Co-operative Pension Scheme (Pace)

Pace pension scheme

Responsible Investment

6 April 2017 to 5 April 2018

The co-operative bank

The Pace Trustee is pleased to publish its annual report on responsible investment for the year to 5 April 2018. This explains what the Trustee and Pace's investment managers have been doing during the year to make sure we meet the requirements of our Responsible Investment Policy.

During the year, the Trustee agreed to make some important changes to Pace, to make sure that the pension obligations of the Co-operative Group and the Co-operative Bank are managed separately in the future; this report covers the period prior to the scheme being sectionalised, and so covers Pace as a whole.

What has the Trustee been doing?

We implemented a revised investment strategy

Over the year, we implemented a lower-risk investment strategy, with lower allocations to more risky assets and increased holdings in defensive assets, to increase the predictability of investment returns where possible. As a result, as at April 2018, Pace no longer invests in equities, and has increased investments in corporate bonds and alternative 'bond-like' assets compared to the start of the period. We also continued to redeem our existing UK property investments and invest in a new inflation-linked property mandate.

These changes have reduced risk in Pace and, given the changes over the last few years to reduce holdings in equities and increase investments in debt, have changed the relationship Pace has with the companies in which it invests (i.e. the issuers of these equities and bonds). Because of this, we've changed the format of this report to focus more on the way our managers pick individual investments and engage with the companies issuing them, with less emphasis on how they exercise their rights to vote at company AGMs (because, while investors in equities have voting rights, investors in bonds do not). A summary of how our managers exercised voting rights is set out in Appendix 1.

In future years, we expect our reporting to develop further to reflect this change in emphasis.

We reviewed our Responsible Investment Policy

We review our Responsible Investment Policy for Pace regularly and ensure that we follow the policy closely and apply it to our investment strategy. Our policy puts an emphasis on asking for members' views on responsible investment and incorporating these with our own views to shape our investment strategy. During the year, the Trustee reviewed the policy and updated it to reflect changes to Pace's investment strategy mentioned below.

Our updated Responsible Investment Policy is on the Pace website.

We have implemented a list of exclusions for companies in extractive industries and controversial weapons as well as countries with poor human rights

In April 2017 we worked with MSCI, a leading provider of investment tools and research, to produce an exclusions list to help us avoid investing in assets that don't fit with our core beliefs. We developed this exclusions list so that it's practical to apply and doesn't constrain our investment managers in securing the investment returns needed to pay members' benefits. The investment exclusions we agreed include:

- Extractive industries: companies involved in extractive industries which are also rated poorly by MSCI with respect to how their specific environmental risks are addressed
- Controversial weapons: companies involved in the manufacture or distribution of land mines, cluster munitions, chemical weapons, blinding lasers or depleted uranium munitions
- Human rights: debt-based investments issued by countries which score poorly on a number of indicators of effective governance and provision of basic rights and services to their populations.

Throughout the year, we worked with MSCI to implement the exclusions list and keep it up to date. As at April 2018, the exclusions list covered:

- Corporate bonds issued by 368 companies in the extractive industries with poor environmental ratings
- Corporate bonds issued by five companies involved in the manufacture or distribution of controversial weapons
- Government bonds issued by 68 countries with poor human rights scores.

These exclusions are applied to Pace's corporate bond and Liability Driven Investment mandates, which made up over 85% of Pace's assets as at 31 March 2018 (over £9bn). We monitor the implementation of these exclusions, and over the year (as instructed) our bond managers have not made any purchases prohibited by the exclusions list. A small amount of residual holdings (0.3% of Pace's total assets) are in investments on the exclusions list; this is expected to naturally fall over time.

We agreed to support the RE100 initiative

Our members' voices are valuable to us. This is why we decided to publicly support the RE100 initiative, after this was raised by a member of Pace.

Run by The Climate Group, an international non-profit organisation, the RE100 initiative is a collaborative, global initiative to encourage and recognise companies which make a public pledge to move to 100% renewable electricity for their international operations by an agreed date.

We believe that by joining other asset owners to support the RE100 initiative, we are making a positive and progressive step to encourage companies to participate by using renewable energy, consistent with our Responsible Investment Policy.

Engagement in other forums
Pace publishes its statement of compliance with the Financial Reporting Council's UK Stewardship Code, which is updated annually. Six of the Scheme's ten portfolios (at 5 April 2018) have managers with a published statement of compliance with the Financial Reporting Council's UK Stewardship Code. Appendix 2 summarises our managers' compliance with the UK Stewardship Code; in addition, all of Pace's mandates are managed by signatories to the United Nations-backed Principles for Responsible Investment ('UNPRI').

