



# The Green+ Gilt:

How the UK could issue sovereign bonds that deliver climate action and social renewal

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Grantham  
Research Institute  
on Climate Change  
and the Environment



Green Finance  
Institute



“As hosts of COP26, the world is looking to the UK as we continue to show leadership and ambition with regards to green finance. A Green+ Gilt, which so clearly aligns green investment with social and economic benefits throughout the UK, would provide such a globally important signal, whilst supporting the further development of a sterling green bond market here in the City of London.”

**William Russell, Lord Mayor of the City of London**

“The UK needs a strong and sustainable recovery from COVID-19. A Green+ Gilt is a key instrument that the Government should deploy to help channel savings into programmes and projects that enable us to build back greener in the places that need it most. It can signal the direction of future opportunities and reduce perceived risk. Now is the time to be ambitious. Green investment can have rapid impact and drive strong and sustainable growth.”

**Professor Lord Nicholas Stern, IG Patel Professor of Economics and Government, and Chair of the Grantham Research Institute, London School of Economics and Political Science**

“Acting on this proposal would show real UK leadership in green finance by bringing to market a green sovereign bond that has clear social impact characteristics. There is huge appetite for more sustainable finance investment opportunities. The UK must continue to develop its competitive edge in delivering financial solutions to some of the most pressing social and environmental challenges facing the world today.”

**Miles Celic, Chief Executive, CityUK**

“The proposed Green+ Gilt has the potential to be a world-leading sovereign instrument by closely aligning green and social objectives. It provides a mechanism for unlocking a wall of investment, across the UK, into building resilience and our net zero and sustainable future.”

**Emma Howard Boyd, Chair, Environment Agency**

“A Green+ Gilt that combines green investment with clear social and economic benefits will reinforce the UK’s reputation as a centre for financial innovation, while mobilising capital that will benefit both people and planet. As well as being a clear signal of commitment to building back better it will catalyse wider green+ bond issuance ahead of COP 26.”

**Dame Elizabeth Corley, Chair, Impact Investing Institute and Board Member, Green Finance Institute**

“AFME members would warmly welcome the innovative Green+ bond structure that combines Green and Socially Sustainable investment opportunities and supports inclusive growth.”

**Michael Cole-Fontayn, Chairman, Association for Financial Markets in Europe**

“Following the Covid-19 pandemic there is an urgent need to support both a green recovery and level up infrastructure spending across the country. We have seen robust commitment from the investor community to invest in bonds that directly address the impacts of the pandemic and support affected communities. We believe that both investors and the wider society would welcome, with open arms, a liquid green UK sovereign bond with clearly defined social benefits such as the proposed Green+ Gilt.”

**Simon Bond, Director of Responsible Investment Portfolio Management, Columbia Threadneedle Investments**

The UK has a proud tradition of leadership in climate action and global finance. The urgent need to rebuild the economy in response to the COVID-19 pandemic provides the government with an opportunity to issue a sovereign bond ('gilt') that supports both a green recovery and social renewal. This would have significant benefits both domestically and internationally, particularly in the run-up to the COP26 climate summit in November 2021.

The Green+ Gilt would build on the growing issuance of green and social sovereign bonds across the world. It would mark an important step forward in the development of the global green bond market by showing how the use of proceeds can simultaneously deliver environmental benefits, reduce inequality and help us build back better.

Based on investor feedback<sup>1</sup> and analysis of recent market precedents, this paper sets out how a Green+ Gilt could be structured as a cost-effective instrument, able to meet the government's goals of both "levelling up" regional inequalities and achieving net-zero without the need for hypothecation.

The UK's first green sovereign bond, issued at scale, would catalyse the development of the sterling green bond market, and would send a signal to global capital markets and policymakers of the UK's commitment to sustainable finance.

In sum, a Green+ Gilt could help to finance an ambitious COVID-19 recovery programme, and would deliver five main benefits:

- 1. Environmental:** tackle climate change by creating funding for projects that contribute to a resilient, net-zero economic recovery.
- 2. Social:** create 'green collar' jobs, build skills and channel investment across the country into areas of greatest need.
- 3. Fiscal:** provide the UK government with low-cost funding and offer a cost-neutral way of diversifying the gilt investor base.
- 4. Systemic:** showcase the UK financial system, catalyse further green and social bond issuance and facilitate the exporting of green finance and broader sustainability expertise.
- 5. Global:** demonstrate UK leadership ahead of COP26 and the G7 in 2021, stimulating international momentum as other countries issue similar types of sovereign bonds.

