PIMCO – ESG for Commercial Banks

Think like a treasurer, engage like a partner, hold to account as a lender

PIMCO's sustainability/ESG framework

PIMCO has incorporated sustainability factors into its investment process for decades. The process emphasizes rigorous analysis of broad secular trends that are at the core of both global sustainability and long-term asset returns. In recent years, PIMCO has developed a platform that supports Environmental, Social and Governance (ESG)-focused investment solutions and has enhanced its credit research process to incorporate a robust ESG assessment for corporate and sovereign credit issuers that complements the traditional ratings assigned by credit analysts.

At PIMCO, we are in the business of delivering risk-adjusted returns for our clients in a manner that is sustainable over the long term. That means making sure that the investments we make on their behalf represent business models that are competitive not only today, but also well into the future. Our credit research analysts complement traditional analysis of companies' financial statements with careful consideration of intangibles and secular ESG trends that can have a profound impact on companies' financial condition if they materialize.

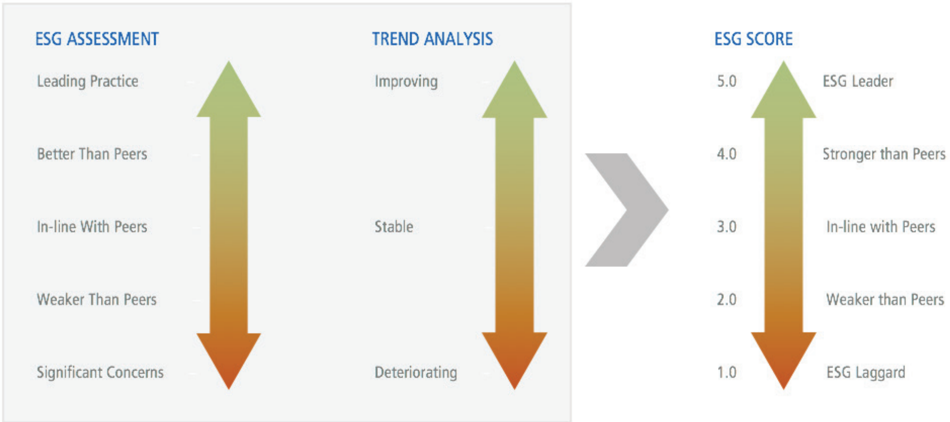
PIMCO is committed to being the world's premier fixed income investment manager. With our launch in 1971 in Newport Beach, California, PIMCO introduced investors to a total return approach to fixed income investing. In the 45+ years since, we have continued to bring innovation and expertise to our partnership with clients seeking the best investment solutions. Today we have offices across the globe and 2,100+ professionals united by a single goal: creating opportunities for investors in every environment.

Overview of PIMCO's ESG assessment

Overall process

PIMCO's 50+ credit research analysts assess the ESG profile of the issuers that they cover relative to peers with a goal of separating leaders from laggards. Using industry-specific ESG frameworks similar to the Sustainability Accounting Standards Board (SASB) materiality map, PIMCO analysts review their companies' ESG performance based on

Figure 1: PIMCO ESG Scoring System



information available in public filings, recent ESG news and controversies, as well as through regular engagement with company management teams to assign separate scores for Environment, Social and Governance. PIMCO's resulting ESG assessments are proprietary and distinct from those provided by ESG rating providers, with scores distinguishing between issuers with Leading Practice ESG practices to those that raise Significant Concerns (see Figure 1). Credit analysts also provide a forward-looking assessment of the ESG Trend for each issuer to recognize companies whose ESG performance is significantly improving or deteriorating. These factors are combined to create a granular PIMCO ESG Score that adjusts the relative weighting of the E, S and G pillar views and trend assessments based on the company's business profile and differences in industry dynamics.

