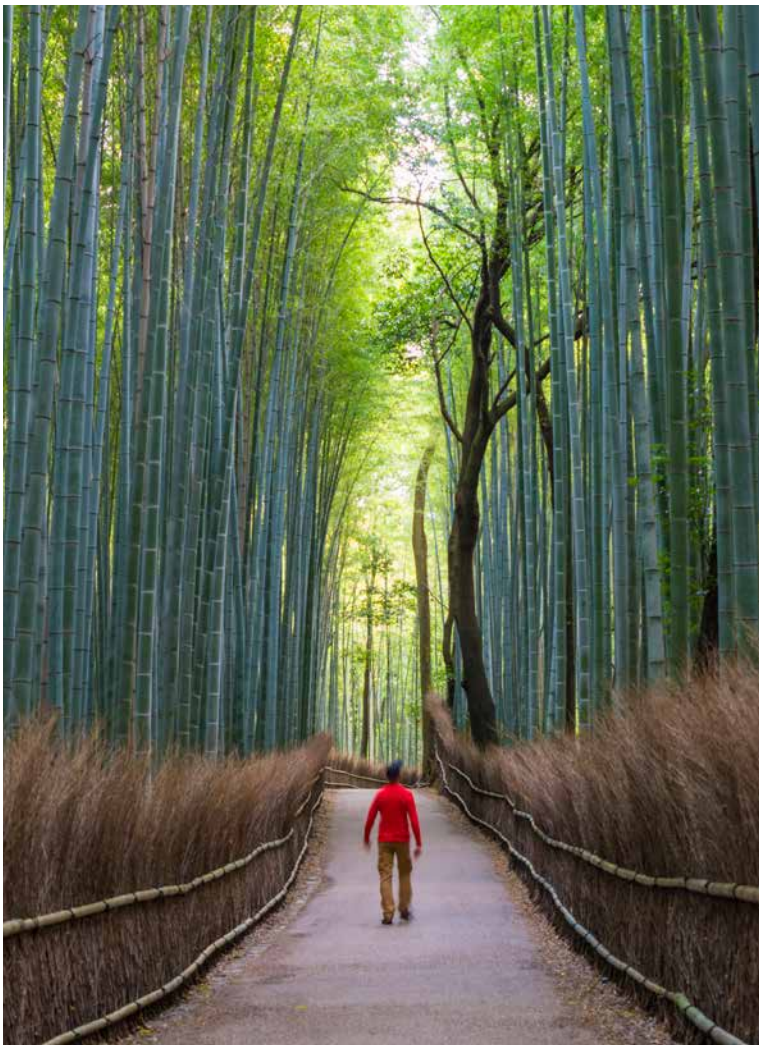
Green gilts

An update on our recent engagement activities and some key considerations for our clients.



Anne-Marie Morris
Senior Solutions Strategy Manager

Safwan Mir
Solutions Strategy Associate

Jonathan Lawrence
Responsible Investment Analyst - Active Strategies

When it comes to 'green gilts', we believe a balanced approach is necessary in order to understand how they could fit functionally into portfolios and where, as investors, we need additional comfort about the 'impact' and 'additionality' of the bonds.

In 2020, we published a short piece on green gilts, addressing some of the key considerations. A lot has changed since then, including the Chancellor putting theory into practice by announcing the issuance of the first ever sovereign green bond to inaugurate a domestic green gilt market. On 27 January 2021 the UK DMO, on behalf of HM Treasury, announced that HSBC and J.P Morgan have been appointed as structuring advisors for this first issue of a green gilt. Furthermore, the March Budget included plans to issue green gilts twice in 2021, with total green gilt issuance for the financial year to be at least £15 billion.

LGIM have been long-term advocates for integrating ESG into the investment process for our clients. We are strong supporters of fostering innovation towards green growth and helping our clients navigate this new market.

We continue to engage proactively with the UK Debt Management Office, the Treasury, HSBC and J.P. Morgan and with industry working parties to express our own views on how these gilts should be put to market, taking into account the considerations outlined above.

Over the next two pages, we highlight a few key areas of focused in engagement with stakeholders, through which we aim to align the issuance of green gilts with the needs of our clients.

Legal & General
INVESTMENT MANAGEMENT

1. Green Bonds: An ESG perspective

We believe it is important that our clients understand how the characteristics of these bonds differ from their non-green counterparts. Critically, we emphasise that the overall ESG risk exposure of the bond is the same when compared to the non-green counterpart – this is because the repayments of interest and principle are funded from the same balance sheet/ cashflows of the issuer. This therefore is relevant when considering the portfolio application with respect to pricing, liquidity and other instrument features. It is vital to analyse how the bond can improve the risk and return characteristics of the investor's portfolio.