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<sup>1</sup> Investors comprising asset managers, asset owners and bank treasury investors with a total of £3 trillion of assets under management were canvassed in order to ascertain market appetite for and the preferred structural features of the proposed Green+ Gilt.

# The Green+ Gilt: channelling finance to a resilient, net-zero economy

The first dimension of the Green+ Gilt is to channel finance to deliver the government’s commitment to a resilient, net-zero economy.

Five priority categories have been identified which respond to UK national priorities and accord with previous corporate and sovereign green bond issuance. These are:

PRIORITY CATEGORIES	SUBCATEGORIES	SOCIAL IMPACT GENERATED*
<b>CLEAN INFRASTRUCTURE</b>	<p><b>Clean Energy:</b> renewable generation &amp; distribution</p> <p><b>Clean Transport:</b> rail, electric vehicle &amp; charging infrastructure</p> <p><b>Industrial Decarbonisation:</b> carbon capture &amp; storage, hydrogen networks</p>	<p>Employment generation</p> <p>Socioeconomic advancement</p> <p>Access to basic infrastructure (energy)</p> <p>Access to basic infrastructure (transport)</p>
<b>ENERGY EFFICIENCY &amp; GREEN BUILDINGS</b>	Building efficiency spending for renovations and retrofits including improved insulation, heating and domestic energy storage systems	<p>Employment generation</p> <p>Socioeconomic advancement</p>
<b>CLIMATE ADAPTATION &amp; NATURAL CAPITAL</b>	Investment for ecosystems resilience and regeneration, including flood defence mechanisms, restoration of carbon-rich habitats, climate-friendly agriculture and clean water	<p>Protecting local, vulnerable communities</p> <p>Employment generation</p> <p>Socioeconomic advancement</p>
<b>GREEN JOBS</b>	Investment in reskilling and education to address immediate unemployment from COVID-19 and structural shifts from decarbonisation	<p>Employment generation</p> <p>Socioeconomic advancement</p>
<b>GREEN DEVELOPMENT FINANCE</b>	Establishing a National Investment Bank with a sustainability mandate, seeking out net-zero aligned projects for which risk levels need to be reduced	Capture all category

\*Based on the ICMA Social Bond Principles

Based on market precedent, proceeds of the issuance could be directed towards projects that form part of existing spending commitments, although our investor feedback stipulated that such a “look back” period should be confined to a maximum of two years.

By way of example, the German government’s recent inaugural green Bund refinanced qualifying expenditures from their 2019 budget. The €6.5bn transaction was widely welcomed by the market and was more than five times oversubscribed.



# The Green+ Gilt: generating jobs and social renewal across the country

The novel feature of the proposed Green+ Gilt is that financed projects would consciously deliver social co-benefits in addition to environmental outcomes, thereby contributing to a ‘just transition’.

Careful allocation of the Green+ Gilt proceeds to the right projects will enable the government to demonstrate how environmentally sound investments can create high-quality jobs and contribute to “levelling up” the UK economy in terms of region and sector, with local solutions targeting deprived areas and communities. This would help to ensure that the cost of the transition is not borne by those in society least able to afford it.

Using the ICMA Social Bond Principles (SBP), each eligible project would have at least one well defined and measurable social co-benefit, with a relevant social metric for each project category. These could include outcomes such as affordable housing and infrastructure, employment generation, access to essential services, skills development and education as well as other aspects of socioeconomic advancement. Social co-benefits would also be generated by allocating finance to projects in Local Administrative Units in areas of relative deprivation.

Currently, there are three recognised types of “labelled” bonds designed to address sustainability challenges. The most well-established of these are Green Bonds that allocate proceeds to environmental projects, whereas more recent innovations include Social Bonds and Sustainability Bonds; the former focused on social outcomes and the latter allocating proceeds to a combination of both social and environmental programmes.

Social bond supply has grown rapidly in response to the global pandemic, reaching \$40bn in the first six months of 2020 compared with \$17bn for the full year 2019. This is dwarfed by the green bond market which reached a new record issuance of \$258bn last year.<sup>2</sup> Despite markedly slower growth during the global lockdown, green bond issuance is still expected to reach \$175bn to \$225bn in 2020.<sup>3</sup>

Due to the relative maturity of the green bond market, there is a broader and deeper pool of green investment capital. Historically, in order to appeal to these investors, bonds would require strict environmental use of proceeds, with investors wary of less well-defined social outcomes.

