Purposeful investing
– our approach to ESG
Environment, Social and Governance ("ESG") risks have always been an inherent part of our investment process when assessing the suitability of long-term investments, and are a natural consequence of a focus on our purpose. We continue to integrate ESG factors into our investment decisions to manage risk, but also view ESG investing as an opportunity. In 2020, PIC invested a further £500 million in renewable energy, committed to divesting from coal producers, reduced its exposure to fossil fuels and now has more invested in renewable energy than in oil & gas.”

Rob Groves
Chief Investment Officer
The purpose of PIC is to pay the pensions of our current and future policyholders. Guaranteed pensions for our growing policyholder base are backed by a purposeful investment strategy. This strategy prioritises the management of key risks, including environmental, social and governance, as integral to paying the pensions of our policyholders over the coming decades. Investments with a lasting impact on current and future generations in areas including renewable energy, social housing, and national infrastructure are socially beneficial outcomes of our focus on our purpose.

Our philosophy

Given our long-term horizon of paying pensions decades into the future, it is our responsibility to protect our assets from the impacts of both financial and non-financial risks. We recognise that issues such as climate change, human rights, and corruption can have very real financial implications over the medium to long-term. We believe that strong stakeholder relationships – both at PIC and within the companies we invest – are fundamental to a sustainable business.

Key outcomes of our purpose

- **Policyholders:** Guaranteed pensions for life; excellence in customer service
- **Employees:** Stimulating, fair and rewarding workplace
- **Economy:** Significant investments in urban regeneration, social housing and areas that balance intergenerational equity
- **Environment:** Increasing investments into renewable energy, with concurrent reduction in exposure to carbon-producing industries
- **Society:** Active engagement in public policy debates around purposeful, long-term investment in the economy, and stakeholder capitalism
- **Capital providers:** Growing store of value expected to provide secure, long-term returns
- **Key suppliers:** Partnership model of engagement
OUR ENVIRONMENTAL, SOCIAL AND GOVERNANCE ("ESG") APPROACH

Purposeful investing

What drives investments at PIC

- **Purpose**: To pay the pensions of our current and future policyholders we must ensure long-term financial and non-financial risks and opportunities are considered. This means that ESG factors play an integral part in our investment analysis.

- **Impact**: The greater the socially beneficial outcomes of an investment, the higher the likelihood of long-term stability, needed to back future pension payments.

- **Risks**: Mitigating risks is at the very heart of our investment process, and this includes those associated with climate change. Climate risk has also been incorporated into PIC’s corporate risk taxonomy covering physical, transition and liability risks.

- **Opportunity**: Attributing value to ESG factors can uncover attractive investment opportunities. PIC now has more investments in renewable energy than in traditional fossil fuels.
Who is responsible for oversight of ESG risks at PIC?

PIC’s Head of Responsible Investing, Cléo Fitzsimons, leads our ESG strategy. She is responsible for integrating ESG into the investment process, assessing new ESG opportunities, embedding ESG into the overall investment strategy, and ensuring that PIC is an active member of the sustainable financial industry.

PIC’s Head of Credit, Mark Gull, who has overall responsibility for PIC’s investments in the investment-grade corporate bond portfolio, works closely with the Head of Responsible Investing to ensure ESG considerations are included in the overall investment process and portfolio construction.

Given the importance PIC attributes to ESG, members of senior management are accountable for its proper implementation. PIC’s Chief Investment Officer (“CIO”) is responsible for ESG portfolio considerations. PIC’s Chief Risk Officer (“CRO”) is responsible for ensuring PIC adequately manages climate risk. Both the CIO and the CRO directly report to the CEO.

As PIC’s portfolio continues to grow, the Company has an increasingly visible and important role to play within the economy and society. The investments we make to secure the pensions of our policyholders for decades to come help green the economy, provide social housing, regenerate our cities, support our universities and benefit younger, and future, generations.

These are the socially beneficial outcomes of an investment strategy tied closely to our purpose, which is to pay the pensions of our current and future policyholders. This means we need long-term, secure cash flows: the starting point for assessing all opportunities and risks within our asset portfolio, including those associated with ESG factors.

PIC’s portfolio consists of £37.1 billion invested in listed debt, with approximately 19% of the portfolio invested in private debt issued by private companies and institutions, which we have sourced directly. In accordance with the insurance regulatory framework, known as Solvency II, and to align our assets and liabilities, PIC invests in listed corporate bonds or private debt instruments, to match its pension liabilities.

