 credit crisis: Have we really learned the right lessons?
 - Emerging markets: will competitiveness trump sustainability lending?

F&C
Investments

Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

- Leveraging our clients' share ownership position to encourage companies to improve long-term business performance through better management of environmental, social and governance (ESG) risks
- Exercising our influence through voting and engagement, drawing on the skills of one of the largest specialist teams worldwide
- Implementing in full the UN Principles for Responsible Investment (PRI)

Why this report?

Our Obligations to You

F&C represents you when speaking with companies about their environmental, social, and governance (ESG) practices. Your provider of pensions and investments has entrusted us with your portfolio, and tasked us with ensuring that the companies you hold adopt responsible practices and run their business with an eye to success over the long term.

As your representative, we have an important obligation to you – to be vigilant about how companies: 1) plan their future growth with the capital you have entrusted to them; 2) manage and minimise business risks, including those related to ESG factors; and 3) protect financial returns over the long term.

What does this mean in practice?

This means that as your representative, we engage in direct face-to-face dialogue with senior management of the companies in your portfolios, listen to what they have to say, communicate your concerns – and, when necessary, challenge them to do better. This generally also means exercising our voting rights – your voting rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.¹

Transparency: It cuts both ways

Just as we expect transparency from companies as part of their obligations as responsible corporate citizens, you should expect no less from us. As the ultimate owners of the companies in your savings and pensions portfolios, you are entitled to know what companies are doing in your name with the money you have entrusted to them – and you should likewise know how we have represented your interests in exploring these questions.

At F&C, we take our obligations to you very seriously. With this quarterly report, we tell you how we have asked questions and spoken up in your name to ensure that companies know and act on the concerns of their shareholders. An electronic copy of this report can be found at: www.fandc.com/gsi.

reo® is operated on behalf of:



¹ This applies for all funds managed directly by F&C, as well as several other funds that have appointed F&C to undertake share voting on their behalf. Some funds carry voting separately.

Welcome to the second decade of *reo*[®]

After ringing in the tenth anniversary of *reo*[®] in 2010, F&C enters its second decade of investor engagement with the introduction of a brand new publication called *reo*[®] **Viewpoint**. **Viewpoint** will be phased in during Q1 2011, and replace the decade-old quarterly *reo*[®] Report beginning in Q2. Like its predecessor, **Viewpoint** will contain succinct, topical stories on key areas of engagement, and cover the full spectrum of Environmental, Social and Governance (ESG) themes affecting companies held in F&C client portfolios around the world, as well as engagement with regulators, public policy makers and trade bodies. But unlike its older forebear, and in response to client demand, **Viewpoint** will be much shorter, appear more frequently and be available online. **Viewpoint** will appear every two to four weeks, and will continue to include a quarterly statistical update on F&C's overall engagement activity. In addition, *reo*[®] clients will continue to receive quarterly updates on the engagement activity undertaken on their own funds through the Confidential *reo*[®] Report.

We look forward to bringing you more timely engagement news in 2011, and hope you will enjoy *reo*[®] **Viewpoint**.

In this final public *reo*[®] Report, we provide a ten-year retrospective of F&C's engagement with the banking sector, which highlights how we probed the manner in which banks first began to evaluate non-traditional risk factors as part of their credit assessment processes – a fitting prelude to the global credit crisis that erupted in 2008. Will the shock of a near collapse in the banking system genuinely drive banks to factor in risks that lie outside traditional models? It remains to be seen.

We also take a look at progress Down Under, where rumblings of reform in corporate governance and climate change are afoot. And we revisit our 2009 Sustainable Real Estate study, analysing what has changed in one year and where the industry is progressing and stalling in both developed and emerging markets.



Karina Litvack
Head of Governance &
Sustainable Investment,
F&C Management Ltd

In this report...



Quarter in Review: Engagement Highlights

6-7

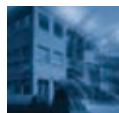
- Cancún: As the clock ticks to 2010, a glimmer of hope
- Indigenous groups and industrial expansion: can they co-exist?



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- Speaking up on pay and board diversity
- Pressing companies on climate change



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Focus on The banking system: Is it sustainable?

10-11

- Have we learned all the right lessons from 2008?
- ESG risk management:
Ten years of engagement progress
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- What challenges remain?



F&C is committed to promoting compliance with the principles of the UN Global Compact. Readers of this *reo*[®] report can look for the ♦ symbol to see where our engagement has covered the UN Global Compact Principles on Human Rights, Labour Standards, Environment and Anti-Corruption.

