Insight
Environmental, Social & Governance

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ESG in LDI and the Rise of Green Gilts

Environmental, social and governance (ESG) considerations are increasingly at the forefront of investment decisions being taken by UK pension schemes. In part, this is driven by new regulation and requirements being placed upon schemes, such as the recently proposed Department for Work and Pensions (DWP) rules that will require trustees to report on their approach to climate change risks.

Schemes are increasingly introducing ESG strategies in equities and focusing on stewardship voting and engagement, but what does ESG mean for Liability-Driven Investing (LDI) strategies?

Current State

ESG considerations are currently incorporated in our clients' LDI strategies in a number of ways:

- **For Sterling Corporate bond, Non-Gilt bond and Cashflow Driven Investment (CDI) funds** — we apply ESG screening to exclude holdings in bonds issued by companies involved in the production of controversial weapons and companies in violation of the UN Global Compact Principles. More information can be found **here**. Bond portfolios are typically constructed by a stratified sampling process — where a bond is excluded we simply include a bond with similar characteristics from a non-excluded company.

- **For Liquidity Funds** used for cash collateral, the primary objective of such funds is principal preservation, and our Credit Team have found a positive correlation between maturity restriction, a measure of counterparty credit risk, and our R-Factor ESG score of these counterparties.[1] On a monthly basis, we publish documentation showing investors the **ESG profiles for our liquidity funds**.

- **For our segregated clients**, we can include the R-Factor ratings of the counterparty banks which the mandates face, either through bilateral swap or repo positions, as part of our regular client reporting.

ESG is often focused on *which* assets are bought for the portfolio. When considering instead *"who"* investments are traded with, particularly when buying or selling bonds, or executing swaps that are centrally cleared, removing any ongoing bilateral counterparty exposure, we see that clients typically place achieving best-execution ahead of ranking the individual ESG credentials of the panel of available brokers to trade against.

If we focus on the *"which"* assets consideration, beyond the areas discussed above, this is currently very limited for LDI mandates, given their investments are predominantly in UK government bonds, as well as interest rate and inflation swaps. This may soon change, however, as the UK government has launched the first green gilts.

The Future of ESG in LDI?

The most immediate route to greater integration of ESG into LDI is likely to come via green gilts. The UK government has published its **Green Financing Framework**, setting out its climate and environmental agenda detail and, in September, the Debt Management Office (DMO) raised £10bn via issuance of a green gilt maturing in 2033.[2] The syndication of a second green gilt, with a longer-dated maturity of 2053, followed in October.

With this new green supply hitting the market, we focus on three key questions that may shape pension scheme demand for these new bonds:

Just how green will these new bonds be relative to existing gilts? While the proceeds of green gilt sales will be earmarked for green projects, the government makes no *guarantees* that such projects will exist and be funded. The cashflow to pay green gilt coupons and maturities will come from general government revenues — no different to existing gilts.

Where will green gilts price relative to existing bonds? Based on the early price action of the green gilts, as well as other government bond markets which have seen green issuance, for example Germany, it is widely expected that green gilts will trade more expensive and yield less than equivalent existing bonds. Noting the uncertainties about just how green these new bonds will be, how much of a "greenium" will pension schemes be willing to pay for them?

What is the suitability of green gilts for LDI hedging mandates? Beyond price considerations of new green gilts, we expect a two factors to influence pension scheme demand:

— Current expectations are for the DMO to initially build out a curve of nominal green gilts only — this may limit demand from pension schemes with a high proportion of real liabilities and who favour index-linked gilts for their hedging portfolios.

— What sort of liquidity will we see in green gilts? It has been suggested that green gilts may be less volatile than existing gilts, as more investors will have a "buy and hold" mentality, and this may be attractive to pension schemes. More broadly however, liquidity and trading volumes will be an important factor in the how green gilts price in repo markets.

Aside from green gilts, we expect pension schemes may increasingly demand that ESG considerations feed into their asset managers' counterparty panels, both for long-term exposures such as bilateral derivatives and term repo transactions, as well as for cash transactions and cleared derivatives. Our Credit Risk and Investment Risk teams have already integrated ESG criteria and scores within their processes.

Conclusion

Incorporation of ESG considerations into investment strategies is a key consideration for our UK pension scheme clients. We are at the forefront of incorporating ESG into many of our funds and portfolios, and can point to a depth of experience across a variety of asset classes and markets. To date, the integration of ESG into LDI strategies has been relatively limited, but this could change with ongoing interest from schemes and the opportunities created by a growing green gilt market.

Our LDI and ESG teams would be very happy to discuss incorporation of ESG into your scheme's investment portfolio.

Endnotes

1 https://ssga.com/library-content/pdfs/cash/elr-product-overview.pdf.

2 https://gov.uk/government/news/uks-first-green-gilt-raises-10-billion-for-green-projects.

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- Invest as stewards
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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.