EdenTree SRI Expert Briefing – September 2014

Banks

Introduction

The EdenTree range of SRI screened Amity Funds hold over 250 different company stocks and debt instruments across their portfolios. As well as having a strong and compelling investment case, each holding must be researched and approved by the SRI team. Banks have seldom been out of the news in the past few years with the whole sector brought low by multiple scandals. In this SRI Expert Briefing we outline our views on banks, whether there is a case for them as responsible investments, and why we continue to be underweight in Western banks.

Q. Why are we discussing banks?

A. We are often asked by clients for our views on the banking sector in light of its contribution to the global financial crisis. It is therefore legitimate to ask 'can banks still be viewed as ethical and therefore suitable for inclusion in our ethical funds?' This Expert Briefing sets out our views on the sector for clients.

Q. Aren't banks all the same?

A. Although they each provide financial services to customers, the banks vary in terms of their focus. For instance in the UK, Lloyds Banking Group (which operates several brands: Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows) is focused almost exclusively on domestic retail banking and insurance for consumers and small businesses. Barclays, whilst having a strong UK retail presence, is also an international investment bank. Others, such as US banks Morgan Stanley and Goldman Sachs are focused on investment banking and securities management, with little or no retail exposure.

Q. Are investment banks more challenging, ethically, than retail banks?

A. Not necessarily**.** In the UK, despite its 'vanilla' retail focused profile, Lloyds has been the most exposed to PPI (Payment Protection Insurance) mis-selling, incurring fines and penalties of over £10bn. Most of the banks, whether retail or investment, have been implicated in behaviours that have fallen short in terms of probity and business ethics.

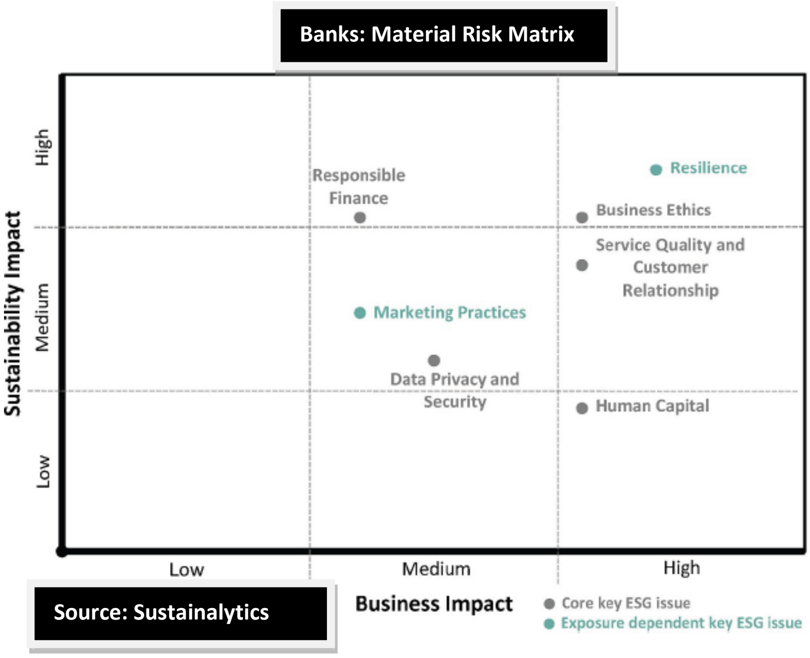
Q. Does this then make the whole sector potentially unethical?

A. Banking and financial services provide the vital infrastructure that allows a modern economy to function. Whether it is business banking, mortgage products, savings and investments, loans or current accounts, the banks are at the heart of an efficient, operational modern economy. They therefore have high social utility and value for nearly every adult individual and enterprise in society. We do not therefore view banking or the provision of financial services as intrinsically unethical. However unethical culture and behaviour has clearly damaged the sector's reputation and its perception as socially useful.

Q. What are the ethical issues surrounding banks?

A. Banking, by its nature relies on trust. Trust operates at many different levels, from basic security of data and customer funds, to the appropriate targeting and sale of products and services to customers. Banks have suffered service 'outages' in which data protection has been compromised. The industry has become engulfed in mis-sold products requiring compensation and remediation on an enormous scale.

There is evidence that the weight of regulatory pressure, greater capital liquidity requirements and public opprobrium have together begun to have an effect in changing behaviour. Government has re-emerged as the single largest influencer, and in some cases, stakeholder, in the industry. Other key ethical issues of concern for responsible investors might include financial exclusion and literacy; customer service; responsible lending practices; tax visibility and executive pay.



