PRI Principles for Responsible Investment

PIMCO

ENGAGING WITH UTILITIES AND GLOBAL BANK ISSUERS

SIGNATORY TYPE	**Investment manager**
OPERATING REGION	**Global**
ASSETS UNDER MANAGEMENT (AUM)	**US$1.69 trillion***
FIXED INCOME AUM	**US$1.57 trillion***
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WHY ENGAGE WITH ISSUERS?

We believe that successful engagement can reduce credit risk, unlock value and influence positive impact.

Reduce credit risk and unlock value. Default and spread widening are dominant potential risks in corporate debt investing. Avoiding 'losers' and taking an active approach to identifying 'winners' is one of the most significant factors in portfolio management. PIMCO's ESG assessment for corporate and sovereign credit issuers enhances this analysis. Intangible factors and secular ESG trends can have a material impact on companies' financial conditions if they materialise. Alongside discussion on financial matters, engagement on ESG factors focuses on risk management issues such as how business strategy addresses culture and conduct, cybersecurity and product safety.

Influence positive impact. Our dedicated ESG portfolios also have the engagement objective to incorporate the UN Sustainable Development Goals (SDGs) to help facilitate positive impact. If issuers embed these goals into their core business activities, then investors like PIMCO can measure the impact of their capital, alongside financial returns.

* As at 30 September 2017

Figure 1: PIMCO's ESG engagement motivations. Source: PIMCO

REDUCE CREDIT RISK AND UNLOCK VALUE *Protect the value of clients' assets*	INFLUENCE POSITIVE IMPACT *Deliver risk-adjusted returns for clients, sustainable over the long term*
▪ Encourage behaviour designed to improve fundamental credit metrics ▪ Add forward-looking insights on issuers' business strategy and plans to address ESG oversight (conduct and culture, and risk management e.g. climate change, product safety, cybersecurity)	▪ Understand how a firm's activities align to the UN Sustainable Development Goals (SDGs) to identify business models that are competitive into the future ▪ The SDGs enable PIMCO to measure/report on the social impact of our capital allocation in ESG portfolio

ENGAGEMENT PROCESS

ENGAGEMENT TO REDUCE RISK AND UNLOCK VALUE

PIMCO has developed a robust platform to support the analysis of ESG issues across our firmwide investment process, with ESG factors evaluated from both the top-down (i.e. macro) and bottom-up (i.e. security-specific) perspective.

The first and most important step in PIMCO's top-down process is to correctly identify the major long-term themes – such as ageing populations and climate change – that will impact the global economy and financial markets. From a bottom-up perspective, PIMCO considers all potential risks and opportunities, including those that are ESG-related, that could affect particular issuers or industries. We continually enhance our proprietary credit research software with specific ESG-related attributes, including data from ESG third-party providers and other sources such as public filings, together with feedback from regular engagement with company management teams.

These factors are combined to create a proprietary PIMCO ESG score, which is included in credit analysts' research notes with rationales for material E, S and G issues that could impact performance.

The assessments also provide a forward-looking ESG trend for each issuer that recognises companies whose performance is significantly improving, while identifying those that are deteriorating.

PIMCO's ESG assessments are considered when evaluating investments across the firm. For example, a portfolio manager may decide to switch between two companies with similar risk profiles trading at comparable spread levels based on their relative ESG value.

Figure 2: PIMCO's active portfolio management includes comprehensive ESG analysis Source: PIMCO