In the wake of COVID-19, traditionally green-only investors are increasingly recognising the importance of investments that support environmental outcomes with demonstrable, positive social impact.

The Green+ Gilt proposal recognises these market developments and would provide access to the broad universe of green investors, in order to ensure greatest demand and tightest pricing, whilst also generating social benefits in line with government objectives.

The addition of social co-benefits with well-defined social metrics for each project was widely welcomed by the investors approached, with the focus on jobs and skills particularly well received.

<sup>2</sup> Source: Green Bonds Global State of the Market 2019, Climate Bond Initiative.

<sup>3</sup> Source: Moody's Investor Services Research.

# The Green+ Gilt: proven cost effectiveness and diversification of investors

To date, 16 countries have issued green bonds<sup>4</sup>. These sovereign green bonds have secured a cost of capital that is no more than conventional non-green issuance and, in a number of cases, have achieved tighter pricing and a lower cost of capital for the public finances.

The most recent issuances from Sweden and Germany during past weeks were both oversubscribed and successfully achieved a one basis point discount to the conventional non-green equivalent bonds.

Investor feedback was very positive on the likelihood of an equivalent oversubscription that would result in a pricing advantage for the Green+ Gilt, which is a clear and growing feature of recent transactions. However, the group did not recommend explicitly targeting a pricing benefit of 1 to 2 basis points at issuance, which it was feared would result in demand from “niche” investors only.

In addition, green bonds bring the benefit of investor diversification away from traditional sovereign investors. For example, green investors made up 61% of the demand for Poland’s green sovereign bond, almost none of whom had previously invested in Polish sovereign issuance.

Furthermore, UK-based funds were the second most significant investors in both the French and Dutch green bond issues after their own domestic investment communities.

A Green+ Gilt would widen the investor base for gilts at a time of unprecedented public spending requirements, attracting the growing pool of green bond investors, and encourage international investors to fund UK projects.

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<sup>4</sup>Seven countries have also issued other use of proceeds labelled bonds.

# The Green+ Gilt: strengthening the capacity of the UK financial system

Sovereign green bonds not only raise cost-effective capital for public spending, they can also have a catalytic effect across the financial system. As the financial sector pivots towards an increased focus on climate action, positive impact and sustainability, the City of London needs to be at the forefront. This has become more pressing given the EU's strong leadership in sustainable finance.

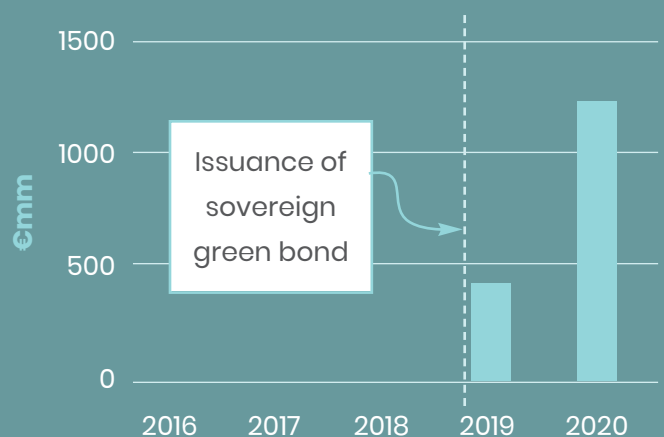
Although the UK financial system has many strengths in sustainable finance, less than 3% of the labelled green, social and sustainable bond market globally is denominated in Sterling and the UK is well outside the list of Top 10 countries in terms of issuance. This means that UK banks are under-represented in the league table of underwriting institutions.

A Green+ Gilt would also have a demonstration effect across the rest of the economy, encouraging business as well as local authorities and other public agencies also to issue bonds that deliver green and social benefits. The Green+ framework could be adopted by other UK issuers, providing a template for further issuance, reducing start-up costs and building broad-based momentum. This would help to meet the growing demand from retail investors and institutional investors for high-quality assets that deliver positive social and environmental impact.

An analysis of sovereign green bond issuance across European countries supports this assertion and demonstrates the catalytic effect on the volume and variety of subsequent green bond issuers accessing these markets. Notably in Ireland and Belgium, issuing sovereign green bonds helped kick-start their broader green bond markets.