Companies featured in this report

Quarter in Review

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
AmBev	BR	Desarrolladora Homex	MX	Jindal Steel	IN	Unilever	NL
AngloGold Ashanti	ZA	Freeport-McMoRan	US	Lonmin	UK	US Securities and Exchange Commission (SEC)	US
Arcelor Mittal	LU	GlaxoSmithKline	UK	Mexichem	MX	Vedanta	UK
BHP Billiton	AU	Grupo Mexico	MX	Novartis	CH	Wal-Mart	US
BP	UK	HSBC	UK	Rio Tinto	UK	Walmart Brasil	BR
Chevron	US	Hypermarcas	BR	Royal Dutch Shell	NL/UK	Wal-Mart de Mexico y Centroamerica	MX
Cosan	BR	ICA	MX	Santander Brasil	BR		

Focus on Australia

page 8

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Asciano Group	AU	Computershare	AU	Qantas	AU	Woolworths	AU
BHP Billiton	AU	Fairfax Media	AU	UGL	AU	WorleyParsons	AU

Focus on sustainable real estate

pages 9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
British Land	UK	Citycon	FI	Growthpoint Properties	ZA	Land Securities	UK
Capitaland	MY	Corporate Office Properties	US	Klepierre	FR	Regency Centers	US

Focus on banks

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Banco Compartamos	MX	Citigroup	US	HSBC	UK	RBS	UK
Banco Itaú	BR	Credicorp	PE	Industrial & Commercial Bank of China (ICBC)	CN	Sonangol	AO
Banco Santander Brasil	BR	Credit Suisse	CH	JPMorgan	US	Standard Chartered	UK
Barclays	UK	Deutsche Bank	DE	Lloyds	UK	UBS	CH
BBVA	ES	Goldman Sachs	US	Rabobank	NL	Wells Fargo	US
BNP Paribas	FR	Grupo Santander	ES			YES Bank	IN

Activity report: How **reo**[®] helps implement PRI

F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, and in its ability to help clients implement the UN Principles for Responsible Investment (PRI). Key features are:

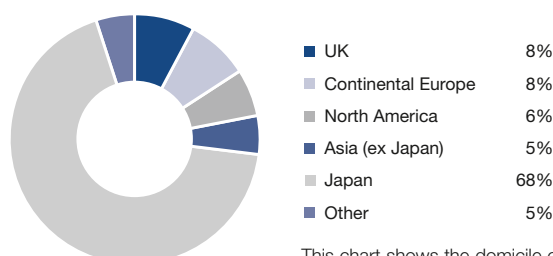
- A 18-person team of Governance & Sustainable Investment specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary
- Global engagement – in all markets
- Comprehensive voting – F&C votes all of its clients' shares worldwide, as well as publishing the voting record each month.

Number of companies engaged this quarter

Programme name	Number of companies engaged
Corporate Governance	742
Business Ethics	116
Sustainability Management & Reporting	101
Environmental Management	55
Ecosystem Services	28
Climate Change	53
Labour Standards	66
Human Rights	64
Public Health	15

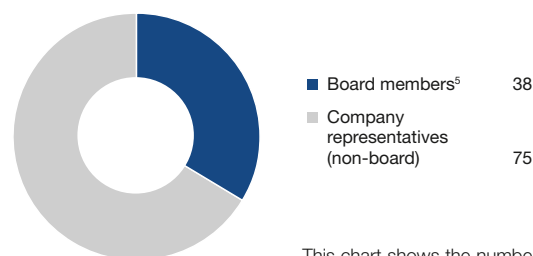
Total number of companies engaged this quarter ²	880
Number of countries	37
Company meetings voted ³	815
Corporate Governance engagement letters sent ⁴	454

Geographical spread



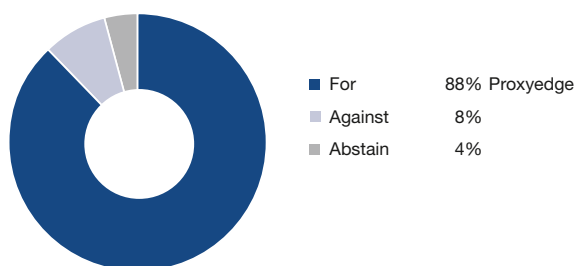
This chart shows the domicile of companies that have been engaged by F&C in the last quarter.

Number of company meetings



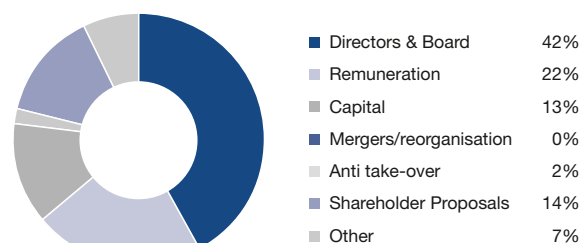
This chart shows the number of company meetings – both face to face and by telephone – carried out by F&C this quarter.

Resolutions at shareholder meetings



This chart shows how F&C voted at shareholder meetings over the past quarter.

Reasons for Votes Against Management



This chart shows the reasons why F&C has voted against management in the last quarter

2 Companies may have been engaged on more than one issue.

3 i.e. company meetings for which F&C has issued voting instructions.

4 Data refers to the period from 01/09/2010 to 30/11/2010.

5 Includes Named Executive Directors in the US.



Quarter in Review

Global Round-up

First stop: Mexico



This quarter, F&C travelled to Mexico City, meeting with the stock exchange to discuss local governance practices as well as the imminent launch of a new sustainability index.

