DECEMBER 2020

GREEN GILTS
AN OVERVIEW

THE UK GOVERNMENT IS SET TO ISSUE GREEN BONDS IN 2021. THIS IS A WELCOME COMMITMENT AND COULD ENABLE PENSION SCHEMES TO ACHIEVE THEIR BROADER ENVIRONMENTAL OBJECTIVES WHILE INVESTING PRUDENTLY TO REACH THEIR FINANCIAL TARGETS.

The UK government has announced it will issue its first green gilt, also known as a green UK government bond, in 2021, subject to market conditions.[1] We expect issuance before the 2021 United Nations Climate Change Conference (also known as COP26) in November 2021.

Chancellor Rishi Sunak said the issue is planned as the first in a series of issuances as the government looks to "build out a 'green curve' over the coming years helping to fund projects to tackle climate change, finance much-needed infrastructure investment, and create green jobs across this country".[2]

Green bonds are debt instruments issued by an entity to achieve a positive environmental objective. Examples of the categories typically targeted by a green bond include renewable energy, green buildings, clean transportation, water management, biodiversity conservation, sustainable land use and climate change.

To date, European governments have led the way in sovereign green bond issuance, with recent examples including Germany and Sweden. A sharpened focus on environmental, social and governance (ESG) considerations within the investment community means the UK could potentially benefit from strong demand and augment its investor base by issuing green bonds.

WHAT ARE CURRENT GREEN BOND STANDARDS?

Current guidelines for issuers are voluntary. The most widely accepted are the International Capital Markets Association (ICMA) Green Bond Principles[3] and the EU Green Bond Standard[4].

Today, most issuers aim to align their green bonds with the ICMA principles. To be aligned with the ICMA Green Bond Principles, a typical green bond framework is expected to cover the following areas.

- **Use of proceeds:** How the proceeds are being used should be explicitly noted as part of legal documentation for the specific security. Financing should only be for projects aiming to achieve an environmental objective.
- **Selection and evaluation:** Issuers must set out their sustainability objectives, the process for determining eligible projects, the eligibility criteria covering any exclusions and the process for environmental and social risk due diligence.
- **Management of proceeds:** A separate account should be set up to monitor and track the net proceeds which have not been allocated.
- **Reporting:** An allocation and impact report should be made available to investors including appropriate key performance indicators (KPIs), both qualitative and quantitative, to demonstrate impact.
- **Verification:** It is recommended a second-party opinion be sought to verify alignment with the ICMA principles.

Adhering to the principles can help an issuer demonstrate accountability and transparency in achieving their environmental objectives. Without these requirements there would be difficulty in identifying whether an issue is truly 'green'. The principles have become the market standard for corporates and sovereigns issuing green bonds.

A key rationale for issuing any green bond is for an issuer to demonstrate how it will achieve a positive environmental effect. It is still early in the process, but we would expect the UK government to adhere to the ICMA Green Bond Principles at a minimum. By doing so, the additional reporting requirements and verification would serve to demonstrate how the UK government is achieving a positive impact, increasing overall transparency and disclosure to investors.

[1] https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services

[2] https://www.gov.uk/government/speeches/chancellor-statement-to-the-house-financial-services

[3] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/

[4] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-green-bond-standard_en

AN OPPORTUNITY FOR THE UK TO ADDRESS FUNDAMENTAL ENVIRONMENTAL ISSUES

The UK has set out an ambitious target to achieve net zero emissions by 2050, and significant investment will be required to transition towards achieving this goal. The government has provided some colour on this commitment through its 10-point plan (see Table 1) for a "green industrial revolution", which we anticipate would be the starting point for developing its green bond framework.

While climate change is expected to be at the heart of the UK government's green gilt framework, the government could extend the framework to include other categories, such as biodiversity conservation, waste management, or sustainable water and wastewater treatment, for example.

Table 1: The UK government's 10-point plan for a "green industrial revolution"[5]

Point	Potential green bond category	Example Key Performance Indicators
Advancing offshore wind	Renewable energy	Capacity generated in GWh
Growth of low carbon hydrogen	Renewable energy	Annual GHG emissions avoided in tCO_2e pa
Advanced nuclear power	(Typically excluded from green bond frameworks)	
Zero emissions vehicles	Clean transportation	Annual GHG emissions avoided in tCO_2e pa Number of clean vehicles deployed
Green public transport, cycling and walking	Clean transportation	Annual GHG emissions avoided in tCO_2e pa Estimated reduction in car use in km driven
Jet zero & green ships	Clean transportation	Annual GHG emissions avoided in tCO_2e pa
Green buildings	Green buildings	kWh/m^2 of gross building area (GBA) for energy use $kgCO_2/m^2$ of GBA for carbon reduction
Carbon capture, usage & storage	Climate mitigation	Amount of carbon dioxide captured in $MtCO_2e$
Protecting natural environment	Environmentally sustainable management of living natural resources and land use	Amount of landscape area maintained/safeguarded in km^2
Green finance and innovation	N/A	N/A

WHAT ARE OTHER SOVEREIGN ISSUERS DOING?

