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CIFA
CYPRUS INVESTMENT FUNDS ASSOCIATION

Newsletter

Table of Contents

Rating Agency Approval must not Lead to Complacency

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Globalisation and the expansion of world trade and foreign investment have demonstrated the clear need for an objective and technocratically substantiated assessment of national economies. In this context, the importance of rating agencies as institutions for analysing the comparative advantages, challenges and future prospects of national economies has evidently come to the surface. The reports of international organisations, such as Moody's, Standard & Poor's and Fitch, now have crucial influence on the decisions of international investors and, consequently, on the economic policy of sovereign states.

On a practical level, states recognise that a negative rating has significant adverse impacts on attracting foreign investment and leads to higher borrowing costs in the government bond markets. This is especially true in the case of the Eurozone, where the existence of a single currency does not allow individual states to exercise a national monetary policy. With fiscal policy as their primary tool, member states should strive to ensure conditions for socio-economic growth and stability on the basis of a long-term sustainable budget. Otherwise, excessive spending leads to growing public debt which deprives the economy of valuable resources and limits the ability to respond effectively in times of economic downturn and emergencies.

The need to maintain sustainable public finances in the long run is fully compatible with an expansionary fiscal policy during times of recession. It is for this reason primarily that the recent decisions of the heads of the member states and the ambitious plans under the "EU Next Generation" programme, through which 750 billion euros will be channelled to the member states, were welcomed by the rating agencies and investors. This specific EU programme aims to provide the resources for a Europe which is based on the principles of social solidarity and one that's in a position to undertake a leading role towards combating climate change and technological improvement.

In Standard & Poor's recent assessment of the Cypriot economy, the sovereign credit rating was maintained at investment level with a stable outlook. It appears that, despite the negative consequences of Covid-19, the rating agencies have maintained their confidence in Cyprus and approve its handling of the situation so far. However, this should not lead to complacency. The reports of the rating agencies also highlight long term structural weaknesses, such as the existence of sizeable public and private debt, the high level of non-performing loans, the increased probability of bankruptcies when the instalment moratorium period ends, and the dependence of the economy on a small number of sectors which are vulnerable to external shocks.

The reality is that there are no easy ways to deal effectively with persistent and deep-running problems and weaknesses. However, proper utilisation of the opportunities afforded by "EU Next Generation" can help not only to address the social problems created by the pandemic but also to adapt to tomorrow's demanding times, without affecting the long-term sustainability of public finances which remains the key to positive evaluations by rating agencies and investors.

Automating onboarding for the Fund Management Industry

Aris Iliopoulos
Regional Managing Director
at Profile Software

The positive side-effect of the pandemic crisis is the evolution of technology to manage daily operation

The wealth and fund managementy industry has greatly benefited from the use of tools that automate processes. This has already started many years ago, however it was never accepted across the board so fast. It is now more than ever that fund managers can appreciate the value of automation and innovation in their relationships and operational activities.

Customers experiencing speed, ease, security and convenience during onboarding, are more likely to remain loyal, think positively of the brand and provide referrals.

Digitising the customer journey, while automating processes can contribute to a transformation that is easy to deploy and can offer great returns to the business.

Promoting greater digitilisation and automation is something Profile Software has always supported

The simple fact is that differentiation in delivering advanced customer experience in the wealth management industry is becoming of paramount importance; the offering is niche and the market needs are constantly changing.

Client onboarding is an obvious area for improvement. This was evident prior to Covid-19 with advisers needing to free themselves from the shackles of manual

data input and paper processing. The goal is to make this process as flexible and frictionless as possible.

Compliance within onboarding is also key

Depending on the policies in place, firms remain compliant, keeping up to date with regulatory changes (GDPR, MiFID II, etc.).

Indeed, online onboarding during Covid-19 has been a real differentiator and has been valuable both in itself as a remote, digitised option as well as in terms of allowing the adviser more time to build a better and enhanced relationship with the customer – engaging fully in a period of great uncertainty.

"But onboarding is not the only area to benefit from technology"

Digitising the customer journey - including the provision of the same 'look and feel' across users, while automating processes from onboarding to valuation and rebalancing - can contribute to a transformation that is easy to deploy and can offer great returns to the business.