We followed with one-to-one meetings with builders **ICA** and **Desarrolladora Homex**, as well as **Mexichem**, a fluorine and mining company. We also met with **Grupo Mexico** to discuss social risks and recent violent labour disputes in its massive copper mining operations. Finally, we met with **Wal-Mart de Mexico y Centroamerica**, the region's largest retailer, to review the company's recent improvements in sustainability management and offer suggestions to improve relations with its employees and massive domestic supplier base.

Next stop: Brazil



F&C travelled to Brazil at the invitation of **Royal Dutch-Shell**, whose recently-announced \$12 billion joint venture with Brazilian ethanol market leader **Cosan** will set the stage for Shell to ramp up its involvement in what is currently the most carbon-efficient of any first-generation biofuel. In addition to visiting two plantations and their adjoining ethanol factories, F&C had detailed one-to-one meetings in São Paulo with Cosan, focusing on the company's controversial governance record and its recent allegations of slavery, which had prompted blacklisting by both **Walmart Brasil** and the country's national

development bank.♦The company has undertaken ambitious reforms to its environmental and social practices, many of them a condition of the Shell deal.

F&C also took this opportunity to have detailed visits with consumer goods manufacturer **Hypermarcas**, beer and soft drinks giant **AmBev**, and **Santander Brasil**, the Spanish giant's local affiliate, to explore how they are incorporating sustainability value drivers into their business strategy.

Dodd-Frank tackles Conflict Minerals in DR Congo



F&C submitted comments to the **US Securities and Exchange Commission (SEC)** regarding the introduction of Section 1502 of the Dodd Frank bill, which focuses

on how minerals sourced from the Democratic Republic of Congo (DRC) could be used to finance conflict and human rights abuses (a.k.a. 'conflict minerals'). While the law sets new standards for labelling end-products as "DRC conflict-free", F&C urged the SEC to support the development of a responsible, sustainable mining sector able to create jobs, improve revenue transparency and contribute to political and economic stability. F&C is concerned that if the rules proceed without the development of chain-of-custody systems, companies will stop sourcing minerals from the DRC altogether – thereby likely destabilising the region and leaving it vulnerable to groups whose mining activities may fuel conflict.♦⁶

In other news:



F&C celebrates 10 years of reo®

This quarter, F&C hosted a one-day client seminar to celebrate the tenth anniversary of its flagship **reo®** engagement product, during which it considered the engagement successes and failures of the past ten years. Speakers from leading companies including **Unilever** and **HSBC** joined WWF and F&C's in-house experts to debate how forest protection could achieve cheap and effective greenhouse gas abatement, and the role investors should play in driving such actions. Speakers from **Novartis**, **GSK** and the **World Health Organisation** debated how rapid growth in emerging markets was transforming drug delivery from charity case to business case, despite challenges posed by poverty and weak intellectual property protection. In a final session on governance and the challenges posed by investor stewardship, **Lonmin**, the Dutch investor association Eumedion and the UK Financial Reporting Council considered the relative merits of voluntary "comply or explain" regimes vs. rules-based compliance, and debated which would prevail given past failures to exercise good stewardship.



Governments reach historic agreement on biodiversity

This quarter, at the **UN Convention on Biological Diversity**⁷ in Japan, 193 governments agreed on a 20-point rescue plan to stop mass extinction of species by 2020. F&C has long called for urgent action to protect the earth's natural capital♦, and with scientists warning that one fifth of animal and plant species face extinction, F&C welcomes this agreement.

A major new study to which F&C contributed, *The Economics of Ecosystems and Biodiversity*⁸, highlights that degradation of nature cost the global economy \$2-4.5 trillion in 2008. F&C will now encourage investee companies to support and implement the remedial measures enshrined in the Convention. F&C has also endorsed a new benchmarking tool by the *Natural Value Initiative* to evaluate how mining and energy companies manage risks and opportunities associated with their impact and dependence on biodiversity and ecosystem services.



Wal-Mart agrees to stronger board oversight of social issues

F&C's US-based engagement team has been engaging Wal-Mart for over ten years. This quarter, in partnership with other US investor groups, F&C succeeded in persuading Wal-Mart formally to recognise that its Board needed actively to manage social issues: the company has added 'an explicit review of social, community and sustainability initiatives'⁹ to the remit of the Board's Compensation, Nominating & Governance Committee, thereby marking yet another step forward for the world's largest private-sector employer. Despite making impressive strides in its environmental strategy, Wal-Mart continues to face significant employment-related controversies, including a massive class-action gender discrimination lawsuit whose fate at the hands of the US Supreme Court is about to be decided, and allegations of unfair practices towards trade unions. F&C continues to engage♦ in detailed dialogue with company executives to improve Wal-Mart's policies, practices and reporting in these areas.

6 http://www.fandc.com/FundNets_FileLibrary/file/SEC_Submission_Re_Conflict_Minerals_Disclosure_under_Dodd_Frank_Section_1502.pdf

7 <http://www.cbd.int/>

8 www.teebweb.org

9 <http://investors.walmartstores.com/phoenix.zhtml?c=112761&p=irol-govCommittee&Committee=323#4>

♦ This symbol indicates that F&C's engagement is reinforcing the 10 principles of the UN Global Compact.