With several inaugural issuances coming from European sovereigns over recent years, and Germany in 2020, Europe has certainly shown leadership when it comes to green bond issuance. While green bonds can cover a whole host of environmental objectives, we have seen that European sovereign issuance have primarily targeted climate change-related categories. Table 2 summarises European sovereign green bond issuance to date.

Table 2: European governments have already issued green bonds – some examples[6]

Country	Maturity (years)	Final Maturity Date	Issuance Size	Example green projects
France	22	25/06/2039	€27.4bn	Energy efficiency of buildings, transport solutions, smart grids
Germany	10	15/08/2030	€6.5bn	Bicycle infrastructure, electric mobility, research on renewable energy research and biodiversity, forest protection
Netherlands	20	15/01/2040	€9.0bn	Development of renewable energy capacity, energy efficiency of buildings, upgrading railway infrastructure and bicycling parking, reinforcing flood defences
Ireland	12	18/03/2031	€6.1bn	Clean water and wastewater treatment, low emission vehicle incentives & infrastructure, afforestation programmes, R&D of renewable energy technologies, flood relief

[5] https://www.gov.uk/government/publications/the-ten-point-plan-for-a-green-industrial-revolution

[6] Source: Bloomberg and Insight Investment. As at 30 November 2020.

SHOULD PENSION SCHEMES INVEST IN GREEN GILTS?

The spotlight on ESG considerations has continued to grow over time. Since October 2019 UK pension scheme trustees have been explicitly required to demonstrate how they consider ESG factors, including climate change, as part of their investment decisions.

Most UK pension schemes use liability-driven investment (LDI) strategies, and so far the integration of ESG factors in LDI has been concentrated on counterparty credit risk assessments and engagement. At Insight, our engagement has also been directed toward regulators, governments and other relevant public bodies to ensure upcoming changes do not inadvertently harm our clients or damage the feasibility of leveraged risk-management portfolios. Examples include our engagement on RPI reform, the transition from LIBOR, and central clearing requirements.

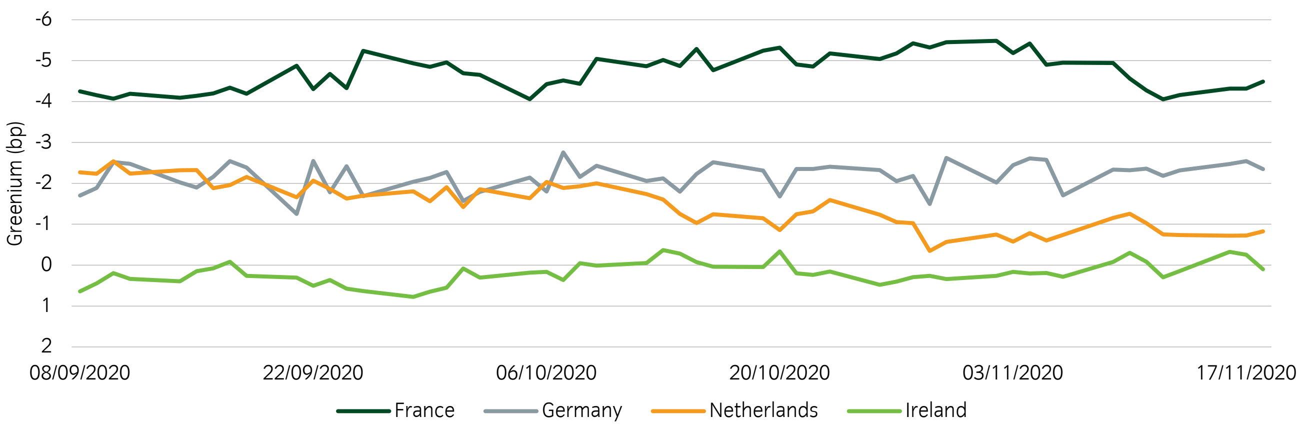
The key question for pension scheme trustees is whether investing in a green gilt falls within the remit of their fiduciary duty. Green gilts offer pension scheme trustees the ability to align their LDI portfolios with their broader environmental objectives, such as mitigating the risks of climate change. However, there are some important things to consider in the face of an upcoming green gilt.

Pricing

Green bonds rank pari passu with bonds of the same rank and rating and do not have any credit enhancements to explain any pricing differences. The expectation is that green gilts would follow a similar approach and be fungible with non-green gilts.

There have been suggestions in the market that there is a 'greenium' associated with green bonds, implying that green bonds have a lower yield than other equivalent bonds. Our analysis of European sovereign green bond issuance so far suggests there has been a 1bp to 2bp premium when compared to non-green bonds of a similar maturity (see Figure 1).