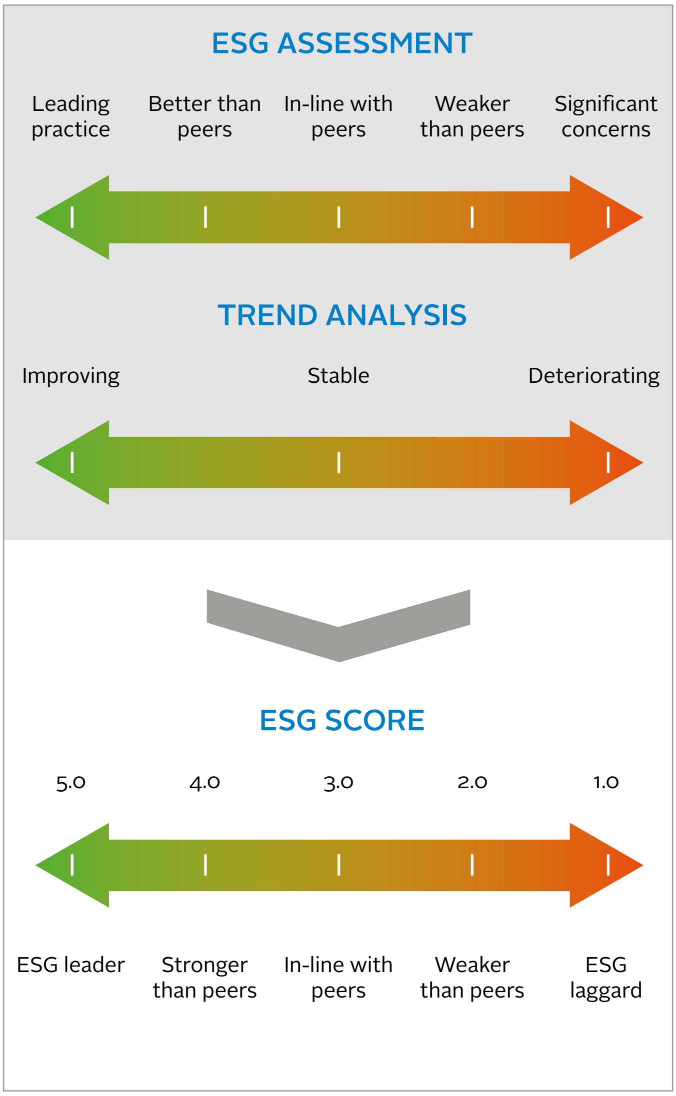
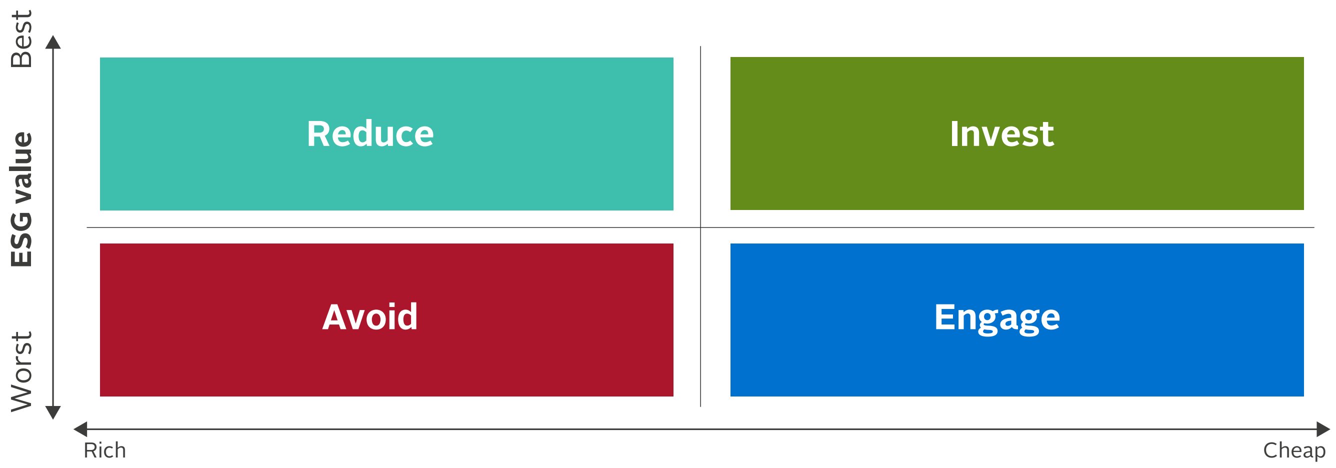


Figure 3 demonstrates how this works in practice with potential investments falling into four quadrants, each with an associated action. Our credit analysts focus particularly on engagement with companies that trade cheaply, but have weaker ESG profiles, to encourage behaviour designed to improve credit risk metrics.