Quarter in Review: Engagement highlights

Cancún: As the clock ticks to 2012, a glimmer of hope

In December 2010, world leaders gathered in Cancún, Mexico at the UN COP16 summit to hammer out a successor to the Kyoto Protocol that would limit global warming to 2°C above pre-industrial levels. With expectations running very low after the stalemate of the 2009 Copenhagen summit, the event offered a ray of hope, with headway in four key areas that F&C had actively pressed for through its policy engagement¹⁰:

- **Emissions monitoring, verification and reporting (“MRV”):** progress was made towards new UN guidelines for assessing country compliance with emissions reductions targets. In addition, guidelines will be developed to assess whether developed countries deliver on commitments to provide financial support to developing countries. This is the cornerstone of a future global deal on climate change, as it puts pressure on national governments to deliver on pledges and report on emissions reductions transparently.
- **A new Green Climate Fund:** managed by the World Bank, this will mobilise up to \$100 billion in financial flows to developing countries by 2020, with a focus on accelerating adaptation to climate change in emerging markets. However, clarity is needed on who will provide and receive this money.

- **Low-carbon technology:** in a critical breakthrough for facilitating technology transfer to emerging markets, governments agreed a framework for international co-operation, overcoming key concerns by the US and others about intellectual property rights.
- **Deforestation:** a framework known as “REDD¹¹” was formally launched, enabling developing countries to obtain funds to keep existing forests standing and to restore degraded areas. Curbing deforestation is one of the cheapest ways to cut emissions, and F&C had pressed hard for this landmark agreement – though much remains to be done to turn this into practical financing mechanisms¹².

Overall, Cancún has shown that governments are prepared to take action on climate change – but with key actors such as the US, China, Russia and others still playing chicken, no one wants to be the one to blink first. Yet without a global, legally-binding treaty to replace the Kyoto Protocol, the risk of severe social and economic climate damage looms ever greater. This will now be the focus of the next COP17 negotiating round in South Africa in 2011 – when the clock towards the expiry of the existing agreement will have but one year to tick to zero.

Indigenous groups and industrial expansion: can they co-exist?

Shell's oil sands projects in Canada; **Vedanta's** bauxite mine in Orissa, India; **Jindal Steel's** steel plants in Andhra Pradesh, India; **Shell's** biofuel crops in Brazil: these are just some of the projects around the world where exciting development opportunities face concerns associated with the long-standing presence of indigenous people. Characterised by a long history of marginalisation and oppression and a special relationship with the land and its resources, indigenous peoples in many parts of the world have mounted fierce opposition to industrial expansion, forcing companies to recognise their unique needs and rights – or else face reputation damage, delays and even revocation of operating licenses.

F&C has long flagged the importance of robust, constructive relationships with host communities – including indigenous groups – in sectors with a high social footprint¹³. One such industry is mining where, over the last four years, much progress has been made, with companies such as **Rio Tinto** and **BHP Billiton** developing sophisticated policies that reflect the needs of even the most vulnerable and marginalised groups.

But while some companies have innovated, others have been slower off the mark. And as many, spurred by ever-

growing demand for commodities, begin to push into remote areas for access to oil, iron ore and agricultural products, the challenges posed by indigenous groups living in these areas cannot be ignored, either by the companies themselves or by investors concerned with the long-term success of such activities.

To facilitate cross-industry dialogue on this complex issue, F&C organised a workshop for oil, steel and mining companies¹⁴ as well as fellow investors in late 2010. Co-hosted by the International Council on Mining & Metals¹³, the event was attended by representatives of 18 major companies, including **BP**, **Chevron**, **Shell**, **ArcelorMittal**, **AngloGold Ashanti**, **Freeport-McMoRan**, and **Rio Tinto**¹⁴. Participants shared their experience and explored questions such as: How to integrate indigenous peoples' rights and needs in project development? What strategies for sharing benefits from resource extraction work best? Where does engagement of indigenous peoples fit in with that of other groups, especially host governments? Without answers to these questions, companies will struggle to realise the full potential of the many exciting opportunities presented by new resources and technologies.

10 Global Investor Statement on Climate Change: Reducing Risks, Seizing Opportunities & Closing the Climate Investment Gap

http://www.iigcc.org/_data/assets/pdf_file/0015/15153/Global-Investor-Statement.pdf

Cancún Communiqué: A call from business for ambitious, robust and equitable global action on climate change

<http://www.cpsl.cam.ac.uk/pdf/The%20Cancun%20Communique%202010.pdf>

11 Reducing Emissions from Deforestation and Forest Degradation in Developing Countries

12 In particular, the REDD programme has yet to be linked to existing carbon trading mechanisms such as the European Emissions Trading Scheme (ETS), sharply limiting its scope and effectiveness. Still, forest protection may be linked to carbon markets through future bilateral agreements, for example between the US state of California and the Brazilian state of Acre.

13 www.icmm.com

14 Other participants included **Antofagasta**, **ARM**, **Cairn Energy**, **Goldfields**, **Goldcorp**, **Heritage Oil**, **MMG**, **Statoil**, **Teck**, **Vale**.