This is a significant differentiating factor when reviewing the investment and ESG strategies of life insurers, like PIC, compared to other asset owners, such as pension schemes.
Our approach to ESG integration

We believe companies which demonstrate positive sustainability characteristics are better placed to maintain sustainable cash flows and service their debt over the long term.

These characteristics include whether they have a clearly defined purpose, and recognise responsibilities to key stakeholders beyond customers, such as employees, suppliers, society and the environment. In order to meet these obligations it is crucial that they have a long-term focus.

As resolved by PIC’s Board, PIC’s ESG strategy integrates ESG risks into investment decisions and we ‘engage’ with our investments in the private debt portfolio. This type of strategy is explained in the table below.

Our approach has always been to have our expert credit analysts do the detailed risk analysis for credit-investment decisions, because they have the most knowledge of specific issuers. PIC gathers third-party ESG data from various sources and uses the data within its own risk-based methodology to assess investments on ESG criteria. Analysts consider material ESG risks alongside other risks and liaise with our Head of Responsible Investing where concerns arise. Every member of the investment team is expected to consider ESG factors when reviewing an investment opportunity. This means our analysis process is forward looking, and takes into consideration the risks to potential investments over many decades.

PIC is a signatory to the United Nations’ Principles of Responsible Investment (“UNPRI”) as are all of PIC’s key external asset managers.

<table>
<thead>
<tr>
<th>CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)</th>
<th>IMPROVING INVESTEES’ ESG PERFORMANCE (known as: active ownership or stewardship)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integration</td>
<td>Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns</td>
</tr>
<tr>
<td>Screening</td>
<td>Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor’s preferences, values or ethics</td>
</tr>
<tr>
<td>Thematic</td>
<td>Seeking to combine attractive risk return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing</td>
</tr>
<tr>
<td>Engagement</td>
<td>Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors</td>
</tr>
<tr>
<td>Proxy voting</td>
<td>Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues</td>
</tr>
</tbody>
</table>

https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article
Our external managers, who run our listed debt portfolios (UK, US and emerging market), all have specific mandates to ensure they are actively considering ESG factors. ESG-related issues are a standing agenda item at our regular meetings and they are expected to formally report on them quarterly. The active consideration of ESG factors may result in a change of a portfolio holding or a shortening of the exposure to a name or sector where the long-term visibility around the sector is uncertain.

We manage two parts of our portfolio internally: risk free assets and non-risk free, which is largely bilateral or privately sourced debt investments. We do not explicitly consider ESG factors for our “risk-free assets” because they are principally UK gilts and derivatives. However, ESG factors are fundamental considerations for our privately sourced debt investments because they are very long term in nature.

We engage with the management of our privately sourced debt investments to understand their ESG risks and help them manage a variety of potential long-term disruptions, as well as encouraging better governance and transparency in reporting. There are specific initiatives in which we are involved on this front, such as the Good Economy’s “Building a Sector Standard Approach for ESG Reporting” for social housing. PIC is a founding member (see case study on page 08).

Engagement can also include considerations of how the borrower balances the needs of all stakeholders, including their employees; the composition of the borrower’s board and senior management team; its ability to develop and execute short- and long-range plans; their approach to enterprise risk management and oversight based on business complexity; how it approaches issues related to climate change; and the borrower’s ability and willingness to measure performance and implement change based on internal objectives or shifts in the competitive landscape.

Our bilateral, long-term relationships with these borrowers allow us to engage with them extremely closely to understand their ESG awareness.

Roughly 50% of our c£50 billion portfolio is managed internally, and the other 50% is managed by our external managers, which include Wellington Management, Schroders Investment Management, Janus Henderson Investors and J.P. Morgan Asset Management.
Environment

DIVESTMENT FROM THERMAL COAL

During 2020 we informed our investment managers that they should divest our remaining holdings in companies which rely on either the extraction or the burning of coal for more than 10% of turnover, by the end of 2025.

This policy is rooted in PIC’s purpose: we believe that coal is not viable in the long-term as a source of energy due to its high pollution levels, and therefore there is a real risk that cash flows generated from coal extraction or burning will not be sustainable over the long term.

The factors that we considered as part of this decision are:

1) Potential carbon taxes on coal-burning companies. This is a growing possibility as the cost of climate change is increasingly factored into energy production.