We continue to monitor our environmental, social and governance ('ESG') priorities
As the Trustee we recognise that environmental, social and governance factors can affect the financial performance of the companies and other assets we invest in. This is why we continue to consider ESG factors (along with a number of others) in our general approach to investment.

Our investment managers continue to take account of ESG factors when they are implementing their investment mandates. As part of this, our investment managers engage directly with the companies they invest in, to understand and assess topics like board constitution, appropriate use of capital and directors' remuneration. When the Trustee appoints a new investment manager for Pace, we also consider the manager's approach to incorporating ESG factors into their investment strategy.

A summary of how our investment managers approach ESG factors is on pages 5 to 10.

We have assessed Pace's investment exposure to climate change risk
As a reminder, Pace has also worked with our investment adviser to better understand Pace's exposure to climate change risk. Climate change has become an increasingly pertinent risk to the environment, and we recognise that it also poses a potential risk to the value of the Scheme's assets.

This work looked at how Pace's investment returns might be affected by international efforts to limit global warming to two degrees celsius (the so called 2DC scenario). This included an assessment of risks arising from technology changes, resource availability, impacts of physical damage and policy changes.

The analysis showed that Pace has a very low exposure to climate-related risks, and that the impact of a 2DC scenario would result in only very marginal reduction in the expected returns on Pace's assets over the next ten years. This was a significantly lower level of impact than for most UK pension schemes, and was mainly due to its low-risk investment strategy, with no remaining exposure to equities (these tend to have the highest climate-related risk). A summary of this analysis is available on the Pace website.

What have our investment managers been doing?

Our investment managers put a lot of work into investing responsibly and considering environmental, social and governance factors in their investment processes, and some go as far as extending this to how they run their business.

The following sections cover in more detail the policies and approach taken by Pace's investment managers, focusing on the scheme's largest holdings.

Investment Grade Credit Mandates

Mandate managers: Legal & General Investment Management; Royal London Investment Management; Insight Investment Management.
Allocation: c33.7% of total holdings as of April 2018.
Objectives of mandates: Pace invests in corporate bonds through 'buy and maintain' approaches which seek to hold bonds to maturity where possible, avoiding defaults through strong stock selection and limited trading, while building diversified portfolios.

Legal & General Investment Management ('LGIM')

Manager's policy on responsible investment

LGIM is committed to addressing ESG issues by developing and carrying out corporate governance and responsible investment activities, including Active Ownership, Advocacy, ESG Integration and Product Development.

For credit mandates, LGIM analyses ESG issues when assessing and projecting the future creditworthiness of borrowers. LGIM believes that ESG may vary depending on the type of debt issuer, its industry sector, its geographical footprint and the type of instrument and the intended holding period. LGIM integrates these ESG criteria in their investment process.

LGIM looks for the companies which it invests in to demonstrate that sustainability is effectively integrated into their long-term strategy as well as their daily operations. For example, where climate change is identified as a material issue for the invested business, LGIM would expect companies to have sufficient expertise and experience on the board to ensure effective strategic and operational oversight. In addition, LGIM would expect companies to publicly disclose any concerns they may have with current or evolving legislation, and to publicly report on any lobbying activity that is undertaken as a result of such concerns.

In addition to its ESG policy, LGIM has implemented a separate policy for controversial weapons to exclude those companies involved in the manufacture and production of cluster munitions, antipersonnel landmines, and biological and chemical weapons.

LGIM is also committed to addressing the issue of climate change and has a specific climate change policy. It engages with companies that it invests in to ensure investee companies' strategies are aligned with global climate goals, as well as working with its clients to provide investment solutions that can build a low-carbon economy.

How LGIM exercises stewardship in relation to investments where it does not have voting rights

LGIM's engagement activity is conducted using two related approaches. It combines financial analysis with ESG factors to address material issues that can impact a company's profitability and creditworthiness.

LGIM sets clear objectives and timelines when it first engages with companies where issues have been identified, and these are reviewed throughout the engagement process by using a bespoke data management system, to allow their management to oversee the progress of engagement activities.

To effectively tackle ESG issues that impact the value of their clients' assets, LGIM applies a multi-layered escalation strategy. Where the initial engagement does not lead to an appropriate outcome, LGIM may choose to adopt a stronger stance by using different escalation tools – for example, through voting against individual directors' reappointments, direct engagement with regulators or through applying pressure by means of public statements and press releases.