◆ This symbol indicates that F&C's engagement is reinforcing the 10 principles of the UN Global Compact.



Focus on A year of change in Australia: Governance and Climate

Introduction

2010 was a big year for policy reform in Australia, as the government-led Productivity Commission and Cooper Review took a fresh look at corporate governance and the pensions industry, respectively. In response, the Australian Stock Exchange (ASX) released its revised Corporate Governance Code, featuring new provisions on executive remuneration and gender diversity. Superannuation funds, meanwhile, came under pressure to demonstrate good stewardship of beneficial owner interests, with fund trustees formally called upon to incorporate environmental, social and governance (ESG) issues into their investment strategies.

F&C Speaks Up on Pay

The 2010 voting season saw F&C maintain its strong focus on pay. With the Productivity Commission pressing boards to ensure that remuneration plans be aligned with core business strategy, be risk-adjusted, and avoid termination payments that reward failure, F&C used its votes to call for improved pay disclosure. However, we remain concerned about persistent weaknesses, including:

- **Linking pay and performance:** The link between pay and performance is a key indicator of good governance, yet is often missing. Many companies rely on a single performance target to trigger payouts, or generic metrics that fail to reflect key business drivers – while others have no performance-based pay whatsoever. For example, F&C voted against the remuneration report at **Computershare** to protest against needlessly vague performance targets that showed no clear link to the business strategy. We rely on remuneration committees to provide clear information about performance targets and to explain how they are aligned to core business objectives in proxy materials. By contrast, an example of good practice was **Fairfax Media**, where the remuneration committee used its discretion to reduce pay following sluggish performance during the global financial crisis.
- **Avoiding perverse incentives:** some standard features of Australian remuneration plans may drive the wrong kind of performance. For example, many Australian plans still include features that allow for automatic vesting in cases of a change of control, or re-testing if performance targets are missed. We oppose automatic vesting provisions because executives may be incentivised to support business combinations that are not in the long-term interest of shareholders. We likewise object to re-testing, which gives executives a second bite at the cherry despite failing to meet targets agreed by shareholders previously. Our view is that at-risk compensation should remain at risk and incentive-based pay should only vest in full when performance targets are hit. As a result, we voted against remuneration plan and associated equity grants at **WorleyParsons** and **Asciano Group**. Conversely, F&C welcomes the

introduction of deferred compensation plans and longer-term performance periods, particularly in industries with a longer business cycle such as the mining sector. We therefore welcomed the introduction of a five-year performance target at mining giant **BHP Billiton**, whose remuneration plan we supported.

Here come the girls: Focus on board diversity

As governments across Europe debate whether or not to impose Norwegian-style gender quotas at company boards, Australia pushed through a diversity disclosure requirement in the ASX code. The revision calls on companies to disclose their board diversity policy as well as the number of women in their organisation, senior management and board. In response to this change, F&C began to evaluate ASX-listed companies on board diversity and is heartened to see some companies already developing strategies and disclosing targets to improve both corporate and board diversity. For example, Qantas outlined a detailed remuneration strategy going beyond just board diversity and set a target to employ 450 indigenous Australian employees by the end of 2011. Focusing on board diversity, Woolworths set a target of having one-third of board and executive positions filled by women by 2015.

Investors press companies on climate change

With the Labour party's recent national election win, the Carbon Pollution Reduction Scheme is back on the policy agenda and introduces additional climate risks for companies in high-emitting sectors. But many Australian companies have shown little leadership on this topic, prompting investors to up the ante and introduce shareholder proposals at energy-intensive companies that have failed to disclose a climate change strategy. When infrastructure developer UGL refused to allow shareholders to vote on such a proposal, F&C protested by abstaining on the re-election of one long-standing board member. As a general rule, F&C encourages companies to assess their climate-related risks, establish a baseline of their greenhouse gas emissions, and develop a strategy to prepare the business for future carbon legislation♦. In particular, F&C encourages high-emitting, energy-intensive companies to evaluate the impact a cost of carbon would have on their operating costs, capital investment plans, and market competitiveness, and to publish a comprehensive climate change strategy.

Next Steps:

As 2011 unfolds, F&C will continue its policy of active voting, with dialogue both before and after the vote. We intend to engage more Australian companies on climate change and water-related risks given the global trend toward energy efficiency and low-carbon growth. We will also continue to press companies for risk-adjusted, performance-oriented remuneration plans that benefit both management and investors. For companies with clear gaps in diversity, we will also encourage them to develop a diversity strategy.



Focus on Sustainable Real Estate: Update one year on

Introduction

In 2009, F&C undertook a detailed benchmarking study¹⁵ of the environmental, social and governance (ESG) practices of 38 listed property companies. Based on a set of 17 ESG indicators, the study revealed a relatively wide spread, with 13 leading companies showing sophisticated strategies and operating systems, while a long tail of 19 laggards had yet seriously to consider how ESG issues would impact their business strategy. One year on, we've updated the study in order to assess progress, particularly in light of the global financial crisis¹⁶.

The Future of Sustainable Property: All about location

The property sector in developed and emerging markets faces a starkly different future, both in economic and ESG terms.