During the Covid-19 lockdown, the ability to perform tasks remotely was fully proven and has now become the new normal. The flexibility to operate remotely is becoming the new norm for wealth managers and clients alike. Both parties need to be able to carry on with their business and move to enjoy secure and compliant automation where possible to refocus time and addition on core functions and processes.

In most cases, the front-end systems perform this automation and therefore often receive greater attention. However, equally important is the ability of the back-end system to analyse and process information fast and accurately so as to complete complex or demanding operations with ease.

Simplification is a key driver

It is said that customer experience revolves around key touch points, creating intuitive and easy-to-use features within complex investment management tools and offering seamless omni-channel portfolio management capabilities.

Vendors offering:

Clients benefit from a full-service environment that is scalable and always on. This was evident by the number of clients who moved to a full cloud service offering when Covid-19 hit. Indeed many clients who had yet to deploy its full benefits were very keen to do so and appreciated being able to leverage the service and enjoy full service with no downtime at all during what was a troubling time of uncertainty.

"Continual development is also key facet of a successful vendor"

Profile continually develops its offerings and in particular adding in AI and machine learning tools where the investor can enter details and have them matched to those already existing in the database and have that data added to the profile. It saves repetition and time. It also helps when it comes to suggesting investment ideas based on the entirety of the data that is held on the client side rather than what he or she has just entered into a questionnaire.

Ready-to-use connection with other systems is also required so as to ensure data integrity and to streamline operations across users. The 'single screen' customer view allows for consistency, easy reporting and personalisation, where needed, to address growing market requirements.

Security and compliance are the third aspect

A secure system that is compliant to regulatory framework and also takes into account local variations provides a level of comfort to wealth managers – most of whom deal with clients from multiple jurisdictions. Vendors able to provide advanced functionality that automates the onboarding process, as well as ensuring that customer data is protected, and the process is user-friendly are an attractive proposition for wealth managers.

Ultimately investing in innovations that benefit the wealth manager and client alike not only contribute to the bottom line they are also future proofing a business. The risk of failure from not taking action is far greater than any risk associated with technological disruption as a result of new technology. Wealth managers know this and should look to take the appropriate steps to ensure client demand in terms of end clients and their internal wealth manager clients alike can be met.

Liquidity Management Practices Implemented by Fund Managers

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Liquidity Management Practices implemented by Fund Managers

A Brief Introduction

Since coming into effect at the end of last month, the European Securities and Markets Authority's (ESMA) new guidelines on liquidity stress testing have highlighted the importance of effective liquidity risk management. In the context of Alternative Investment Funds, many of which have relatively illiquid strategies, liquidity risk is largely the degree to which the AIF Manager is able to fulfil the redemption orders when requested.

In a growing market, as can be found in the Cyprus Alternative Investment Funds Industry, fund managers are required to balance the market's competing needs (e.g. high yields, low cost, value add, etc...), while at the same time ensuring the fund continues to maintain its value to current and potential investors.

Understanding each Fund

While managing the liquidity risk of the funds under their purvie, fund managers need to review each fund separately so as to understand their nature and the specific liquidity risks faced. During this process, the key issues to be addressed and properly documented involve the degree at which the fund's assets can be liquidated, the rate/estimated timeframe at which they can be liquidated, and the liquidation cost.

Especially in opportunistic real estate asset portfolios, there is a relatively high likelihood of mismatch between the timing of redemption and the actual disposal proceeds. This scenario can arise for numerous reasons, including longer than expected disposal periods, reduced proceeds due to unfavourable market conditions, and discounts applied in liquidity shortage situations. To ensure that adequate cash is readily available for investor redemptions, fund managers need to ensure that the sales velocity mismatch is as low as possible. To do so, fund managers should look to form prudent forecasting measures with the assistance of real estate experts, and have in place proper redemption notices that will enable the fund to dispose of assets at favourable rates.

Stress Testing

Another critical step in the liquidity management process is the setting up and monitoring of appropriate liquidity limits that reflect each fund's characteristics, as well as adhere to their underlying obligations and redemption policies. This is where stress testing comes into play.

