Investment Insight

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EDEN VALLEY, CUMBRIA

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What are Green Bonds? And how will the UK's first green gilts work?

Green Bonds present a compelling opportunity for pensions funds to invest with their ESG and responsible investment beliefs intact. But will they deliver the best risk-adjusted returns? Daniel Loughney and Mark Lyon consider the pros and cons.

To help the UK meet its 2050 net zero target and other environmental objectives, Chancellor Rishi Sunak recently announced plans to issue its first Sovereign Green Bond in 2021 – and intends to follow up with a series of further new securities being issued to meet growing investor demand for these instruments. The government is expected to issue £15bn of "green gilts" in 2021 and although this represents just 5% of expected government issuance, if successful, it could result in a deep and liquid market over the long term.

As part of the Government's bid for global leadership in green finance ahead of hosting COP26 in Glasgow in November, these bonds will help finance projects that will tackle climate change, finance infrastructure investment and create green jobs across the country.

The Chancellor also announced the introduction of more robust environmental disclosure standards so that investors and businesses can better understand the material financial impacts of their exposure to climate change, price climate-related risks more accurately, and support the greening of the UK economy.

The Chancellor's announcement coincided with the Government's ten-point plan for a Green Industrial Revolution (see table below) with the promise to mobilise £12 billion of investment, and potentially three times as much from the private sector, to turn the UK into a world centre for green technology and finance.

This is not a UK phenomenon. Green Bonds which have been rolled out in several European countries offer a compelling investment for investors with a clear commitment to responsible investment (RI) and environment, social and

UK Government's ten point plan for a green revolution

Action Point	Bond Category	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	Usually excluded from green frameworks	
Zero emissions vehicles	Clean transportation	Annual GHG emissions avoided in tCO^2e pa Number of clean vehicles deployed
Green public transport, cycling and	Clean transportation	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/m2 of GBA for energy use $kgCO^2$/m2 of GBA for carbon reduction
Carbon capture, usage & storage	Climate mitigation	Amount of C02 captured in MtCO2e
Protecting natural environment	Management of wildlife and land use	Landscape maintained/safeguarded in km2
Green finance and innovation	N/A	N/A

Green bonds and projects in Europe

Country	Maturity (years)	Final Maturity Date	Issuance Size	Example of 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

Governance (ESG) issues in particular. And the market is growing rapidly. The market capitalization of the ICE Bank of America Green Bond Index, a global index, is c. $750bn having been less than $130bn just five years ago. Moody's expects the global issuance of Green Bonds to increase by 39% to $375bn in 2021, equivalent to 5% of total global bond issuance. Sustainable bonds, a mix of Green Bonds and social and sustainability bonds, are expected to account for up to 10% of global issuance. This significant increase in issuance will be driven in part by EU issuance to fund the NextGenerationEU ("NGEU") budget to support a green recovery in the aftermath of the COVID-19 pandemic.

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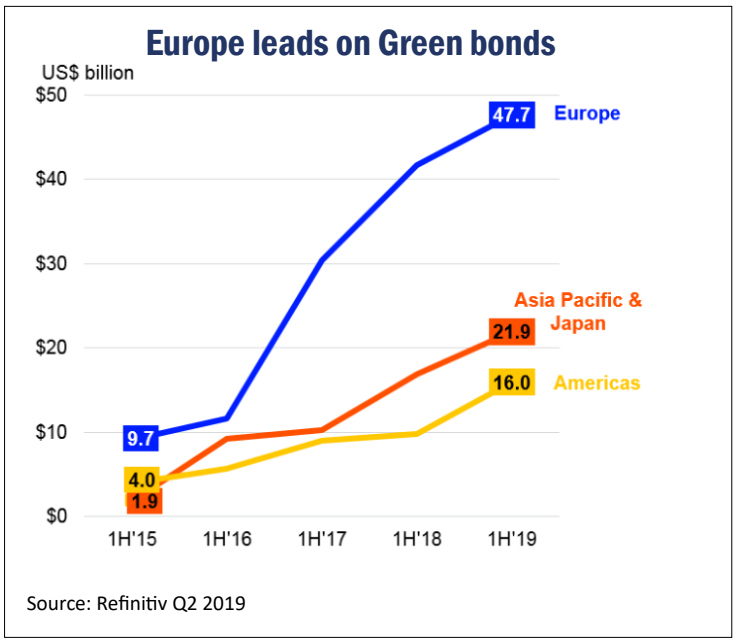
Investor demand for assets that have positive ESG credentials may result in lower funding costs for the UK government and green gilts will be integral to the Government's Green Industrial Revolution. Therefore, while climate change is expected to be at the heart of the Government's green gilt framework, the government could extend the framework to include categories, such as biodiversity, waste management, or green buildings.

For the determined responsible investor, it is crucial that the Bond issuers can demonstrate how they will achieve a measure and transparently report their positive environmental effect. Although current standards are voluntary, most issuers align their Green Bonds to the International Capital Markets Association's Green Bond Principles which recommend transparency, disclosure and promote integrity in the development of the Green Bond market but they are neither binding nor regulated.

For that reason, many commentators, Border to Coast included, believe it is important that an internationally recognised set of principles should be encouraged to enhance investor confidence. This will prevent opportunistic issuers from gaming the system while failing



to demonstrate the criteria for determining the projects to be funded are actually hitting ESG targets and how they are monitored, reported, verified and certified. No mean feat for an issuer.

To date there has been a modest premium (or greenium) for Green Bonds which suggests that investors do not necessarily have to sacrifice returns to achieve their green goals. Investment in Green Bonds could also enable pension funds to achieve their long-term carbon reduction goals (including "Net Zero" commitments) more easily than could be achieved in other asset classes.

However, there may be occasions where investor demand drives green bond prices to an unsustainable premium compared to their traditional equivalents. This would raise two important questions. Would an investor be prepared to accept a lower return in these circumstances? And how does a pension fund trustee reconcile their green credentials when a 'non-green' option offers the higher risk -adjusted return?

They might be reconciled by the prospect that liquidity in government bonds is comparable with the 'non-green' option, but this may not be the case for corporate bonds. However, Partner Funds should consider that Green Bonds will become a bigger part of the global debt universe over the long term driven by investor and political demand.

The success of green bonds in the UK will be determined by a deep and liquid market, risk-adjusted returns that are comparable with conventional bonds, suitable measurement and reporting standards, and investor confidence that their allocation decisions are having a positive ESG impact.

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Important information