When it comes to climate change, the developed world's challenge will be to improve the energy performance of existing buildings, given that new buildings represent only 2% of the total stock. Yet the built environment accounts for a full 40% of energy consumption when taken across the full lifecycle of a property. As a result, the focus needs to be on retrofitting old stock, which is costly, disruptive, and achieves less dramatic efficiency gains than outright replacement. Against this challenging backdrop, the UK's Carbon Reduction Commitment (CRC), which came into force in 2010, has been a good initial catalyst for encouraging property companies to measure and reduce their emissions.

In emerging markets, however, the balance between replacement and new-build is turned on its head, with rapid urbanisation driving unprecedented growth in commercial and residential development, and planning authorities encouraging the emergence of second and third-tier cities to reduce density in major capitals. Emerging market property companies therefore have a once-in-a-lifetime opportunity to "de-couple" their growth from the high emissions, resource constraints, and exposure to climate impacts that have dogged developed markets: by adopting sustainable building and urban designs, they can slash both building and transport emissions and create cities that are capable of withstanding the impacts of climate change to come.

F&C Acts

Following our 2009 review, we re-assessed the original 38 property companies against the same 17 ESG indicators. In addition, in recognition of evolving property trends in emerging markets, we added seven emerging market companies to the sample set:

Key Findings:

- **Climate change strategies on the rise:** Our research indicates that property companies are taking a more detailed and strategic approach to energy

efficiency and climate change. Since 2009, six additional companies, including **Corporate Office Properties** and **Klepierre**, have disclosed their carbon emissions and/or set targets to reduce emissions. We believe this reflects stronger policy drivers, such as the EU Energy Performance of Buildings Standards, as well as greater competition across the sector to compete on energy performance.

- **Greater transparency on business ethics and anti-corruption:** With heightened enforcement of anti-corruption laws in the US and Europe, transparency on management systems – a weakness identified in the 2009 report – is being addressed more forcefully. Our update reveals improved transparency and employee training in order to build a stronger ethical culture. Some US companies, such as **Regency Centers**, enhanced their code of ethics to clarify what they cover and how they are implemented. Similarly, UK companies **Land Securities** and **British Land** improved disclosure of anti-corruption systems in advance of the UK Bribery Act coming into effect in 2011.
- **Steady rise in average ESG scores:** From 44% in 2009, the average ESG score across the original sample has inched up to 54% in 2010¹⁷. Most-improved were Finland's **Citycon** and Singapore's **Capitaland**, with the former leaping from 40% of the total possible score to 71% by developing a wide-ranging sustainability strategy; **Capitaland** also rose following publication of a dedicated sustainability report, where stakeholders can locate information across a range of ESG issues, including health and safety and supply chain management.
- **Emerging markets – Lagging the pack, despite biggest opportunities:** Of the seven emerging market companies in the expanded sample, **Growthpoint Properties** of South Africa scored highest, with a clear commitment to the environment and climate change, and management systems covering labour standards and supplier responsibility. However, in contrast to their developed market peers, the average ESG score for emerging market companies stood at less than half the original group's, at 25.5%.

Conclusion and next steps

The evidence suggests that property companies are taking encouraging steps to improve their key ESG practices. Mature markets show the greatest awareness and progress, yet the opportunities to score real advances through transformational design lie in emerging markets. F&C will continue to engage with property companies to help drive adoption of sound ESG practices♦, focusing in particular on emerging market property companies who have the greatest opportunity build the sustainable cities of the twenty-first century.

¹⁵ For the full text of F&C's 2009 study Sustainable Real Estate Securities: How solid are your foundations? visit www.fandc.com/sustainablerealestatesecurities

¹⁶ Full results of the 2010 updated report will be published in Q1 2011.

¹⁷ On a like-for-like basis. This figure excludes emerging market property companies added to the sample set in 2010.

♦ This symbol indicates that F&C's engagement is reinforcing the 10 principles of the UN Global Compact.



Focus on Banks: Is the banking system sustainable?

Broader lessons from the 2008 credit crisis

As the 2008 credit crisis plunged the world into debt levels of unprecedented proportions, the focus has rightly been on preventing outright collapse of the financial system. But with taxpayers and investors now nursing their wounds and pondering how best to avoid a repeat performance, have we really learned all the right lessons? Will the shock of near-collapse drive a lasting appreciation of the need to factor in risks that lie outside traditional risk models?

This is the question F&C has been posing through its engagement with the banking industry. The last two years have seen us weigh in on questions of fundamental banking reform, as well as conduct one-to-one dialogue with our top bank holdings on board effectiveness, risk management, and remuneration strategy¹⁸. But banks face other longer-term risks through their exposure to social and environmental factors that can affect the quality of their assets and future income streams. Factors such as climate change, water stress, biodiversity loss and population growth threaten to disrupt social and economic relationships and destroy value on a scale that, while not yet fully understood, could herald a crunch that would make its 2008 predecessor seem modest. We have therefore encouraged banks to revisit their credit assessment and due diligence processes to ensure that they not only reflect conventional credit, market and operational risks, but also the environmental, social and governance ('ESG') risks that could undermine stability and growth across the economic system.