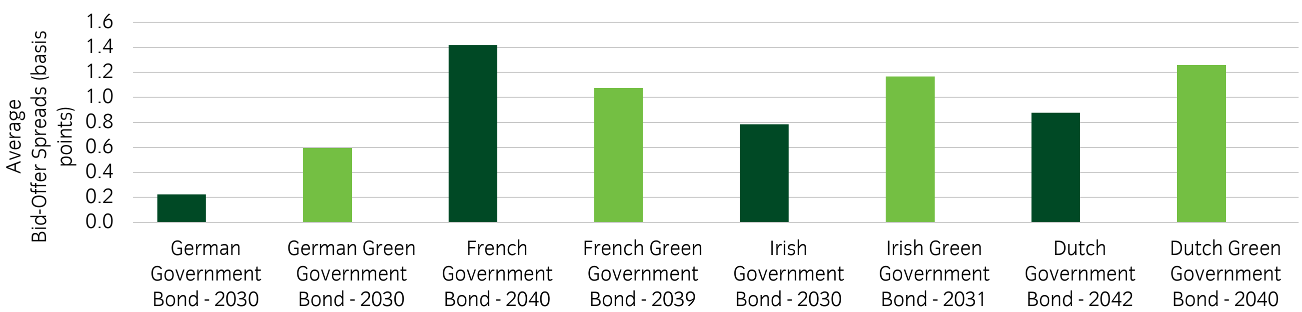
Figure 1: Most European green government bonds have exhibited a small premium – or 'greenium' – in recent months[7]



Liquidity

It is extremely important for green bonds to follow similar liquidity patterns to non-green bonds to ensure investors are able to switch in or out without attracting significant costs. For the majority of European green sovereign issuance, the average green bond bid-offer spread has been marginally higher than the non-green bond bid-offer spread (see Figure 2, overleaf). The difference between the two is small enough to suggest that the liquidity of green bonds is close to that of non-green bonds.

Figure 2: Average bid-offer spreads (in yield terms) – green versus non-green sovereign debt[8]



[7] Source: Bloomberg. As at 18 November 2020. For illustrative purposes only. Greenium is calculated by subtracting the spread on a conventional government bond from an equivalent green government bond of similar maturity.

[8] Source: Bloomberg and Insight Investment. As at 8 December 2020.

What does this mean for fiduciary responsibility?

The analysis above leads us back to the question of whether pension scheme trustees should invest in green gilts, if the pricing were to follow the same pattern as European sovereign green issuance. The argument against doing so is that pension scheme trustees' fiduciary duty is to ensure they are achieving strong risk adjusted returns in order to meet member benefit payments. The 'greenium', a green bond premium over equivalent non-green bonds, means that green issuance is generally slightly more expensive while the credit risk remains the same.

However, while green gilts might trade at a premium relative to other equivalent bonds when they are issued, there is nothing to suggest that green gilts cannot become even more expensive as demand for green gilts increases, representing a good investment opportunity for pension schemes. Furthermore, as part of trustees' fiduciary duty, they are required to explicitly consider and manage ESG risks, including climate change. The UK government has already suggested that the rationale for issuing green gilts is linked with supporting the UK with transitioning to a low carbon economy. This means there is a potential argument for pension schemes to invest in green gilts as a way of demonstrating the management and mitigation of climate risks through the projects that are being financed.

SHOULD IT END THERE?

The UK government could consider issuing other forms of sustainable debt to help with achieving other important objectives.

- **Social gilts:** We have seen the European Union issue SURE (Support to mitigate Unemployment Risks in an Emergency) social bonds to provide financial assistance for member countries to retain employment and to provide support for health-related measures for workplaces during situations like the pandemic.

  At a time when the UK government has been spending unprecedented amounts to ensure companies can continue operating, individuals remain in employment, and to support the healthcare system, it is perhaps timely to consider this type of issuance alongside green gilts.

- **Sustainability-linked gilts:** A new development within the corporate bond market, sustainability-linked bonds are debt issuance for which the financial or structural characteristics change depending on whether the issuer achieves specified sustainability targets. These have shown the potential for issuers to demonstrate their broader sustainability strategy is aligned with their funding strategy.

  No government has yet issued a sustainability-linked bond. It would help the UK government demonstrate its accountability by aligning sustainability KPIs with the structure and payments of a gilt.

CONCLUSION: A WELCOME DEVELOPMENT

The UK government's announcement is very welcome and a positive commitment, which brings the UK in line with other nations leading the fight against climate change. With a huge buyer base of defined benefit pension schemes requiring assets that match their liability profiles, green gilts would provide pension scheme trustees with an excellent opportunity to fulfil their broader financial commitments and, at the same time, manage the environmental risks associated with their portfolios while helping support the UK in transitioning to a low-carbon economy.

We are not yet clear on the size, maturity or projects the green gilt is expected to finance. However, the 10-point plan set out by the government indicates the potential scale of the areas of focus. This is the beginning of a series of green gilt issuance, we hope to see the programme develop materially to deliver on these and other ESG objectives.

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