Engagement with issuers

PIMCO believes that bondholder engagement is critical to understanding the risk and reward profile of the issuer and ultimately making investment decisions. Engagement can be a critical factor in encouraging positive change. The objective of engagement at PIMCO is to influence change, improve returns and reduce risks for our clients. Given PIMCO's size and global presence, our analysts and portfolio managers spend a significant amount of time meeting with senior management of issuers, including over 1,000 calls and in-person meetings conducted in Q1 2017 alone. In addition to discussing financial matters, we also focus on strategic issues that relate to responsible business practices, such as how risk management and business strategy address climate change risks. We also encourage firms to move toward greater transparency for reporting and disclosure among industries, including by encouraging companies to provide full disclosures using SASB standards. Information gleaned throughout the engagement process is incorporated into our ESG assessments, often pushing an issuer's ESG score higher or lower.

For ESG-focused portfolios, we follow a proprietary engagement protocol which is driven by a dedicated specialist working in concert with our broader ESG and portfolio teams. This protocol is guided by the following principles:

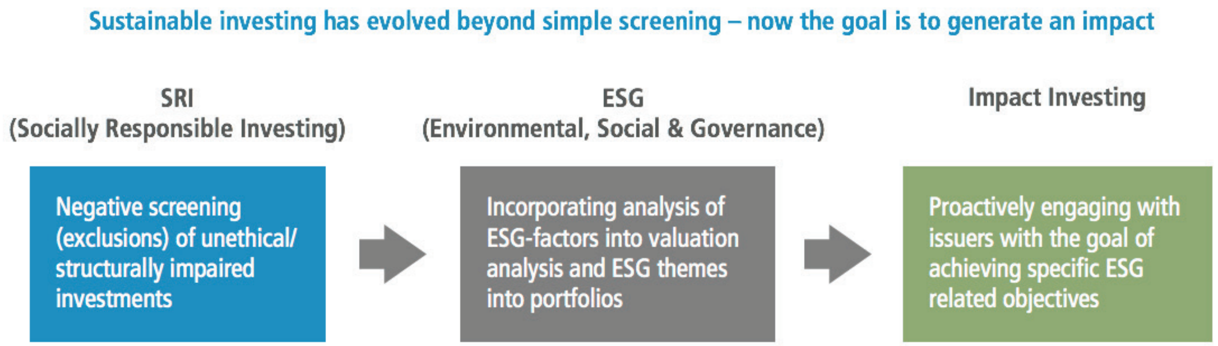
- Think like a treasurer: Identify issuers with capacity to change, then develop a set of core engagement objectives.
- Engage like a partner: Successful engagement is based on collaboration, a productive dialogue and mutual agreement on objectives.
- Hold to account as a lender: Measure progress against a pre-defined benchmark. Agree on planned remedies if underperformance is material. Divest where necessary.

PIMCO's engagement approach varies based on the specific engagement plan for each issuer and may include in-person meetings with company management, regular conference calls and questionnaires. Although we do not have access to the communication channels available to equity investors (e.g., proxy voting), given the scale of our fixed income operations and our touchpoints with company management we have found this method of dialogue to be highly effective. In addition, the fixed income universe offers the opportunity to engage with issuers who may not be accessible to equity investors, such as private companies and occasionally sovereigns.

Investing for impact

The engagement model is core to PIMCO's active management approach. We believe that an evolution is underway in which the passive screens traditionally used in Socially

Figure 2: Sustainable investing has evolved beyond simple screening – now the goal is to generate an impact

