Summary

- The announcement on green sovereign bonds reflects a broader trend around responsible investment, with pressures mounting from both the pandemic and COP26.
- There are still logistical concerns that the government must overcome, although if done right there could be room for future developments.
- The sovereign green bonds could have more of an impact as a catalyst, pushing the UK government into an environmental leadership role.

Kickstarting a green recovery

Sophie Smith examines the government's plan for green sovereign bonds, the challenges and benefits they could bring, and what they could mean for pension schemes and the wider economy

In November 2020, Chancellor Rishi Sunak provided a financial services update, which aimed to place the UK at the forefront of green finance. This included plans for the first Sovereign Green Bond, expected to be issued in 2021. The gilts aim to help the UK meet its 2050 net-zero target and other environmental objectives, but what could they mean for the pensions industry, and for broader environmental, social and governance (ESG) trends?

"It's great news," says Aegon investment solutions managing director, Tim Orton, "the introduction of green gilts by the UK government marks a significant moment and adds to the growing range of ESG investments on offer". Orton explains that, although equity-based ESG investments dominate at present, the value of sterling-denominated green bonds is very small, whereas the euro and US dollar denominated markets are somewhat bigger. "Green gilts will therefore significantly increase the market for those looking to fund sterling-denominated projects and help allow more holistic exposure to responsible investing across asset classes," he explains.

They also provide capital for large projects that help to cut carbon emissions, with the added incentive of government backing, points out Interactive Investor head of pensions and savings, Rebecca O'Connor. She explains that green infrastructure, once constructed, tends to generate reliable, long-term revenue that usually matches the aims of pension schemes. Furthermore, she notes that whilst the early stages of new development can be risky, with the risk of delay or cost over-runs, sovereign bonds issued by the government help shelter pension scheme investors from some of this risk, making earlier stage investment more attractive.

Adding to this, Sackers partner, Stuart O'Brien, stresses that, as with all investments, trustees will have to make their investment decisions by putting financially material matters first and cannot act altruistically.

"Benefits to wider society may frequently be compatible with positive financial attributes to the pension scheme but this can't just be assumed," he adds, warning however that it would be problematic if trustees are asked to pay a premium to fund the government's green activities (or cover the additional costs of monitoring and reporting) in relation to instruments that fundamentally offer no better credit rating or default risk. Indeed, Cambridge Threadneedle responsible investment portfolio management director, Simon Bond, acknowledges that pension schemes must also consider the financial returns, stressing however that there will be little difference from other sovereign bonds from a risk or yield perspective. "A gilt is a gilt is a gilt whether its green or not when it comes to credit," he emphasises, explaining that the main difference is the use of proceeds, which can have wider environmental benefits.

Remembering the S&G

It is not only environmental benefits that the gilts could bring however, as Bond emphasises that the proposals will also bring social benefits, with Sunak's update highlighting the creation of green jobs as one key example. Echoing this, O'Connor says that the gilts could help kickstart the building of expensive but necessary infrastructure that can struggle to get off the ground without government backing, giving the UK economy a much-needed boost. Furthermore, Impact Investing Institute chief executive, Sarah Gordon, says that since the UK government's 10-point Green Recovery plan clearly sets out interlinked environmental and social goals, notably in creating green jobs, any green gilts issued by the government should provide explicitly for social co-benefits, in a format the Impact Investing Institute and Green Finance Institute have labelled Green+ Gilts. These proposals, which were presented to the government in the month prior to the Chancellor's announcement, have already received the public support of 40 asset owners and investors, representing organisations and assets under management of more than £10 trillion.

Agreeing, Bond highlights the gilts as a very appropriate instrument to support the government's 'build back better' initiative, stating that in the aftermath of the pandemic, there is no lack of projects that would benefit the environment and also benefit that green recovery. He clarifies, however, that the details as to what exactly the pre-defined projects will be are yet to be revealed.

Green enough?

Broader concerns as to how exactly the green in these green bonds is defined are emerging, as Orton warns that different investors have different criteria, which the government will need to consider when structuring the bonds, whilst Interactive Investor, head of funds, Dzmitry Lipski, emphasises that it is essential that the gilts meet ESG criteria wherever possible, to attract as many investors as possible.

Whilst Gordon agrees to an extent, she says that considerable progress has been made in the 14 years since the first green bond was issued, highlighting the extensive resources available to market actors, including the Green Bond Principles, Climate Bonds Initiative, and the Science Based Targets Initiative. Furthermore, Lipski says that the bonds are "nothing new", and that those already in issuance serve as a handy blueprint for the UK government when designing the bonds.

Getting the foundations in place

Other logistical barriers still remain however, as Lipski also highlights concerns around securing the development permissions and the developers – both resources and equipment – to deliver these largescale infrastructure projects in a timely manner. Adding to this, Bond points out further issues facing the government around reporting, emphasising that if the government is going to follow the International Capital Market Association (ICMA) green bond principles, this will require reporting on an annual basis of the disbursements and the impacts, using predefined statistics, which could present further challenges.

Trustees will also need to consider their own reporting requirements when exploring the potential of the green sovereign bonds, as O'Brien notes that the new Taskforce on Climate-related Financial Disclosures (TCFD) requirements will require trustees to conduct scenario analysis and measure certain emissions-based metrics. However, he warns that both of these are currently more challenging for sovereign debt than many other asset classes, and that standardisation of calculation of greenhouse gas emissions, in particular, is notably lacking at the moment. "Whether green sovereign bonds will be easier on that front remains to be seen," he adds, "although trustees will need to be careful not just to make allocations on the basis of improving metrics for metrics' sake without demonstrating the financial materiality of doing so to the pension scheme."

Sparking a shift

Bond highlights the framework for the gilts as another challenge, explaining however that once this framework is in place, it could make it easier to respond to future crises from within the framework. For instance, he says that if the government was to encompass social benefits as outlined in the Green + Gilts proposals, it could potentially issue social bonds of the back of that same framework should the need arise, as other agencies and international firms were able to do earlier this year amid the pandemic, with French Agency, UEDIC, issuing social bonds to pay for their furlough scheme earlier this year.

Adding to this, Gordon says that whilst at this stage the UK government has announced a green transaction, the unprecedented challenges of the past year have bought the social elements of the E, S and G into sharp focus, pointing out that bonds whose proceeds address social themes have been the fastest growing sector of the labelled bonds market. "Since the government's 10 point Green Recovery Plan clearly sets out interlinked environmental and social goals, notably in creating green jobs, it can be supposed that issuance with broader social themes is an option in the future," she says.

Furthermore, Bond says that it is hoped that the bonds will act as a catalyst, driving the government into a leadership position to illicit and encourage further issuance, such as from corporates and bank, as has already been seen in countries such as Germany and Sweden.

"That's what we see as the power of this, it's not just the amount the government borrows and spends, it encourages other borrowing and spending from more private courses", he adds. This is echoed by O'Connor, who warns that stronger targets and agreements on collective global climate change efforts at COP26 will help provide the impetus and framework for further green investment on a global scale, adding that there will be a greater sense of urgency to make up for lost progress.

Written by Sophie Smith