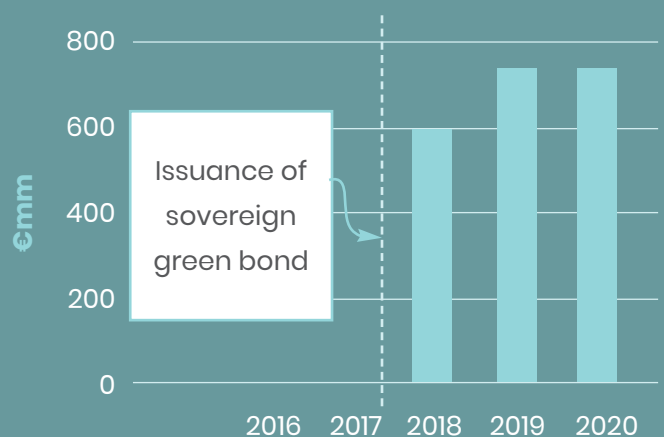
## IRELAND:

Amount of green bonds issued per year (excluding sovereign issuance)



## BELGIUM:

Amount of green bonds issued per year (excluding sovereign issuance)



In more mature green bond markets such as France and the Netherlands, the issuance led to a greater diversity of issuers accessing the green bond markets.

France is the largest sovereign bond issuer to date. The French green OAT stands at €25.24bn after 10 forays into the green bond market to increase the size of the bond since its initial 2017 issuance. It is also home to the greatest volumes of labelled bond issuance. This in turn supports French banks' leadership in the green and sustainable bond league tables – a key credential for attracting further green bond business from both domestic and foreign issuers.

A Green+ Gilt would give UK financial institutions an opportunity to boost their presence in the sector, improve league table standing and generate underwriting, advisory and legal fees.

The UK, through the £5.8bn UK International Climate Finance programme (ICF), plays a crucial role in addressing the global challenge of climate change. The Green+ Gilt would showcase the UK's green finance ecosystem (financial, legal, consultancy, assurance, academic etc.) and bolster the export potential generated by programmes such as the ICF.

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## The Green+ Gilt: demonstrate international leadership by the UK

By issuing a Green+ Gilt, the UK would show real leadership by producing a sovereign bond that responds to the global imperative of a green and inclusive recovery from the coronavirus crisis. As host of the COP26 climate summit in November 2021, the UK is developing an ambitious agenda for financing climate action with its partners and the Green+ sovereign bond is a model that could be emulated by countries across the world.

This could generate significant market momentum in terms of flows of finance towards investments in both developed and developing countries. The scale of the economic shock facing the global economy means that the Green+ Gilt could also be a signal of commitment that would be relevant to discussions with heads of state and finance ministers that will take place as part of the G7 process which the UK will also be hosting in 2021.



# The Green+ Gilt: further critical design features

The hypothecation of the proceeds of a green sovereign issuance has previously been a topic of debate. It is widely accepted by the market that hypothecation is not a necessary requirement for issuing a green sovereign bond and the investors consulted for this paper concurred. The precedent set by the French green OAT was well-received and stipulates that “proceeds are managed in compliance with the general budget rules and finance an equivalent amount of eligible green expenditure”.

Investors expressed broad support for the Green+ Gilt to be issued with a maturity of between 5 and 10 years. This maturity would also be optimal for offshore investors, depending of course on the liquidity of the currency swap curve.

Recent market developments to ensure liquidity of green sovereign bonds have included the German “twin” issuance whereby green and equivalent non-green Bunds were issued simultaneously to maintain parity between the conventional and green issues. Investors were ambivalent regarding this construct, expressed little concern regarding the likely liquidity of a well-priced Green+ Gilt and cited the French OAT model with its repeated taps to reach the typical size for a French government bond as a preferred strategy.

# The benefits in brief

To date, 16 countries have issued green bonds<sup>4</sup>. These sovereign green bonds have secured a cost of capital that is no more than conventional non-green issuance and, in a number of cases, have achieved tighter pricing and a lower cost of capital for the public finances.

## A Green+ Gilt would:

- Show that the UK is a market leader by developing the green and social capital markets.
- Underpin economic recovery by directing proceeds to the growing net-zero economy whilst at the same time creating jobs and other social benefits.
- Address the lack of investment and consequent productivity gap faced by the UK by upgrading infrastructure, supporting innovation and building skills.
- Respond to rising investor demand by providing a liquid instrument that can feature in every relevant portfolio.
- Catalyse green and sustainable finance and demonstrate UK financial capability, forming a template for further issuance by the private sector and localities.
- Establish a framework for further issuance domestically and internationally that can build economic confidence on the road out of the COVID-19 crisis.

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<sup>4</sup>Seven countries have also issued other use of proceeds labelled bonds.

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