LGIM monitors investee companies over the long term and the progress on engagement activity is regularly reviewed by their dedicated team using company disclosures, independent research providers, their investment teams and the media.

Manager's approach to incorporating ESG factors into bond selection for Pace's mandate

LGIM confirmed that its portfolio managers take into account Pace's view on ESG and our exclusions list when choosing securities.

Royal London Asset Management ('RLAM')

Manager's policy on responsible investment

RLAM is committed to being a responsible investor. It believes that corporate bond investing demands a bespoke fixed income and ESG approach, and as a result developed an approach that is intended to be both credible and realistic, with a strong emphasis on redressing bondholders' traditionally weak control. RLAM invests in businesses that provide a 'net benefit to society' and believes that they are leaders in ESG issues while generating financial returns for investors like Pace.

RLAM focuses on engaging with investee companies by having a long-term investment outlook and closely monitoring companies where it considers it will be able to have the greatest influence. In the past six months, RLAM has targeted engagement around decarbonisation of portfolios across its utility holdings, the climate resilience of its water holdings and the strategic response to energy efficiency regulation that its Commercial Mortgage Backed Securities ('CMBS') investments and other real estate issuers are taking. RLAM believe that engaging with these issuers is particularly important because they have a greater reliance on debt markets.

RLAM aims to generate sustainable, risk-adjusted returns that reflect a wider understanding of what will drive economic performance in the future. As part of that commitment, RLAM seeks to understand ESG risks and opportunities as part of its investment process. To achieve this, it engages with companies and industry regulators to understand the issues and to promote best practice. For example, RLAM helps to finance companies that are making a commitment to green electricity. RLAM also helps fund companies building out the infrastructure of the future, including telecommunications and green power distributors, and supports innovative companies who are working to transform industries or improve industrial processes.

How RLAM exercises stewardship in relation to investments where it does not have voting rights

RLAM takes an active approach to stewardship by engaging with issuers in their fixed income portfolios. RLAM regularly monitors its investee companies using its own research and also through regular engagement meetings with management and non-executive directors to discuss issues relating to strategy and governance. Through dialogue with investees' management teams, RLAM's aim is to satisfy themselves with the effectiveness and efficiency of the board of investees, and to ensure that they are aware of, and appropriately managing, all material risk factors, including environmental and social risks.

Manager's approach to incorporating ESG factors into bond selection for Pace's mandate

RLAM confirmed it reflects Pace's exclusions list when choosing securities to invest in, and will continue to work with Pace to ensure ESG is incorporated into its investment process for Pace's mandate.

Insight Investment Management

Manager's policy on responsible investment

Insight's Responsible Investment Policy focuses on three areas, which include:

- Integrating material ESG factors into their investment process
- Exercising their stewardship role by engaging with companies on ESG factors
- Supporting sustainable economic development.

These focuses are applied in the credit evaluation of all assets at Insight and are essential components of their checklist to better quantify long-term risks. As well as applying Pace's exclusions list, Insight's ESG framework overlaps with Pace's Responsible Investment Policy in a number of areas:

- Insight has a policy to not have any exposure to companies involved in the manufacture or distribution of incendiary/illegal arms or weapons.
- Insight does not typically invest in companies in the extraction industries on a 'Buy and Maintain' basis and therefore they are unlikely to feature in Pace's investments in light of Insight's focus on building long-term, secure investments.
- Insight closely monitors risks from the extractive, utilities and energy sectors as it believes they are most vulnerable to a transition to a low carbon economy and have a big impact on climate change.
- Insight expects companies to uphold a minimum standard on labour and health and safety. It will engage with companies that fail to meet these minimum standards on a case by case basis. New issues such as equal pay are becoming more relevant for how they evaluate corporate culture and over time expect to use this data as part of their issuer due diligence.
- Insight believes corporate governance is a critical component of issuer risk. Insight evaluates corporate governance for every company that it invests in and will engage on governance risk wherever it considers it to be material.

How Insight exercises stewardship in relation to investments where it does not have voting rights

Insight takes an active approach to voting and stewardship. For its fixed income portfolio, Insight aims to engage with all companies prior to investing to review performance, strategy, risk management and ESG issues. It holds regular dialogues with companies through different methods. Insight focuses on the areas where companies have received low scores in its 'landmine' checklist. The issues Insight engages on include the oversight and effectiveness of boards of directors, environmental performance, health and safety events, accounting deficiencies and strategic changes. If Insight identifies issues and is unhappy with management's responses to its engagement on these issues, it would reduce or completely sell these holdings.