Banking and ESG Risk Management: Ten years of progress

F&C's first efforts to investigate how banks approached ESG risks began in 2001, with a benchmarking study of how ten leading European banks integrated environmental risks into their core credit assessment processes¹⁹. At that time, only a handful – **Credit Suisse, Barclays and Lloyds** – recognised that ESG risk factors played a potentially material role in financial outcomes, but even they regarded reputational risk as the primary concern. While reputation undoubtedly matters, evidence increasingly points to a connection to default risk and credit quality, especially as stakeholders begin to connect the dots between behaviour today and impacts tomorrow.

Ten years on, an increasing number of banks have recognised the need for strong ESG risk management. The Equator Principles²⁰, launched in 2003, proved a turning point as banks themselves took a lead in integrating environmental and social performance criteria into project finance transactions. However, given that project funding usually

represents a marginal part of a bank's loan book, F&C has worked to encourage banks to implement ESG risk management practices across all corporate lending, investment banking and advisory activities.♦

Our engagement efforts have involved over 90 banks in 35 countries, focusing on a broad range of ESG themes beyond traditional corporate governance. Examples include:

- **Barclays'** involvement in the controversial Narmada dam project in India, where we pressed for proper implementation of the Equator Principles in its project finance activities (2004);
- **HSBC, Rabobank, UBS** and six others, whose approach to human rights-related risks we analysed in a joint publication with KPMG entitled *Banking on Human Rights: Confronting human rights in the financial sector*²¹ (2004). This led to F&C joining the UNEP FI Human Rights Work Stream²² (2004-09)♦;
- **Standard Chartered's** loans to **Sonangol**, Angola's state-owned oil company, where, given the country's egregious record of misusing extractive revenues, we urged a more systematic integration of ESG issues into country risk analysis. This culminated in a workshop co-hosted with the UK Treasury entitled "Transparency Initiatives in Extractives Industry Finance" that focused on oil-backed loans and use of proceeds²³. (2003-05)♦;
- **Barclays, BBVA, Citigroup, Banco de Credito del Perú (Credicorp), Banco Itaú, Deutsche Bank, HSBC, RBS, Grupo Santander, Standard Chartered and Wells Fargo**, where we provided substantive feedback on sustainability reporting practices (2006-2010);
- **HSBC**, whose funding for an Asian forestry company accused of illegal logging prompted us to press for stricter enforcement of sustainability-related lending guidelines across all types of financing, including investment banking and debt and equity underwriting (2007)♦;
- **Barclays, BNP Paribas, Citigroup, Goldman Sachs and JP Morgan**, where we probed how they had assessed the legal and reputational risks associated with participating in a controversial loan to a Russian oil company (2007)♦;
- **RBS and Santander**, which we encouraged to adopt the ESG risk policies and tools of **ABN Amro Bank** following their acquisition of the Dutch bank's assets (2008);
- **Banco Compartamos** of Mexico, where we explored its approach both to safeguarding credit quality despite the financial crisis and to extending the reach of its microfinance activities (2008);

18 See <http://www.fandc.com/new/Institutional/default.aspx?id=94094#75988> for quarterly reo® reports containing articles on the banking industry, i.e. 2008 Q4, 2009 Q1, 2009 Q2, 2009 Q4 and 2010 Q2. See also the research review "Banks and the Credit Crunch – where do we go from here?" at http://www.fundnets.net/fn_filelibrary/file/co_gsj_Banking_Final.pdf

19 A Benchmarking Study: Environmental Credit Risk Factors in the Pan-European Banking Sector, F&C, September 2002. Banks included in the study were Barclays, RBS, Credit Suisse, Santander Central Hispano, Unicredito Italiano, ING, Standard Chartered, Lloyds TSB and Société Générale.

20 The Equator Principles (EPs) are a voluntary set of standards for determining, assessing and managing social and environmental risk in project financing. They were developed by private sector banks – led by Citigroup, ABN AMRO, Barclays and WestLB – and have been adopted by 67 financial institutions.

21 See http://www.us.kpmg.com/microsite/FSLibraryDotCom/docs/Banking%20on%20Human%20Rights_FC_KPMG.pdf. Other participating banks in the study were ABN Amro, Credit Suisse, Morgan Stanley, RBS and Standard Chartered.

22 The UNEP FI Human Rights Work Stream (2007-09) aimed to address human rights risks and opportunities as they relate to the activities of finance institutions.

23 Participants in this workshop included Barclays, Deutsche Bank, JPMorgan Chase, RBS, Standard Chartered and UBS

♦ This symbol indicates that F&C's engagement is reinforcing the 10 principles of the UN Global Compact.

- **Industrial & Commercial Bank of China (ICBC)**, which we pressed to integrate its green credit policy into its credit risk framework, by setting specific environmental standards for loans to high-carbon emitting industries and increasing lending to low-carbon ones (2009)◆; and
- 25 emerging markets banks, encouraging them to introduce sustainability considerations into their lending practices²⁴ (2010).