It is equally important to understand whether these bonds generate 'ESG impact' for investors. One criticism in the market of these bonds has been the degree to which they generate 'additional' impact above and beyond the use-of-proceeds for a conventional bond. Accusations of greenwashing persist, and across sovereign and corporate issuers we have seen the full spectrum of quality and sophistication of sustainable bond frameworks. For example, some bonds have long 'lookback' periods, meaning green bond proceeds can be used to re-finance projects that have already been undertaken. Other bonds, have been issued without being tied explicitly to the overall strategic objectives of the issuer.

We have seen some significant benefits to investors in this market, including increased transparency and disclosure from issuers. This has also helped to foster more dialogue on ESG topics, something especially important given LGIM's approach to active engagement. However, this is particularly true where the additional disclosure relates to the strategy and targets embedded at the issuer level. For example, a sovereign green bond could be a useful tool to sign post progress towards meeting Nationally Determined Contributions (NDCs) or Net-Zero targets.

2. Use of proceeds: clearly defined and 'additional'

We believe that the use of proceeds should be clearly defined and relate demonstrably to the government's overall strategy to achieve its climate objectives. In our engagement with other investors, we have also agreed that it is critical to incorporate social considerations into the framework as part of the aspirations to achieve a 'just' transition.

Furthermore, whilst the green gilt framework should allow flexibility for different types of spending, to avoid risks of greenwashing, we believe the government should ensure that the use of proceeds relate to projects that bring new environmental or social benefits, and avoid the use of these instruments as simple re-financing tools. In practice, this means that the government will need to identify a large enough stock of projects to which to allocate proceeds. This has been one limitation of the use-of-proceeds market that has also led to the development of the sustainability linked bond market (which provides greater flexibility with respect to the use of proceeds).

3. Weighing up functionality without compromising on 'impact'

A contentious issue with any green bond is weighing up portfolio functionality against 'impact'. At LGIM we do not necessarily see the two as mutually exclusive concepts but the presence of a 'greenium', where green bonds have traded at more expensive levels than their non-green counterparts, has posed a conundrum for investors.

The 'greenium' has fluctuated over time and is a function of demand and supply technicals. In Europe, for example, the ECB bond buying programme (which includes green bonds) has had a significant effect on market pricing. Investors also need to consider how other policies and regulations may influence additional demand and supply drivers.

Currently it is unclear how this dynamic will play out in sterling markets – corporate green bonds are still a very small part of the overall market.

As stated above, the overall risk exposure remains the same despite the label, and therefore additional justification is necessary to qualify a 'greenium'. For example, issuance at a new tenor point on the curve may increase functionality by enabling a better liability hedging profile for our defined benefit clients.

4. Maturity: Align to strategic objectives

We have expressed a preference that the maturities of green gilts should be longer dated for two main reasons:

- First, we believe that issuing at longer-dated maturities could be a benefit to our investors, many of whom are defined benefit pension schemes. It would allow clients to continue to invest in a way that aims to meet their long-term liabilities and could increase their investment opportunity set.
- In addition, by issuing at such maturities, the proceeds would enable the financing of crucial longer term environmental and social projects with similar time horizons to the debt maturity. This could therefore be beneficial in terms of clarifying to investors how the projects relate to longer-term objectives of the government's green strategy.

Its worth noting that, from our discussions, we understand the UK is unlikely to follow the German approach of twinned maturity bonds (i.e. issue a green gilt at the same maturity of a 'non-green' conventional gilt). It has also been expressed that over time the DMO hopes to build out a green gilt curve, therefore ensuring green gilts are issued at multiple maturities.

The role of green gilts in LDI portfolios

Taking into account the considerations outlined above, we believe it's certainly possible that green gilts may play a role as part of an LDI strategy for different investors, whether segregated or bespoke, or pooled.

All else equal, we would therefore expect to be able to consider green gilts part of the universe of eligible instruments for our clients, including within our Matching Core and Matching Plus pooled fund ranges. From an investment perspective, we would look to treat green gilts in the same way as conventional gilts. For segregated and bespoke clients, this would include consideration of green gilts in the spheres of discretionary trades, rebalancing activity and active positions. Being able to choose between green or non-green gilts on a normal risk-return basis would also increase our opportunity set, without taking into account the "greenness" of the gilt. The same principle applies to our more dynamic strategies, such as the Matching Plus funds: pricing differentials between green and non-green gilts, could lead to positive trade opportunities.

If appropriate, and subject to sufficient supply, we could also be in a position to launch green-only fund ranges, covering both levered and unlevered solutions. Subject to legal reviews, the new funds would be added to the current fund range, allowing simple and easy access to our existing pooled and Enhanced Service Agreement clients.

Pension schemes with bespoke or segregated mandates seeking to prioritise the purchase of green gilts ahead of 'vanilla' gilt counterparts may wish to specify additional mandate objectives such as a minimum amount of green gilts to be held within their LDI portfolio, even if this does result in paying a slight premium.

Final thoughts

To conclude, LGIM will continue to be supportive of the government to catalyse a programme of green investment and help develop responsible investment initiatives to help meet the changing demands of our investor base.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

DB125822021