Figure 3: ESG relative valuation Source: PIMCO



For illustrative purposes only

ENGAGEMENT TO INFLUENCE POSITIVE IMPACT

For portfolios that have a specific ESG mandate, we have a dedicated engagement specialist who identifies and engages with issuers with the potential and willingness to improve performance and support positive social and environmental impact.

Figure 4: Principles guiding our engagement process. Source: PIMCO. (As of 31 August 2017)

Principle	THINK LIKE A TREASURER	ENGAGE AS A PARTNER	HOLD TO ACCOUNT AS A LENDER
Rationale	Identify issuers able to change and then develop a set of core engagement objectives.	Collaborate with issuers using a productive dialogue and agree on objectives.	Measure progress against a pre-defined benchmark. Agree on planned remedies if underperformance is material. Divest where necessary.
Action	The ESG engagement specialist works with the credit analysts to develop an engagement profile that reflects the sector-specific risks relevant to the issuer. We also review the company's disclosure on its management of E, S and G issues.	There is a specific engagement plan for each issuer in the ESG portfolios that may include in-person meetings with management, regular conference calls and questionnaires. Although we do not have access to some communication channels available to equity investors (for example proxy voting), the scale of our operations allows us many touch points with management. The fixed income universe also offers the opportunity to engage with issuers who may not be accessible to equity investors, such as private companies and occasionally sovereigns.	Information from our engagement process is reviewed and benchmarked to incorporate into our ESG assessments, often pushing an issuer's ESG score higher or lower. PIMCO's ESG assessments are proprietary and distinct from those provided by ESG rating providers.

We review issuers using three engagement pillars.

1. CORPORATE CULTURE AND CONDUCT

In the pharmaceutical industry, for example, we engage with issuers to learn more about their compensation framework, including whether there are risk-taking controls and culture (corporate principles and values) considerations in the performance assessment of sales representatives.

2. RISK MANAGEMENT

In the financial sector, our discussions with banks include a focus on product safety risk and consumer protection, while for pharmaceutical companies we address supply chain management and US drug pricing. We also identify sector-specific business ethics improvement tools. For banks, this includes a social contract/policy committing to treating customers fairly and ensuring products meet their needs. For drug companies, supplier audits are a key component of risk management, while leading practices include publishing a pricing transparency report. We benchmark sector performance and follow up to engage further with issuers that are lagging their peers.

3. POSITIVE IMPACT

The UN SDGs can provide a common language and reporting framework for investors and businesses to accelerate focus, accountability and impact. For example, the pharmaceutical and banking sectors are often called ‘enablers’ of the SDGs in terms of providing access to finance and healthcare. For others, SDG achievement is to mitigate medium or long-term risks, such as climate impact for power companies. PIMCO is actively engaging with issuers to encourage them to align business strategy and revenues to the SDGs.

Figure 5: The SDGs provide a framework for PIMCO to measure social & environmental impact. Source: PIMCO and UN

ENGAGEMENT IN PRACTICE

EUROPEAN UTILITIES

The first principle of our engagement is to identify issuers with the potential to improve performance. For the utilities sector, the objective of our engagement is to determine which companies are best managing regulatory and operational changes towards clean power. Companies that are slow to make this transition are likely to face higher compliance costs such as carbon taxation.

Our traditional credit analysis includes carbon risk factors like greenhouse gas intensity together with the power production mix, given its clear cost implications. We also look at issuers' dependence and exposure to regulation, including subsidy regimes.

Engagement enables us to go further and evaluate the company's carbon strategy. Meeting the two degree target requires many new policies and regulations and the utility sector, in Europe in particular, is likely to suffer because of future restrictions on high-carbon industries. An important focus of our discussions is to understand firms' planning around two degree policies and assessment of stranded asset risk in their planning assumptions. We have made investment decisions based on this analysis, overweighting credits that we believe are more advanced in the low-carbon transition.

As a credit investor, PIMCO is also interested in plans to issue purpose bonds (green, SDG, social). Utility companies offer scale and existing internal capabilities for green projects.