Q. So, are the ethical scandals now behind us?

A. No. We believe there is more to come, with Western banks remaining in the largest financial institutions are under investigation for multiple misdemeanours; some are still to settle potentially significant penalties with US and EU regulators. The $9bn fine handed down to BNP Paribas, France's largest bank, may prelude similar sized fines to come at other key European banks. In July, the UK's Serious Fraud Office (SFO) announced an investigation into possible manipulation of the $3 trillion a day FOREX (foreign exchange) market at leading City of London banks going back several years, which may ultimately lead to criminal proceedings and further severe penalties across the sector. In July 2014, a class action filed in New York alleged a consortium of banks including HSBC and Deutsche Bank manipulated the daily benchmark price for silver, violating US anti-trust laws. The UK Parliamentary Treasury Select Committee has called upon the financial regulator to investigate allegations that there may have been attempts to rig the daily gold price benchmark. Clearly there is still some way to go before all this plays out.

Q. How does EdenTree view the sector?

A. We draw a distinction between the indispensable economic function provided by the banks – the lubricant of modern economic activity – and the unacceptable, multiple breakdowns in probity and trust. We therefore view banking itself as legitimate for inclusion in the Amity Funds. We are generally underweight in Western banks as they face many challenges for the foreseeable future, such as the need to raise capital under new regulatory requirements (Tier I capital ratio), which will reduce margins and profitability. In the US for instance, Citigroup leads the sector with a core Tier I capital ratio of nearly 10.5%, whilst in the UK, Barclays reported a Core Tier I ratio of 13.2% in its 2013 annual filings. These considerations coupled with the as yet unknown scale of future liabilities makes much of the sector unattractive. Well capitalised regional emerging market banks in areas such as Hong Kong and Singapore, or even in Europe, such as in the Nordics, have largely avoided the ethical and financial scandals exhibited in the West and present a more positive outlook financially and ethically. We have exposure to a number of the better capitalised and well managed banks.

In Europe, we have avoided the more distressed banks, preferring well capitalised, well run institutions such as Santander. The Amity Funds currently have no exposure to the US investment bank sector such as Morgan Stanley, JP Morgan, Bank of America or Goldman Sachs. Our Amity Sterling Bond Fund has specific financial criteria that determine our approach (in addition to the ethical criteria): the Fund holds several corporate bonds issued by the mutuals (the Nationwide, Coventry, Skipton, Manchester, Newcastle and Nottingham Building Societies), that provide valuable diversification and access to the well-regarded sector. Whilst the sector has not escaped entirely without criticism, it has, by and large, capitalised on public discontent over the High Street lenders by maintaining a strong community presence, and products and services well suited to their customers.

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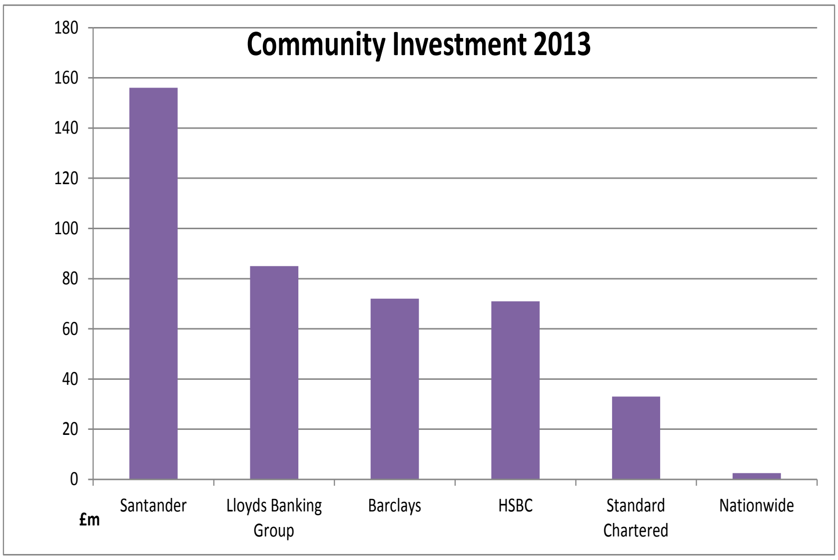
In terms of weightings, the Amity International Fund has a total weight in banks of 11.2%, of which only 1.9% is attributable to Western banks, compared to a benchmark weight of 6.3% (FTSE All World Index). We are more or less in line overall with the Index weighting (11.3%), as much of our exposure derives from well-capitalised Asian banks (including Japan).