Manager's approach to incorporating ESG factors into bond selection for Pace's mandate

Insight has confirmed it reflects Pace's exclusions list when choosing securities to invest in and will continue to work with Pace to ensure ESG is incorporated into its investment process for Pace's mandate.

Asset Backed Securities Mandates

Mandate manager: TwentyFour Asset Management ('24AM').
Allocation: c3.2% of total holdings as of April 2018.
Objectives of mandates: A segregated mandate investing in a diverse portfolio of asset backed securities targeting a return of cash +3.5% pa (with a focus on high credit quality and security of cashflows).

<u>24AM's policy on responsible investment</u>

When making investment decisions, 24AM aims to produce strong returns while taking ESG and other responsible investment considerations into account.

24AM focuses its investment process on governance in relation to the fixed income strategy in which Pace invests, but it has recently begun to integrate social and environmental elements of ESG in each area of their business and investment process. As an example, in its analysis of Asset Backed Securities, 24AM is proactive in ensuring that companies it deals with are not allowing residential mortgage borrowers to overleverage themselves (which has both social benefits and improves the security of Pace's investment), while from an environmental perspective 24AM supports mortgage providers who offer preferred terms to home-owners with environmentally friendly/energy efficient homes.

Currently, 24AM engages with invested companies on ESG issues on an ad hoc basis, depending on the investment, but it is looking to move this to a more systematic approach as it has been developing its ESG proposition over the last twelve months, an approach which Pace supports. Looking forwards, 24AM expects to include specific ESG ratings within its due diligence processes, which may include ratings from an external agency as well as additional information from their discussions with the issuers, servicers and companies involved.

In terms of stewardship of Pace's investments, 24AM believes that voting is not the only way to show good stewardship, and that other methods of engagement are useful. As bondholders do not typically have voting rights, the majority of its stewardship is through direct engagement with companies. It carries out careful due diligence and ESG checks on all companies in which it invests. Any that do not pass its check would not be invested in. 24AM believes that the poor governance of a company is the root cause of an unsuccessful business and ultimately would affect the value of the bonds it issues. 24AM also assesses the sustainability of a company as it believes sustainability is an important factor in a successful business, particularly where the ability to refinance transactions on an ongoing basis is an important consideration.

Given the nature of the investments 24AM makes, it is not practical for Pace's exclusions list to be applied.

Alternative Inflation-Linked Mandates

Mandate manager: PGIM.
Allocation: c1.4% of total holdings as of April 2018.
Objectives of mandates: Segregated portfolio consisting of long-lease property and property-related investments, aiming to provide inflation-linked returns and outperform index-linked government bonds by 2.0% p.a. (net of fees).

Policies and engagement over 2017-2018

PGIM values environmental considerations when considering an investment. It adopts a 'Sustainability Strategy Statement' to guide its actions to make both its investments and business 'greener' and more sustainable. It seeks to reduce or avoid the harmful effects of actions on natural resources, and to take steps to improve the efficiency of their assets.

PGIM sees environmental considerations as an important part of the process of considering a new investment and does not look to acquire assets where it suspects there would be a damaging effect on either the environment or a local community. However, it does recognise that property can be a controversial subject because people tend to have different opinions to development plans. For example, assets which are going through refurbishment or under development will always be controversial to a portion of a local community, while equally the underutilisation of land and old derelict buildings can be just as detrimental.

As part of its investment process, PGIM considers social impact to ensure that they do not acquire assets where they would see a tangible detrimental effect on either the environment or the local community.

Liability Driven Investment Mandate

Mandate manager: BlackRock Investment Management ('BlackRock').
Allocation: c52.3% of total holdings as of April 2018.
Objectives of mandates: BlackRock's objective is to match its overall benchmark which is based on Pace's liabilities using a gilt-based measure.

BlackRock's is a liability hedging portfolio, so responsible investment considerations do not directly impact on investment decisions for its mandate, and as such it does not form part of its investment process. Pace does, however, apply its exclusions list to the portfolio.

Defined Contribution ('DC') Section – Legal & General

Pace's DC section is administered by Legal & General Assurance Society Ltd. and members have the option to invest in a range of funds, which are shown below, together with the proportion of members' assets invested in each fund as at 31 March 2018. LGIM manages the underlying assets of these funds and are a signatory to the UNPRI as well as having published a statement of compliance with the Financial Reporting Council's UK Stewardship Code. As mentioned above, LGIM has carried out significant work in promoting high standards of corporate governance and action on climate change, which have been key themes in its engagement with investee companies.