Stress testing allows the fund manager to simulate a range of normal and stressed conditions so as to assess their potential impact on the overall AIF liquidity and its limits. While ESMA recommends quarterly testing, AIFs are required to stress test their liquidity management risk process at least annually.

Trust and Transparency

In establishing appropriate liquidity management policies, it is of vital importance for fund managers to ensure that clear and pre-emptive procedures, provisions, and tools are in place and properly disclosed to prevent liquidity runs. That being said, it is rather common in distressed situations to observe a mismatch between supply and demand, and hence between the available liquidity and the possible redemption requests. Such mismatch can in turn lead to investor frustration and breach of trust, consequences easily avoided through the opening of clear lines of communication and enhanced transparency.

Liquidity Management Tools

To ensure the clarity of each Fund's investment strategy, liquidity profile, and redemption policy, fund management companies have at their disposal a variety of tools to assist them in managing liquidity. However, the selection of such arrangements needs to be proportionate to the nature, size, complexity, and investment objectives of each fund. Such tools include:

- **Lock-up periods:** Especially for opportunistic real estate asset portfolios, the lock-up period/minimum holding period imposed on each fund may extend for periods of 6 or more years in order for the investment strategy to realise its full potential.

- **Redemption notice period:** For more illiquid AIFs such as the ones invested in real estate, it is common to have redemptions permitted on set timeframes (e.g. on a quarterly basis) and subject to a prior written notice (e.g. 90 days) where it is specified how many days in advance investors have to notify that they wish to redeem.

- **Redemption gates:** The fund can place a restrictive ceiling on redemptions in order to ensure that the extent at which the aggregate amount of redemptions on redemption date does not exceed a predetermined percentage of the Net Asset Value (NAV).

- **Redemption fees:** Such fees can act as disincentive to frequent redemptions and short-term investments. The fees may vary depending on the timing of redemption (higher fee for redemptions taking place during the first year of investment).

- **Suspension of dealing:** In exceptional circumstances, the fund can suspend the redemption, preventing investors from withdrawing their capital. Such a tool, which is perceived by the market as a last resort mechanism, should be activated when no other option is available as it could distort investor confidence and have negative reputational impacts.

Whatever controls are in place to manage liquidity risk, they must be disclosed and communicated in the fund's offering documents since it is imperative that a relationship of good faith is maintained between investors and fund managers.

Socially Responsible Investing: Achieving Sustainable Growth

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ESG Funds

Whilst the vital importance of sustainable finance is already widely known, the recent momentum regarding the implementation of EU regulations has ignited the drive to identify the processes that will address the EU framework for sustainable growth.

The “UN 2030 Agenda for Sustainable Development”, adopted in September 2015, replaced the eight Millennium Development Goals initially set in 2000 and further introduced 17 new Sustainable Development Goals (SDGs) for 2030. The Agenda’s aim is to seek a sustained economic, social as well as an environmental development path that would, amongst other goals, resolve worldwide poverty and hunger, transfer scientific know-how to developing countries, act on climate change, provide affordable and clean energy and to pledge a 40% reduction of CO_2 emissions in all sectors of the economy.

In the same year, the Paris Agreement on Climate Change was signed as recognition of the effective need to address the transition towards a more resource efficient low- carbon society. The collective agreement between all parties involved, was that long-lasting economic prosperity and sustainable growth can be achieved whilst considering environmental, social and governance (ESG) factors in investment decision - making via the use of smart technologies and without damaging the climate.

Such ESG criteria embedded within the investment process of equity and/or bond portfolios, the “ESG funds”, make up a set of standards by which socially and environmentally conscious investors go by when evaluating and screening how sustainable companies or governments rank. A low sustainability score would, for example, include companies with high greenhouse emissions or corruption. Appetite for ESG funds is high amongst investors who want to make a positive contribution to the climate change without compromising returns.