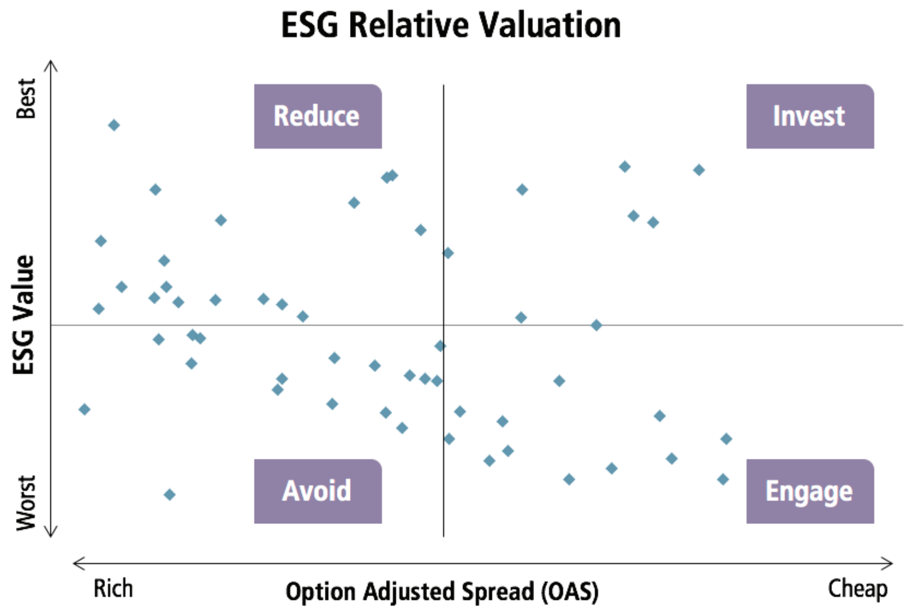


Responsible Investing (SRI) are no longer the only tools available for sustainability-minded investors. Dynamic analysis of material non-financial information in ESG investing enables PIMCO to evaluate corporate performance on ESG factors as part of our day-to-day credit analysis, and to incorporate ESG-related themes in our portfolios. The investment landscape is evolving even further via the ability to direct investments toward issuers through which measurable, beneficial social, or environmental impacts may be achieved – impact investing (see Figure 2). Our view is that credit investors can achieve an impact by proactively engaging with issuers to achieve specific, ESG-related objectives.

Integration into portfolio management

PIMCO credit analysts have assessed over 1,700 parent issuers on ESG performance to date. ESG assessments are highlighted in their credit research notes alongside our internal ratings and recommendations for portfolio managers to consider when they are evaluating investments for all PIMCO portfolios, including for non-ESG-dedicated accounts. Analysts' ESG views include narrative assessments and rationales for material factors that have the potential to impact investment performance. Over time, these assessments have been relevant in shaping the investments in our broader credit portfolios. For example, a generalist portfolio manager may decide to switch between two companies with similar fundamental risk profiles trading at comparable spread levels based on their relative ESG value. The illustration in Figure 3 below separates potential investments into four quadrants: Invest in issuers trading at attractive valuations and with strong ESG profiles; Engage with companies trading cheaply, but which have weaker ESG profiles; Reduce exposures to companies trading at unattractive valuations despite strong ESG profiles, and; Sell/Avoid companies with unattractive valuations and weak ESG profiles.

Figure 3: ESG relative valuation
Sample for illustrative purposes only



Case study of how PIMCO ESG research works in practice: ESG for commercial banks

The approach outlined above can be illustrated tangibly by focusing on how PIMCO looks at ESG for a specific industry: commercial banks. Analysis of ESG factors is particularly important for bank investments because the confidence of their depositors and borrowers significantly drives valuations. Public confidence in the banking system is crucial to the proper functioning of financial markets; likewise, the loss of public confidence in the banking system can severely damage overall economic growth.

The reputation of the banking industry has been tarnished in recent years by systematic failures of governance and breaches of public trust. However, we do not believe that these past transgressions should be overwhelming factors in the forward-looking ESG assessments of individual banks, particularly for banks that performed well through the crisis or banks that have wholly revamped their management teams and governance processes. We view the much stronger regulatory framework and elevated stature of risk management as significant credit positives, both in terms of the higher capital and liquidity balances now held by banks and in terms of lower earnings volatility. While many of the changes may have been mandated by regulators, leading banks have fully internalized the changes and have invested heavily in redefining their cultures and the conduct of their employees. As PIMCO considers investments in individual banks today, we seek to recognize banks that have made significant progress in improving their own cultures and conduct in addition to the more tangible improvements in risk management and financial product safety.