In addition to one-to-one dialogue, F&C has actively contributed to efforts aimed at lifting standards across the industry as a whole. This has included participating in the 2006 consultation process for the Equator Principles review, as well as joining the Climate Principles initiative²⁵ (2010)◆.

How far have we come?

While the state of play amongst leading banks is unrecognisable from a decade ago, progress has been uneven, with only a relatively narrow group of banks, mainly European and Australian, grasping the need for effective ESG risk management. Critical mass to drive a true change in the industry's behaviour has yet to take root, evidenced by the silence of most U.S., Japanese and emerging markets banks. The latter pose a particular challenge given that the bulk of the world's economic growth will come from developing countries, where there is often very limited awareness, will or capital for banks to commit seriously to these issues when competing for business.

We said...

“It's one thing if your potential borrower is dumping cyanide in a river, but if they're dumping carbon dioxide into the air, which is not exactly illegal – what do you do? Banks are in kind of a quandary, because they are competing for business, and if they get holier-than-thou and start to play policeman, they risk allowing other banks to take that business.”

“Banks make a shift towards greener lending”,
The New York Times, 30 August, 2010

Yet amidst this somewhat gloomy picture, some bright spots stand out: impressive practices at Brazilian institutions **Banco Santander Brasil** and **Itaú**, Perú's **Credicorp**, China's **ICBC**, and India's **YES Bank** suggest that change is happening. Discussions with these banks have highlighted strong efforts to deliver financial services to the underbanked (**Credicorp**, **YES Bank**) and set stretching standards of social and environmental compliance (**Santander Brasil**, **Itaú**). Going forward, our engagement will focus on the adoption of sound responsible lending policies that discourage over-aggressive lending practices and set sound risk management standards; the promotion of innovative approaches to drive financial inclusion; and the integration of ESG risks into overall credit risk frameworks.

Let's get engaged

As allocators of funding and trusted advisors, banks are potentially powerful levers for positive change. Yet, unless the credit and reputational risks associated with a particular client or transaction ring immediate alarm bells, few banks will terminate relationships over failures in managing ESG impacts. The best way for banks to drive behavioural change amongst their clients is therefore to leverage these relationships through effective engagement.

With this in mind, F&C has encouraged banks to develop strategies to engage their clients on relevant ESG issues. In the past year alone, we have discussed with **HSBC** its approach to engaging palm oil clients in Southeast Asia; pressed **Credit Suisse** and **Citigroup** to engage agricultural commodities trading companies to develop cotton purchasing policies that address child labour in Uzbekistan's cotton fields; encouraged **Banco do Brasil** to press the construction partners of a dam it financed in the Brazilian Amazon to address stakeholders' environmental and social concerns; and probed **Deutsche Bank's** relationships with oil and gas clients in Turkmenistan, with a view to deterring corruption and money-laundering.◆

Challenges concerning competition and client confidentiality complicate the task of disclosing information about the nature of banks' engagement with clients. Nevertheless, we will continue to encourage banks to navigate these tensions and find a way forward that demonstrates their commitment to driving change.

Where are we headed?

As companies expand into activities that carry significant ESG risks, often in countries with weak legal and regulatory frameworks, banks will compete to fund them. The challenge will lie in not repeating the errors of the last crisis by ignoring risks that do not fit into the register of familiar risk factors. The effects of such long-term risks will be far worse if we do not learn the right lessons about the destructive potential of market failure.

As such, F&C will continue to press banks worldwide to view long-term ESG trends as a source of competitive advantage, and adapt their risk management and business development capacity accordingly. In particular, we will:

- Work with the top banks in our client portfolios to drive the adoption of strong governance structures, sustainable finance policies and tools, and a solid approach to client engagement regarding ESG issues;
- Press banks to improve their sustainability reporting practices;
- Engage with banks, companies and policymakers through our participation in the Climate Principles to drive the adoption of stretching standards on coal-fired power generation and other climate-sensitive industries◆; and
- Step up engagement efforts with key emerging markets banks, encouraging the adoption of responsible and sustainable lending practices in their financing activities.

²⁴ We contacted banks in Mexico, Colombia, Chile, Brazil, Nigeria, South Africa, Egypt, Poland, Turkey, China, India, Indonesia, Malaysia, South Korea and Thailand.

²⁵ Members include HSBC, Standard Chartered and BNP Paribas. This Climate Group-backed initiative commits its members to six principles, ranging from minimising their own carbon emissions to engaging with customers to seek opportunities to build a low-carbon economy, and with policymakers to support the development of sound energy and climate change policies. The Climate Principles group is currently working on the development of detailed performance standards for banks and insurance companies serving clients in high-emitting sectors, such as coal-fired power generation.

◆ This symbol indicates that F&C's engagement is reinforcing the 10 principles of the UN Global Compact.

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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 2010 F&C were voted winners of the 'Gold Standard' in the Fund Management category for the fifth year in succession. 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:

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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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www.fandc.com

What could we do better?

We hope we have accurately reflected your concerns. Still, we want to be sure we get it right – your input is valuable to us.

Thank you for telling us how your money should talk.

Please mark your comments 'reo' report feedback', and e-mail them to:

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