The implementation of EU energy and climate policy targets, per the Paris Agreement, require an additional annual investment of approximately EUR 180 billion while the investments needed to achieve the set SDGs are set much higher. The investment gap required to be filled in is simply too large to be addressed by the European Fund for Strategic Investments alone therefore the financial sector’s assistance in achieving the set goals is of paramount importance. As such, the EU’s financial regulatory framework has sought imperative action to align increased capital flows towards the financing of a low-carbon sustainable economy and that the need for revised strategies and risk management systems that will protect the financial industry from sustainability risks is also raised.

The European Commission’s Action Plan on Sustainable Finance (2018), brought forward numerous legislative proposals in the ESG arena in order to harmonise sustainable economic activities via an agreed EU classification system, known as “taxonomy”. Such regulation will also create a market standard for investors wishing to compare the carbon footprint of their investments to low-carbon and positive carbon impact benchmarks for sustainable investments. Lastly, the proposed legislation ensure that financial intermediaries have common understanding to ensure proper due diligence is performed and that correct disclosures are made.

The initiative for the reform proposals are progressing swiftly. As at the end of 2019, the European Parliament and Council reached a political agreement on an EU-wide taxonomy. Provisional agreements are in place on low-carbon benchmarks and transparency obligations on how the companies should incorporate ESG factors in their daily investment decisions. The complete set of guidelines, however, are not expected to be fully implemented prior to 2021.

It is pity to waste a crisis

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Covid-19 has introduced a significant level of uncertainty in the business environment. The market conditions are changing and the policy reaction should not only support businesses but it should also encourage a new economic order. The challenge for Cyprus is to support the momentum of the economy and at the same time to leverage on the paradigm shift that has stemmed from the reaction to the pandemic in order to build a robust and sustainable economy.

Every crisis embeds an opportunity. For Cyprus, this is an opportunity to revisit its economic model and approach the post pandemic period in a strategic manner. A strategic plan needs to be devised, spanning across all aspects of our economy and society.

As all countries are reviewing their supply chains, in the first instance, Cyprus shall do the same. Certain domestication of the supply chain will create more employment opportunities in Cyprus (with all the associated benefits) and it will reduce our dependency on imports. Increased domestic production will have significant long-term benefits for Cyprus. Policy measures are needed in order to nudge the industry in that direction. If nothing else, Cyprus can benefit from its own internal consumption, as opposed to the existing high dependency on imports.

Another key aspect we have seen from this crisis is the rapid digital adoption. Organisations as well as the public sector, which have until recently been slow adopters of new technologies to enhance the customer experience, have transformed into tech savvy enterprises overnight increasing their operational efficiency and changing the way they conduct their businesses. These organisations as well as the public sector should be encouraged to continue leveraging on technology in all aspects of their activities. This will serve the economic production of these enterprises and ultimately their profitability.

Further, a specific policy target should be to attract international firms in the area of high technology so that Cyprus transforms into a European technology hub. Cyprus, through technology parks, for example, can foster innovation and disruptive technologies in targeted manner. A bespoke range of incentives should be implemented and upon such to reach out to the international community in a targeted manner.

Technology has also enabled many employees to productively work from home. Remote working has many benefits for the society. Organisations should consider, to the extend reasonable of course, whether a certain number of their staff can be working remotely either partially or on a rotation on a permanent basis. A virtual office will mean less use of office space and reduction of related costs and thus financial savings.

In turn, this will result in less travelling and therefore less traffic. We must acknowledge the pleasure of driving around city centres in Cyprus over the past few weeks with the reduced traffic. Reduced traffic means that we save on energy cost and we save on time. Therefore, we increase productivity. Naturally, the environment ends up being a major winner from this, due to reduced pollution and decongestion of city centres.

This crisis offers a unique opportunity for Cyprus to establish a clear vision, strategy and then a roadmap to achieve that. Upon such, specific targeted international investment should be attracted, which should be aligned with specific sectors in accordance with the strategy that will be agreed. Whilst businesses should now be supported to see themselves out of the Covid-19 crisis and thus support the maintenance of the economic structure of Cyprus, we need to ensure that in the medium-term the measures are targeted in a more focused manner. The incentives should be addressed to the new economy and zombie firms that would possibly have failed in any event should not be kept on life support consuming public money. This targeted approach should be enhanced with incentives for international investment into Cyprus.