Material sustainability measures, including integration with SASB

PIMCO's ESG assessment for global banks incorporates many of the material sustainability topics and accounting metrics outlined in the provisional SASB Standards for Commercial Banks (see Figure 4). While our assessment of leadership and governance is paramount, we also carefully assess each bank's integration of ESG factors in its underwriting as well as the company's track record of regulatory compliance and litigation. Detailed stress test results provide a view of banks' internal risk management as well as the aggressiveness of company management in rewarding shareholders versus maintaining a conservative capital cushion in case of a downturn.

Figure 4: SASB Disclosure Topics for Commercial Banks

MATERIAL SUSTAINABILITY ISSUES

Social Capital
- Financial inclusion & Capacity Building
- Customer Privacy & Data Security

Business Model & Innovation
- Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis

Leadership & Governance
- Management of the Legal & Regulatory Environment
- Systemic Risk Management

Individual banks are assessed across 11 major factors ranging from Sustainable Lending Impact (which maps to 'Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis' within SASB standards) to Systemic Importance/Regulatory Environment (maps to 'Management of the Legal & Regulatory Environment' in SASB standards) and Customer Privacy & Data Security. The individual scores then roll up to PIMCO's overall ESG Score, which places greater weight on Governance (60%) and Social factors (25%) and de-emphasizes Environmental factors (15%) given that the material non-financial risks facing bank investors have been historically related to Governance and Social exposures.

Comparing global banks across material sustainability factors

Figure 5 shows a high-level summary of how PIMCO's ESG scores for major global banks across geographies. While there remains considerable variation at the individual bank level within each region, this heat map provides portfolio managers with immediate insights into the key ESG strengths and weaknesses of major banking systems. For example, the U.S. Federal Reserve System has created a strong, stable regulatory framework, and its Comprehensive Capital Analysis and Review (CCAR) stress-testing process enforces strong risk management and capital discipline by constraining payouts to shareholders that could lead to undercapitalization in the event of a severe macroeconomic shock. This supports our stronger view of risk management and accounting at U.S. banks; however, banks in the U.S. have yet to demonstrate lasting improvements in culture/business conduct, and many continue to lag European peers at integrating ESG in underwriting and product safety.