Q. What are the ESG (Environmental, Social and Governance) positives of the banking sector?

A. The banks collectively have the economic critical mass to make a huge difference in their operational footprint; many of the banks are global in scope and their ambitions reflect that reach. Since 2013, Barclays has invested £136.5m in community spend, and is investing a further £250m 'in helping to build the enterprise, employability and financial skills of 5m young people'. Standard Chartered, the developing markets bank based in the UK, has the ambitious target of raising $100m of funding by 2020 to treat avoidable blindness; 45m people have already been reached through its targeted support of World Vision. The bank has also provided $1.2bn of loan funding to the important microfinance sector, and $945m to the renewable and clean tech enterprise sector; $54m was invested in communities.

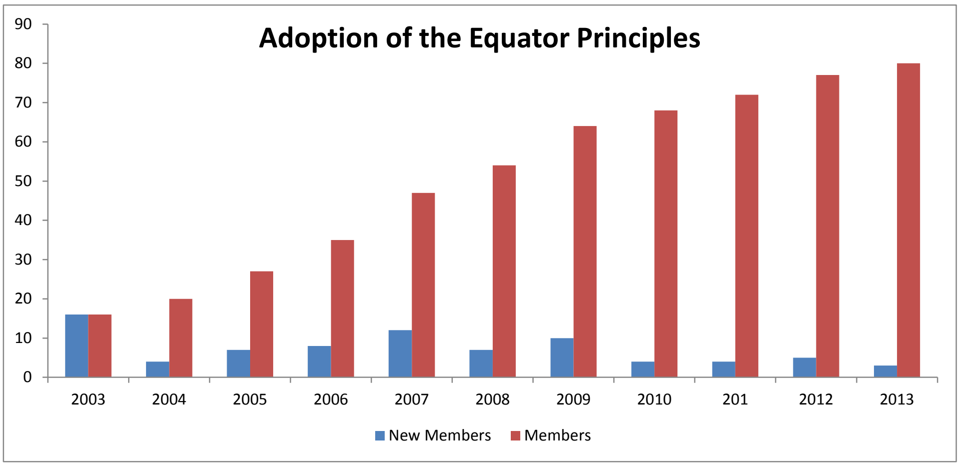


HSBC's ambitious five-year Water Programme will deliver ground-breaking water provision, protection and education including clean water for 1.1m people and sanitation for a further 1.9m in South Asia and West Africa. This builds on HSBC's $100m Climate Partnership that provided clean water for 32m people and helped protect 3m hectares of forestland from development. The bank also invests $100m in other community programmes. The Lloyds Banking Group Foundation invested £255m in communities over the period 2011-2013, supporting 1,568 groups, and £8m of funding towards financial literacy for young people.

The banks also have a strong record in reducing their environmental impact: Lloyds has reduced energy by 12% against a 2009 baseline, saving £22m in costs since 2010. Over 95% of waste has been diverted from landfill. Barclays has committed to a new carbon reduction target of 10% by 2015 against a 2012 baseline. Emissions fell a further 5.2% in 2013 with the bank focussing on lighting, heating and cooling efficiency. Royal Bank of Scotland (RBS) reported a 6% fall in energy use since 2011; since 2007, 100% of its UK electricity use has come from renewables. Banco Santander's focus on higher education has seen it commit €577m to university partnerships over the past three years, representing collaborations with more than 1,000 institutions in 20 countries. Since its foundation 16 years ago, Santander has committed €1bn to more than 4,000 academic, financial and technological projects and is the largest private scholarship programme in the world.

Q. But what about project finance – doesn't this remain ethically controversial?

A. The banking sector's direct environmental and social impacts are relatively modest, relating in the main to managing the energy, water and waste impacts across their large branch networks. Of material significance however, is the role banks play in providing loan finance for infrastructure projects and their impact on communities and the environment. We look to ensure that banks we invest in are signatories to the *Equator Principles*, a risk-management framework for assessing environmental and social risk in large scale projects. 80 global financial institutions located in 25 countries representing around 70% of global project finance have signed up to the framework. We would expect, as a minimum, banks we invest in to be signatories and to report on their adherence to the framework principles. Many of the banks have become significant lenders to the renewables sector as part of a wider initiative to support the transition to a low carbon economy. HSBC's respected Climate Business supports investment in low-carbon energy generation including solar, bio-energy and wind, energy efficient buildings and providing climate finance to environmental markets. RBS will not provide loan finance for the construction of new coal fired power generation. Lloyds Banking Group is behind 3,580MW of renewable energy projects across the UK, and in addition has committed £237m in loans for European renewable energy projects and $258m in the US. Altogether Lloyds is providing loan finance in the renewable sector sufficient to power 8.5m homes. Banks signed up to the Equator Principles will generally decline to provide finance for projects with a significant environmental or social impact detriment, as defined by the Principles risk framework.