This strategy could listen to many names. For example, it can be housed under a social responsibility banner or a Cyprus 2030 title or even better, under an environmental banner. This latter green label is in line with the latest trend in international investments and will thus go down well with international investors.

Why Family Offices are Heading to Cyprus

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Family Ties: Why family offices are heading to Cyprus

Just a few years ago, Cyprus was the 'new kid' on the fund management industry block. Now, that kid is rapidly

growing, blossoming and reaching maturity. The last five years have seen the country's assets under management (AuM) grow from €2.1bn in 2012 to €7.7bn in 2019, with the figure predicted to reach €20bn in the next five years.

In short, Cyprus is well on the way to becoming a major fund management industry player in Europe, alongside longer-established jurisdictions such as Ireland and Luxembourg. This is, of course, against the ever-present background of Brexit, its shifting uncertainties and as yet unknown long-term outcomes. While it's entirely plausible that London as a financial centre will survive the UK's re-evaluation of its future position in Europe, there are certainly opportunities opening up for other players – and Cyprus is well placed to take advantage of them.

What is making Cyprus particularly attractive to fund managers? Having one of the lowest corporation tax rates in Europe, at just 12.5%, is key. Various tax benefit schemes are also available. These include a rate of just 2.5% when capital is injected into a fund under certain conditions, and a discount of 50% on personal income tax for fund managers with an income of more than €100k. The fund regime is flexible, as there are no restrictions around which assets can be held within which fund, but also offers AIFMD compliant solutions for European passporting. The setup costs for a fund in Cyprus – licensing, having a depositary, a fund administrator, non-executive directors, and the like – are more cost-effective than both Luxembourg and Ireland. Cyprus has also signed double tax treaties with more than 60 countries, and English – the international language of business – is widely spoken.

At Trident Trust in Cyprus, we have also seen that setting up on a small island with a highly welcoming, multicultural, educated and friendly environment is proving particularly attractive to high-net-worth family offices choosing to restructure as funds. As they grow, many are finding that regulated fund structures are increasingly necessary and helpful in managing the family's assets. Using a fund structure provides a recognised and well-established legal framework, which allows the family office itself to become a multi-family office, private equity fund manager or boutique wealth manager.

This structure also allows greater control over the assets being managed, and provides the opportunity for the family office team to be incentivised in line with their peers in the corporate fund management environment. The application of regulation and the use of independent administrators, auditors and non-executive directors, gives additional comfort to the family whose assets are being managed that there are appropriate checks and balances, and that the assets are being securely held.

These key elements of control and incentivisation appeal even to single family offices keen to adopt a fund-type structure for their assets. A fund structure can provide an element of control to the family office in the same way a fund manager controls a private equity fund. The family office can own the shares in the general partner that manages the limited partnership and contracts on behalf of the investors. By extension, a fund structure also permits the family office to be remunerated in a way which is consistent with fund managers and aligns their interests with the families whose assets they manage. This usually involves an annual management fee, plus a carried interest fee with respect to illiquid investments, which incentivises the family office team to maximise returns.

Establishing a family office in a new jurisdiction also requires a grasp of many other details, so we assist with all the other administration that comes with a new office. This might involve immigration procedural requirements and concierge services, such as finding suitable schools and accommodation.

For Cyprus, family offices are just the beginning. Fund managers rightly seek good relationship management, reputation and trust when deciding where to base their operations, and more are hearing, from their family office clients, that this island is the place to be. Opportunities are opening up for forward-thinking family offices and fund managers eager for a new and exciting destination. These days, the new kid on the block is well and truly established.

The Liquidity Stress Testing (LST) requirement for AIFMs

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SALVUS Funds

The European Securities Market Authority (ESMA) and the European Systemic Risk Board (ESRB) introduced a new set of guidelines on liquidity stress testing (LST) for UCITS, AIFMs and AIFs. The guidelines took effect on the 30th of September, 2020. The characteristics of the investment products, the inherent risks and the diversity of investors, the use of leverage in investment funds and the resulting increase in the risks of liquidity mismatches formed the basis of this introduction.