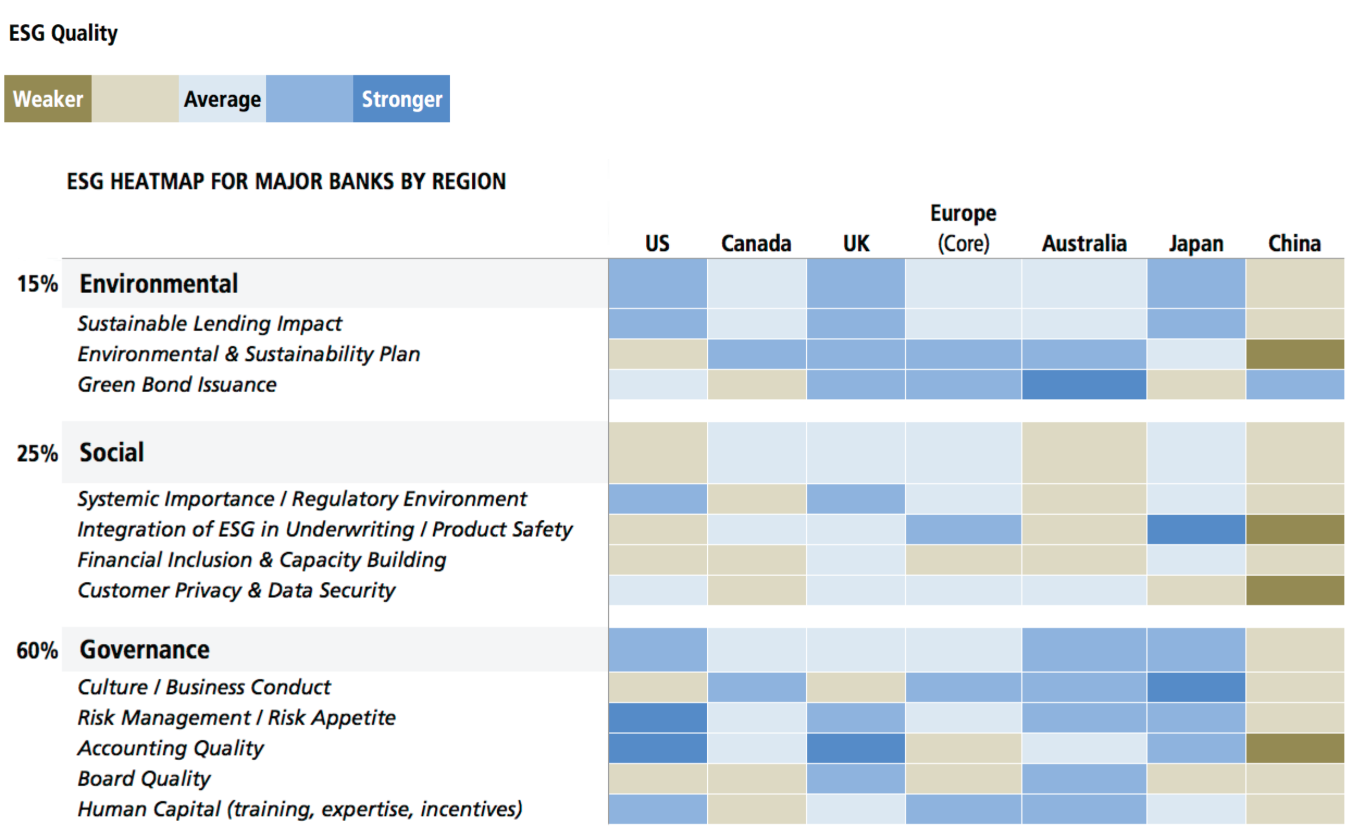
Overview of material ESG factors for global banks

Major factors that PIMCO tracks in ESG assessments are described below, many of which map directly to provisional SASB Standards for Commercial Banks. At present, few banks report according to the SASB Standards for Financial Inclusion & Capacity Building; however, we are encouraging banks to expand their disclosures.

Governance (60% of PIMCO ESG Score)

- Culture/business conduct represents a forward-looking view of the bank's internal business culture/ethical performance. Our assessment incorporates quantitative SASB measures such as the volume and severity of legal and regulatory settlements, though we recognize that these are often backward-looking metrics. Forward-looking inputs include our assessment of the company's reputation in the marketplace (e.g., do their bankers put client interests first?) and recent controversies (e.g., was senior management held accountable when customers were harmed?).
- Risk management represents our view of management's risk appetite as well as the company's capacity to manage those risks over the cycle. Our view incorporates the results of stress tests under adverse economic scenarios, one of the provisional SASB Standards for Commercial Banks. In addition, we consider how management balances short term ROE targets vs long-term solvency, how the company's loan portfolio and loss rates have performed over business cycles, M&A appetite and whether management has set and met achievable targets. We note that it is possible for leading banks to have an aggressive risk appetite as well as a strong risk management and culture.
- Accounting assesses whether the bank's disclosures are "credible," recognizing that accounting standards in some regions enable banks to delay recognition of bad debts for years or to systematically "optimize" risk-weighted assets to report higher capital ratios and/or enable higher payouts. We seek to avoid banks and banking systems that engage in such ploys, recognizing that many investors have been burned by simply trusting banks' published financial data. As a result, our assessments often vary as

Figure 5: ESG heat map for major banks by region



much by country as by company – e.g., peripheral European countries historically have had weaker accounting rankings than banks in the UK or U.S., where regulations are much more stringent and disclosures more robust and reliable.