Q. How does EdenTree engage for change?

A. Given our House view that banking is not subject to a negative screen, we engage around behaviours and on the material issues pertinent to the industry. As well as capital adequacy, regulation and reputational issues, we also engage on material ESG (environmental, social and governance) impacts including lending practices (The Equator Principles or defence lending); environmental footprint; leadership and governance; financial inclusion and executive pay. We have taken a robust approach to executive pay in the banking sector, believing that escalating pay has been to the detriment of shareholders and society. In 2014, we opposed the Remuneration Policies and Remuneration Reports of all the UK listed banks (except Royal Bank of Scotland), the Co-operative Bank, the Nationwide and Skipton Building Societies as being excessive or poorly linked to performance. In cases where they were proposed, we took action to oppose special resolutions to allow bonuses of up to 200% salary where the bank had introduced fixed allowances as a means of circumventing EU bonus caps, which we viewed as inappropriate. Our voting record is available here.

Q. What should responsible investors look for?

A. Banks present complex ethical challenges for responsible investors, but should not necessarily be seen as inappropriate holdings for ethical funds. Banks command enormous social utility and in many ways demonstrate policies and basic products in tune with the needs of their retail and commercial customers. Banks have been at the forefront of financing a vibrant enterprise culture, much of it focused on clean energy and other solutions-based technologies. They have however been heavily implicated in practices that fall well short of that required. Weak product innovation and mis-selling, poor customer service and in some areas criminal activity has left trust in the sector reeling.

There is evidence that the sector is now at last renewing itself, with a focus on delivery, integrity and putting the customer first. Regulation is playing its part, as is a burgeoning of new competition (Metro Bank, Tesco Bank, M&S Bank and the recently floated TSB). The Church of England led consortium vying to re-launch the Williams & Glynn brand is further evidence of new ownership models entering the market. Responsible investors have a critical role to play engaging with the banks to put integrity and business ethics at the heart of what they do. A commitment to treating customers fairly and developing products and services that have benefit and utility at their core is a fundamental requirement (banking practices deemed predatory or usurious or which deceive the intended purchaser should not be entertained, for short or long-term gain). Products and services that emphasise sustainability and responsible finance should be seen as preferable. Banks need to renew efforts to demonstrate their contribution to the public good: ambitious goal oriented programmes focused around health, education and financial literacy to help deliver respect, renewal and trust. Whilst there is no 'perfect bank', EdenTree IM (EIM will look for institutions that in general appear to be attentive to these general principles; we will engage, individually and collectively to affirm an ethical approach is taken.

The EdenTree SRI Team

We have a specialist in-house Socially Responsible Investment (SRI) team who carry out thematic and stock-specific research to identify ethically responsible investment ideas for our range of Amity Funds. Headed up by our Senior SRI specialists Ketan Patel, CFA, and Neville White, the team is also responsible for creating an on-going dialogue with companies, allowing us to engage on a wide variety of ethical and socially responsible investment concerns. For investors, it's an added layer of assurance that client money is being invested in companies that are operating in a responsible and sustainable way. Our ethical and responsible investment process is overseen by an independent Amity Panel that meets three times a year, and comprises industry and business experts appointed for their knowledge and professional insight.

EdenTree - Ethical Investment Specialist

Five Years
Best Ethical
Investment Provider

Since launching the **Amity UK Fund** in 1988, EdenTree has taken a leadership role in managing ethical investments through our research, engagement and strong fund performance. Consequently, we were delighted to receive the Moneyfacts Award for Best Ethical Investment Provider 2013. This was the fifth consecutive year of winning this award, and we are proud to have been nominated for a record sixth time in 2014; we were particularly pleased to win as it is voted for by the adviser community. In 2013, the **Amity UK Fund** was rated 'Highly Commended' in the Investment Week Climate Change and Ethical Investment Awards. We were also awarded Money Observer Best Ethical-SRI Bond Fund for the **Amity Sterling Bond Fund**, and the **Amity UK Fund** won Best Equity Fund in the 2014 Money Observer Ethical/SRI category. Today we offer four retail SRI funds, and two charity funds, covering the major markets and investment classes.

Further information

For further information on EdenTree's SRI range of Amity Funds please contact your EdenTree Business Development Manager, visit www.edentreeim.com or call our adviser support team on 0800 011 3821.

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