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**Due to its member-owned business structure, the Co-op operates its schemes differently to most, with a particular focus on sustainable investing. Jack Gray speaks to Co-op pensions investment and risk manager, James Giles, about the schemes' funding levels, environmental, social and governance investment goals, and de-risking strategies**

# Sustainably different

**Can you give a brief overview of the schemes that Co-op operates?**

The Co-op operates five defined benefit schemes, covering 52,000 pensioners and a further 55,000 members who are yet to retire. The largest of these schemes, Pace, has approximately £11 billion of assets and in 2018 was split into two sections, one sponsored by the Co-op Group, the other by the Co-operative Bank, following the recapitalisation of the bank in 2017. Pace itself was formed in 2006 when a number of pension schemes covering the Co-op's businesses merged – the oldest of these dates back to the 1920s.

Pace also has a growing DC section for ongoing accrual, which is used for auto-enrolment for both the Co-op and the Co-operative Bank, and which currently has 47,000 active members.

The four other DB schemes range from just over £100 million in size to over £1 billion and have been acquired as the Co-op has grown (including the Somerfield scheme, which the Co-op took on following the purchase of Somerfield in 2008).

Over recent years, the investment strategies for all the schemes have been de-risked and broadly aligned, with high levels of hedging against interest rate and inflation risks through LDI, and allocations to buy and maintain investment grade corporate bonds and secured finance alongside modest allocations to passive equity in some schemes. The Co-op section of Pace also has a specific allocation to long-term, inflation-linked property.

**Co-op's most recent financial report showed a £1.64 billion surplus in its pension schemes. How did the company achieve such a strong funding level?**

The 6 July 2019 interim accounts for the Co-op show a surplus on an accounting basis, and the aggregate position across the schemes is also strong on an ongoing funding basis (which is used to set contributions and assess the ongoing position of the schemes; as a result this basis is more of a focus of the trustees and the Co-op). This strong position is the result of a number of factors – the relatively high degrees of hedging in place, which have protected the schemes against much of the fall in interest rates over recent years, contributions from the sponsors and demographic changes.

**Co-op is structured differently than most companies and does not have shareholders. How does this affect the pension schemes?**

The Co-op is owned by its millions of members, rather than shareholders. This means it is able to take a longer-term view with no focus on shorter-term share price movements; being a member-owned organisation, with members having a say in how the Co-op is run, there's also an emphasis on doing the right thing for society and our planet, which has helped inform the pension schemes' responsible investment policies.

**Can you explain the Co-op pension schemes' policy to sustainable investment and what it has done as part of this strategy?**

Investing responsibly is a key aim of each of the schemes, the Co-op and the Co-operative Bank, and has been an area of engagement from members. Each set of trustees, as long-term investors, worked with the Co-op to develop a policy that reflects the belief that environmental, social and corporate governance factors are expected to have an impact on returns. For transparency we've tried to make our responsible investment policies easily accessible to members on the schemes' websites, along with reporting against how they have been implemented.

In setting the policies, we identified areas of focus aligned with co-operative values and where investment could have an impact – specifically the environment, controversial weapons, corporate governance and human rights. We then engaged with our investment managers to review how they incorporate sustainability when selecting investments, and how they engage with investee companies; on top of this, we apply a set of exclusions criteria for our segregated bond holdings to prevent investment in companies whose actions are inconsistent with our policies.

Earlier this year we reviewed our equity investments, which had been in passive market capitalisation weighted index funds. Aligned with our policies, we switched around £200 million across the DB schemes to L&G's Future World equity index funds, which explicitly consider environmental, social and corporate governance factors when determining how much to invest in different companies through 'tilts' to give greater weight to companies that score well against these criteria (and which exclude investment in companies that persistently fail to address climate change). We undertook a similar review for the DC scheme with the Co-op and the bank and in June, the trustee of Pace moved the default investment strategy to invest in the future world multi-asset fund as it believed that this was more consistent with the values of scheme members and the sponsors, and a more sustainable long-term investment.

Pace was also approached by one of our investment managers with an opportunity to invest in affordable housing through our inflation-linked property mandate – as this fitted well with the Co-op's values and was supported by a strong investment case, in November 2018 we announced a commitment of up to £50 million to affordable housing, which is funding developments at a number of sites across the UK.

**The Somerfield Scheme entered into a buy-in with PIC in January 2019. Can you describe the terms of the deal and the process?**

Given the steps taken to reduce investment risk in the Somerfield Scheme in particular over recent years, with a relatively low allocation to equities and high levels of interest rate and inflation hedging in place, the trustee and the Co-op recognised that longevity risk was the largest single residual risk the scheme was exposed to. Working together with advice from Aon, the scheme approached the market in mid-2018 to get quotes for a buy-in policy to cover the majority of pensions in payment at that point. Quotes received were narrowed down to a short-list of three, and following a due diligence process, Pension Insurance Corporation (PIC) was selected in November on the back of attractive pricing, its administrative track record and its strong reputation.

As part of the insurance contract we agreed the assets that would be transferred to PIC – a basket of gilts and cash – and in December 2018 we restructured the scheme's LDI portfolio to hold this 'price lock' portfolio, and at the same time rebalanced the remaining assets to ensure the desired levels of interest rate and inflation protection remained for the un-insured liabilities. As a result we were completely protected against any insurance price movements from this point while the contract was finalised and the assets were transferred, at which point PIC were 'on risk' for the insured pensions – this certainty over pricing was something that was particularly important to the trustee and the Co-op.

**Why did the scheme decide this (buy-in) was the best way to move forward?**

The buy-in allows the trustee and the Co-op to invest in a way that exactly matches the pension payments due to a large number of the scheme's pensioner members (and their spouses). This reduced the volatility of the funding position of the scheme further, reducing the risk to the Co-op of increasing contributions, and improving security for the scheme's members. The trustee considered other options to manage longevity risk, including longevity swaps, but chose a buy-in given the attractive pricing available, the hedging against interest rate and inflation risks that it also provided, and the less complex governance requirements of a bulk annuity. As the buy-in is in the name of the trustee, security is increased for all members of the scheme through the improved stability of the funding level, not just a sub-set of members.

**Written by Jack Gray**