- Board effectiveness represents our assessment of board leadership. Leading Practice banks have diverse boards with deep expertise in banking, risk & compliance and have a track record of replacing underperforming directors. Possible negatives include a combined CEO/Chair role, ongoing regulatory citations, and/or inconsistent strategic focus.
- Human capital is quite simply our assessment of the quality of the non-executive employee base. Does the company attract top candidates and provide them excellent training and advancement opportunities? We often do this using a simple thought experiment: Where would the bank rank for a top-tier graduate applying for a job, assuming that the candidate had received comparable offers from every bank? First-choice employers receive higher human capital scores; banks that attract employees with less sterling qualifications/reputations receive lower scores.

Social (25% of PIMCO ESG Score)

- Systemic importance includes elements of the Systemic Risk Management and Regulatory Environment disclosure topics in provisional SASB standards; however, PIMCO does not automatically presume that large, systemically important ("Too-Big-To-Fail") banks should be viewed negatively. In the post-crisis regulatory environment, the largest banks often offer the greatest protections to creditors due to tighter regulatory scrutiny and higher capital and liquidity standards. All else being equal, this means that bigger can be safer, even in the context of potential "bail-in" for creditors in a resolution. Systemic importance weighs on our ESG assessment only when the bank's business activities create negative social externalities, which we do not feel is still the case in the US and Europe.
- Financial inclusion/integration of ESG in underwriting assesses banks' commitment to providing financing to underserved market segments in a safe-and-sound manner (e.g., without exposing themselves to higher losses or potential regulatory fines). While prior infractions are considered, our rating is forward-looking and incorporates an assessment of both the scope of the lending commitment as well as the company's management of related risks. For banks with a focus on non-prime consumers, we look critically at the benefits that their products offer to customers rather than focusing only on the profitability to the bank. For example, a bank with a strong track record of providing home loans to immigrant communities at reasonable rates could score highly, while a bank offering high-fee, high-interest credit cards to low-FICO borrowers might score poorly. This strategy has allowed PIMCO to avoid payday credits that were later sanctioned by regulators or fined by the Consumer Financial Protection Bureau.
- Customer privacy & data security is at present a subjective measure given that few banks report the specific metrics recommended by the SASB (e.g., volume and impact of data security breaches). Until reporting becomes more ubiquitous, we reserve our highest scores for companies that have communicated strategic investments in data security and had no public data security breaches, while companies that have suffered such incidents score lower.

Environmental (15% of PIMCO ESG Score)

- Sustainable lending impact includes lending exposure to energy, oil & gas, basic materials and mining (SASB). PIMCO views "impact" here more broadly than simply the percentage of loans to industries with negative environmental impacts. We also look at underwriting trends, including whether the bank is reducing lending to the coal sector, expanding lending for renewables and whether the bank is involved in controversial projects.
- Environmental impact & sustainability plan includes a discussion of credit risk to the loan portfolio from climate change (SASB). Leading Practice banks have disclosed detailed sustainability targets and made public greenhouse gas reduction commitments. Extra credit is given for banks that have explicitly mapped their revenues to Sustainable Development Goals (SDGs).
- Green bond issuance gives credit to banks that have been active in issuing "green bonds" – instruments that fund projects with positive environmental benefits – either as a part of their own funding or on behalf of clients.

Conclusion

PIMCO incorporates ESG analysis throughout its investment process to ensure that all portfolios benefit from a detailed review of significant non-financial factors that have the potential to impact long-term credit performance. This analysis supports our favorable credit view for leading global commercial banks given the significant regulatory and risk management improvements that have been made since the crisis. Looking ahead, we will continue to engage with major banks to encourage ongoing improvements in their sustainability and social lending programs, and we will continue to encourage banks to improve the quality of their sustainability disclosures, in particular by disclosing the provisional SASB standards.