2) The potential for legal action taken against companies by activists and others. For example, the New York City Pension Funds filed a lawsuit in 2018 against the five largest investor-owned fossil fuel companies as measured by their contributions to global warming, for the “billions of dollars the city will spend to protect New Yorkers from the effects of climate change”.

3) As ESG considerations become more urgent, there will be changes to the supply and demand dynamic, causing downgrades or defaults in corporate debt linked to the sector.

Taken together, these considerations have a double bottom line impact: a positive impact on climate change and helping us meet our investment purpose.

In addition, we have recently taken an increasingly risk-averse stance to certain carbon-intensive sectors over the past couple of years, such as automotive and oil & gas, as well as increasingly positive stance to greener investments, like renewable energy in response to developing policy and market signals:

— During 2020 we reduced our exposure in the portfolio to oil & gas by about £500 million.

— During 2020 we increased our investments in renewable energy by about £500 million.

This is partly being driven by the potential economic impact: the desire for a rapid transition away from carbon fuels is now driving government policy in the UK and around the world. In anticipation of this shift, investors are selling down positions, so tipping the relative market balance towards investments in greener sectors and technologies. Sourcing investment grade bonds in new technologies remains a challenge.

Long-term investors face challenges:

— The cost of exiting specific positions matched to future liabilities (transition risk) is a factor that needs careful consideration as part of an overall integration strategy.

What is clear is that the global energy transition will be disruptive and costly. If the Paris Agreement goal of limiting global temperatures to a two degree rise relative to the pre-industrial average is to be met, then significant action is required across all industries including Financial Services.
SUPPORTING OUR DIRECT BORROWERS THROUGH THE CRISIS
In June 2020, at the height of the crisis over university admissions and questions about the viability of university business models as a result of the pandemic, PIC wrote to those universities to which we have lent money on a long-term basis, to reassure them that, “In line with our wider stakeholder responsibilities, we will do everything we can to help where a high-quality borrower is willing and able to pay its debt…in the interests of students, the wider university sector, our policyholders and our wider stakeholders.”

PIC has increased its investments from £8.6 billion in 2019 to £11.4 billion in 2020 in assets that we deem as being socially beneficial. We define a socially beneficial asset as one whose primary purpose establishes a net positive outcome to society. The investments we make into socially beneficial assets are in line with our purpose in that the greater the socially beneficial outcomes, the higher the likelihood of long-term stability, needed to back future pension payments.

Breakdown of socially beneficial investments

- A Renewable energy 9%
- B Social housing 24%
- C Education 21%
- D Not for profit 8%
- E Utilities 38%
DEVELOPING STANDARDS OF GOVERNANCE ACROSS THE SOCIAL HOUSING SECTOR

PIC has invested in social housing debt since 2012, and has worked with more than 40 housing associations, lending more than £2 billion in aggregate, managed as part of our internal portfolio. In 2020, PIC was a sponsor of the Good Economy’s “Building a Sector Standard Approach for ESG Reporting” for social housing and was a member of the working group that developed this report.

ESG risk factors are fundamental considerations for us as debt investors when looking at long-dated and illiquid investments such as social housing. As more long-term investors have entered the sector, housing associations have been encouraged through investor due diligence processes to develop their strategies and business models, in particular their governance.

In both 2019 and 2020, PIC surveyed all the housing associations to which we have lent money on a bilateral basis. The results of these surveys show that these housing associations have been working to strengthen their corporate governance, not least because they are increasingly aware of the risks presented by climate change, and are starting to set out their long-term objectives and plans.

This increased due diligence is beneficial for the sector, although it is not standardised across all housing associations. Improved levels of governance make the sector more focused on tenant outcomes and the needs of stakeholders, and therefore better equipped to attract future investment.

Typical areas of focus when reviewing a housing association’s ESG arrangements are:

— the composition of an obligor’s board and senior management team;
— the challenges faced in ensuring the group achieves its objectives while maintaining its social responsibility;
— how it assesses climate risk in its decision making; and
— the obligor’s ability and willingness to measure performance (both financial and non-financial) and implement change based on internal objectives or shifts in the competitive landscape.

PIC was delighted therefore to be a sponsor of the Good Economy’s initiative and to be part of the working group which brought together a range of banks, investors and housing associations, to build a consensus over ESG reporting in the sector. Standardisation of ESG reporting allows housing associations to bring transparency, consistency and comparability to their ESG credentials.

The Good Economy’s aim for the sector “has been to unlock a new wave of investment to enable the sector to deliver high-quality, affordable social housing”, an aim we fully support.