XPS Investment

First green gilt issued. What does this mean for pension schemes?

In brief

- The Debt Management Office has issued a 12 year green gilt. This is the start of a planned issuance of more in the future
- Green gilts are expected to feature in a range of conventional gilt indices and are likely to be widely used alongside conventional gilts
- The use of green gilts will depend on a scheme's ESG strategy and whether they are more or less expensive than conventional gilts

On 21 September, the UK Debt Management Office ('DMO'), on behalf of the UK Government, issued its first green gilt to investors. The gilt, which has a maturity date of 31 July 2033, is the first of two green gilt issuances planned for financial year 2021/22 by the Government, totaling a minimum of £15bn of green gilts being issued.

In this short update, XPS explore the features of green gilts and look at whether they might have a role within your pension scheme's investment portfolio.

What is a green gilt?

A green gilt is a bond issued by the UK Government to finance projects that have clearly defined environmental benefits.

The money raised from these gilts will, therefore, be used to drive the UK's transition towards a greener economy and help the country meet the various environmental objectives it has, such as achieving net zero carbon emissions by 2050.

The UK government is adhering to the International Capital Market Association ('ICMA') Green Bond Principles with its issuance of these bonds. This is a voluntary framework for issuers to follow when issuing green bonds and promotes transparency and disclosure to reduce the risk of 'green washing'.

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What specific activities will be targeted with the proceeds?

The Government has set out 6 categories that will be financed by these gilts. Each category is also mapped to appropriate UN Sustainable Development Goals (SDGs).

	Category	Subcategories	Example expenditures	UN Sustainable Development Goals mapping
1.	**Clean Transportation**	› Low and zero emission mobility, including vehicles, incentives, infrastructure and alternative fuels › Research and development for low and zero emission transportation technologies	Zero emission buses	› Sustainable cities and communities
2.	**Renewable Energy**	› Support development of renewable energy generation capacity such as wind, solar and hydrogen › Schemes for renewable heat use, including heat networks, heat pumps and hydrogen heating › Support for energy storage systems, such as batteries, compressed air/liquid air, and gravitational storage › Research and development for the commercial viability of renewable energy technologies	The Renewable Heat Incentive Scheme The Net Zero Innovation Portfolio	› Affordable and clean energy
3.	**Energy Efficiency**	› Support schemes for energy efficiency programmes for the commercial, public and industrial sectors › Support schemes for residential energy efficiency programmes (including heating, retrofit and insulation) › Research and development for new energy efficiency technologies	The Public Sector Decarbonisation Scheme	› Affordable and clean energy › Industry, innovation and infrastructure
4.	**Pollution Prevention and Control**	› Reduction of air emissions and greenhouse gas control › Waste prevention, waste reduction, waste recycling and energy/emission-efficient waste to energy	Carbon Capture, Usage and Storage (CCUS) Infrastructure	› Responsible consumption and production
5.	**Living and Natural Resources**	› Protection and enhancement of terrestrial and marine biodiversity, ecosystems and natural capital › Sustainable land use and protection, including environmentally sustainable agriculture › Environmentally sustainable clean water, water storage and wastewater management initiatives › Funding for environmental activities of public sector arms-length bodies	The Nature for Climate Fund The Future Farming and Countryside Programme	› Zero hunger › Clean water and sanitation › Life below water › Life on land
6.	**Climate Change Adaptation**	› Flood protection, resilience and other risk mitigation programmes › Data driven climate monitoring solutions › Engineering activities and technical consultancy dedicated to adaptation to climate change	The flood defence programme	› Climate action

The Government has also detailed a list of activities that cannot be funded through these proceeds, recognising that many sustainable investors have exclusionary criteria in place around the majority, if not all, of these activities. The activities that cannot be funded include (amongst others) weapons, tobacco, vehicles powered through fossil-fuel combustion and ethanol.

Green gilt characteristics

These instruments are, at their core, simply government-backed bonds and therefore will have very similar characteristics and trade in a very similar way to conventional gilts where the proceeds are used for everyday government spending.

Whilst green gilts are similar to conventional gilts, they are not identical and, as this is a first for the UK government, the dynamics of the new market are not yet known. However, we benefit from having been able to observe how green bonds issued by other countries have differed to comparable conventional bonds. These examples include various European countries who have issued them to date, including France, Germany and Ireland.

Risk

Both types of gilts are exposed to the same default from a fundamental credit perspective as they are ultimately backed by the UK Government and have the same rank and rating.

Pricing

Although both types of bonds have the same risk, green government bonds have historically traded at a different price than equivalent non-green government bonds. This may be a premium or a discount. Where premium has existed this has been attributed to the high demand for green issues from investors and is widely referred to as a 'greenium'.

Index inclusion

Green gilts will be included in the standard gilt indices, so passive investments are likely to gain exposure through their index tracking approach.

Liquidity

The liquidity of green gilts is unlikely to be materially different to non-green gilts given their appeal, however, trading costs have been marginally higher for green bonds in European countries.

Market technicals

Although price moves are likely to be highly correlated with conventional gilts, different supply and demand realities for each type of gilt mean that prices will move differently to some extent. The potential for pricing to vary from conventional gilts also creates scope for mismatch with liabilities discounted on gilt yields, although this is likely to be modest.

Market depth

Although the intention of the Government is to build out a portfolio of green gilts over time, only one maturity of green gilt currently exists. The green gilt market will lack significant depth relative to the conventional gilt market in terms of both size and different maturity bonds available for some time.

ESG/sustainable objectives

To date, UK pension schemes have been largely restricted in their ability to reflect their responsible investment views within their gilt matching assets. Green gilts, however, give investors a great way to pursue their broader commitments and reflect their sustainable views, to ultimately have a beneficial impact on society.

Price appreciation

There's a belief with green gilts that, because of the expected continued growth in demand for these assets, demand will outstrip supply and the price could appreciate. This scenario is plausible but is not guaranteed. If the price does appreciate relative to conventional gilts the relative benefit to an investor will be temporary unless the gilt is sold at a profit long before maturity. This is because the higher price will be gradually offset through time by the lower yield over the remaining lifetime of the gilt.

Index-linked green gilts

It's not currently known whether the Government will issue index-linked green gilts in the future.

It is important to keep in mind that the green gilt market is a new and immature UK market so any characteristics initially observed may develop and change over time.

Do green gilts have a place in a pension scheme's portfolio?

Conventional fixed gilts are used within a pension scheme's portfolio for a variety of reasons. The most prominent are as matching assets for a scheme's interest rate exposure or as a source of liquidity.

Our understanding is that index providers and asset managers are likely to treat green gilts more or less like conventional gilts. Therefore, schemes that currently invest in pooled and segregated funds with the remit to hold conventional gilts may well obtain exposure naturally through decisions of their fund manager.

The size of the green gilts market is expected to fill out materially over the next few years and products and strategies may develop for schemes to obtain their exposure solely through green gilts, but this is some way off.

There are many facets to a scheme's Environment, Social, and Governance (ESG) strategy, but at its heart, value to the investor needs to be a key consideration. Therefore the pricing and trading characteristics of green gilts, which will be observable once the initial syndication has passed and the market has settled down, will be an important factor in any future decision to make a specific allocation to green gilts.

Conclusion

The issuance of the first UK green gilt is good news for pension schemes and the gilt market.

It provides a means for investors to begin to express their ESG views in an area that was previously not possible and increases investor choice.

However, any explicit target allocation as part of a Liability Driven Investment (LDI) strategy needs to be carefully considered, given the importance of focusing on value for money within the deployment of your ESG strategy.

For further information, please get in touch with Simeon Willis or Steven Hickey.

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