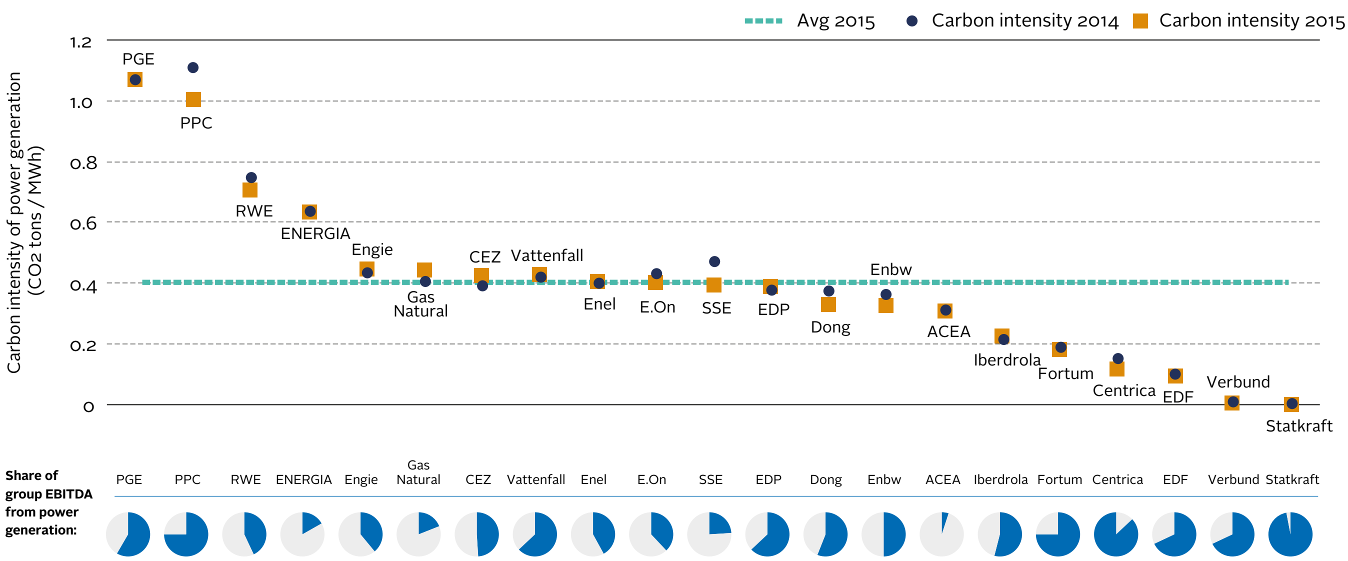
GLOBAL BANK ISSUERS

Analysis of ESG factors is particularly important in the banking sector because the confidence of a bank's depositors and borrowers largely drives its valuation.

As PIMCO considers investments in individual banks, we seek to assess if they effectively manage their organisational culture and conduct, including people and product controls – with the latter ranging from product suitability to the integration of ESG factors into their underwriting. We take governance seriously, so we engage actively to better understand each bank's risk appetite and how management and the board are proactively ensuring regulatory compliance.

For example, we recently engaged with a co-operative bank that we viewed as potentially higher risk because, as a non-listed mutual group, it is not subject to the corporate governance code of its home market. However, we found that the bank has fully committed to complying with best practice. Through these discussions, we established that it has a robust product safety review process, while consumer sales staff do not have aggressive sales targets and their performance assessments include customer satisfaction and good customer outcomes.

Figure 6: Carbon intensity of European utilities. Source: Corporate Reports, PIMCO. As of 31 May 2017



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A further important objective of our engagement is to promote the value of allocating capital towards products and services that contribute to sustainable development. The SDGs can help underpin banks' social value and we think that those that use these global goals to adjust their strategies will have a competitive advantage over those that don't.

Through engagement, PIMCO encourages banks to map their lending activity to the SDGs. For example, one European bank tracks the percentage of corporate loans to firms that have made a particular contribution to the SDGs and has a goal to maintain this key performance indicator at 15 percent for the next three years. This mapping of revenues to the SDGs is currently the exception rather than the rule, but PIMCO has wide influence via multiple interactions and touchpoints across these organisations including investor relations, CFOs, treasurers, and sustainability and origination desks. As a result of this activity, we are currently working with seven leading banks that are among the first to use the SDGs to back both existing and new investments, including issuing impact bonds.