Pace fund	Proportion of DC Section assets (Co-op Section)	Proportion of DC Section assets (Co-operative Bank Section)	Fund objective
Growth (Mixed)	91.8%	94.4%	Long-term investment growth, using a diversified set of asset classes.
Cash	6.5%	3.7%	Provide capital protection, with growth at short-term interest rates.
Growth (Shares)	1.0%	1.2%	Capture UK (30%) and overseas (70%) equity market returns.
Pre-retirement	0.3%	0.1%	Reflect diversified investment underlying a typical traditional annuity product.
Growth (Ethical Shares)	0.4%	0.3%	Track the total return of the FTSE4Good Global Equity Index.
Pre-retirement (Inflation-Linked)	0.2%	0.2%	Reflect diversified investment underlying a typical inflation-linked annuity product.

Appendix 1

As mentioned above, Pace invested in equities through a pooled fund managed by LGIM up until September 2017, when it disinvested as part of its new lower-risk investment strategy. LGIM's policy is to vote 'for' or 'against' resolutions based on proprietary and external research and aims to keep abstentions to a minimum.

The table below summarises how LGIM exercised its voting rights for global equities over the period from 31 March 2017 to 30 September 2017 (approximately the period over which Pace was invested).

Proposal category*	Voting policy with**	Voting policy against**	Abstention	Total
Anti-takeover related	390	38	0	428
Capitalisation	3,576	467	0	4,043
Directors related	16,401	2,421	14	18,836
Non-salary compensation	2,748	831	0	3,579
Reorganisations and mergers	730	138	0	868
Routine/business	7,400	300	1	7,701
Shareholders' resolutions				
Compensation	13	27	0	40
Corporate governance	35	72	0	107
Directors related	108	300	23	431
Health/environmental issues including climate change related	62	59	0	121
Other/miscellaneous	86	74	0	160
Routine/business	66	103	0	169
Human rights	6	2	0	8
Social proposal	3	1	0	4
Total resolutions	**31,624**	**4,833**	**38**	**36,495**

* LGIM uses voting research from ISS among other providers, and the categories set out are in line with their reporting.

** Voting figures are with or against the recommendation of the investee companies' boards.

As well as exercising voting rights on shares, LGIM looks to engage directly with the companies it invests in and regularly meets with senior management. The table shows the number of these meetings over the period from 31 March 2017 to 30 September 2018 and a high-level summary of the issues discussed. Over 50% of meetings covered environmental and social issues during this period.

	Q2 2017	Q3 2017
Total number of companies	85	56
Total number of meetings	111	66
Number of meetings where environmental topics discussed	56	15
Number of meetings where social topics discussed	22	22
Number of meetings where governance topics discussed	69	41
Number of meetings where other topics (e.g. financial and strategy) discussed	44	50
% of meetings including environmental and social issues discussed	64%	50%

Appendix 2

The following table summarises subscription to the UNPRI and compliance with the UK Stewardship Code for each of the investment managers of Pace's Defined Benefit ('DB') Section in the period from 6 April 2017 to 5 April 2018:

Investment manager	Mandate	Management style	Signatory to the UN PRI	UK Stewardship Code compliance	DB Section assets (31 March 2018)
LGIM	Corporate Bonds	Buy & Maintain	Yes	Yes	11.2%
RLAM	Corporate Bonds	Buy & Maintain	Yes	Yes	11.2%
Insight	Corporate Bonds	Buy & Maintain	Yes	Yes	11.2%
24AM	Asset Backed Securities	Active	Yes	No[1]	3.2%
PGIM	Alternative Inflation-Linked	Active	Yes	No[2]	1.4%
BlackRock	Liability Driven Investment	Active	Yes	Yes	52.3%
Insight	Illiquid Credit	Active	Yes	Yes	2.9%
ICG	Illiquid Credit	Active	Yes	No[1]	2.4%
LaSalle	UK Property	Active	Yes	No[2]	1.1% (in the process of being disinvested)
Mercer	Alternative Growth	Active	Yes	Yes	2.9% (in the process of being disinvested)

[1] 24AM and ICG generally support the objectives that underline the Code but have not yet determined whether to publish a statement regarding compliance.

[2] LaSalle and PGIM Real Estate manage investments in real estate, and not UK listed securities to which the UK Stewardship Code applies.