The objectives of the liquidity stress testing (LST) requirement

The ESMA and ESRB guidelines are based on micro-prudential liquidity stress testing and their objectives are focused on

1. Promoting financial stability by mitigating liquidity risk.

2. Encouraging supervisory convergence across EU-domiciled funds and fund managers by setting minimum standards for liquidity stress testing.

The liquidity stress testing (LST) framework implemented by a fund manager should aim to improve the operational capacity of the fund and the contingency planning during liquidity crisis. In a nutshell, beyond ensuring compliance with the regulation, the LST implementation will be there to allow the fund manager to

1. ensure that the fund is sufficiently liquid,

2. manage fund liquidity in the best interests of the investors,

3. to identify potential liquidity weaknesses of an investment strategy,

4. perform risk monitoring and decision making.

Who falls under the scope of the new guidelines?

The stakeholders affected by the Guidelines include fund managers, depositaries and national competent authorities ("NCAs"). The liquidity stress testing guidelines apply to

- UCITS,
- Open-ended AIFs,
- Leverage closed-ended AIFs,
- ETFs operating as UCITS or AIFs,
- Money Market Funds (MMFs).

The fund managers' obligations and the guidelines applicable to them

The ESMA and ESRB guidelines require the fund manager to acquire strong understanding of the characteristics and the liquidity risks of each managed fund, either for the risks arising from the asset or the liability side.

The principle of proportionality applies and the liquidity stress testing (LST) shall be adapted to the nature, scale and complexity of the managed funds.

The guidelines applicable to the fund managers include:

1. Design of the LST models

a. the risk factors which impact the fund's liquidity and the different types of scenarios should be validated in order to build the appropriate model.

2. Understanding the liquidity risks

a. including the risks arises from the assets and liabilities of the fund's balance sheet, and its overall liquidity profile.

3. Governance for LST

a. shall be integrated and embedded into the fund's risk management framework,

b. shall be subject to appropriate oversight, including adequate reporting and escalation procedures.

4. LST policy

a. must include the role of the senior management, the function in charge of performing and reporting the LSTs along with the appropriate results and recommendations,

b. outline the reviews of the procedures and scenarios selected, the frequency chosen, and the methods used for liquidating assets.

5. Frequency of LST

a. at least annually

b. **recommended to be quarterly,**

c. or more frequent as per the complexity of the investment strategy and liquidity of the asset,

d. ad-hoc stress testing must be carried out if a material risk of fund liquidity is identified.

6. The use of LST outcomes

a. ensure the fund is sufficiently liquid,

b. identify potential liquidity weaknesses of the investment strategy,

c. assist in investment decision-making and risk management monitoring,

d. assist in preparing a fund for crisis and for contingency planning.

7. Adapting the LST to each fund

a. as to the frequency, the types and severity of the LST scenarios on the identified stressed conditions,

b. the complexity of the LST model.

8. LST scenarios

a. historical and hypothetical scenarios should be used.

b. where appropriate, reverse stress testing exercise can be considered.

9. Data availability

a. the fund manager should avoid optimistic assumptions,

b. expert quality judgment is recommended.

10. Product development

a. the fund manager shall be able to demonstrate to NCAs (ie. CySEC) the key elements of the fund including the effectiveness of the LST.

11. Stress testing fund assets and liabilities to determine the effect on fund liquidity

a. on the asset side, the fund manager should assess factors such the timing to liquidate and the liquidation costs.

b. on the liability side, a key indicator is the redemptions and sources of risk emanating from the liabilities balance sheet. Risk factors related to the investor type and concentration as per the principle of proportionality shall be considered.

12. Funds investing in less liquid assets

a. Real estate funds are particularly important on stress periods. Such funds are exposed to liabilities arising from serving and maintaining the assets.

13. Aggregating LST across funds

a. the LST results derived separately on asset and liability side should be combined, in order to assess the overall effect of the fund liquidity.

b. the fund manager shall aggregate LST across funds which employ similar investment strategy to gain a broader assessment of the liquidity risks.

The Guidelines effect on depositaries, and CySEC's role

Depositaries should set up appropriate verification procedures to check that the fund manager has in place documented procedures for its LST program. The LST framework does not require the depositary to assess the adequacy of the LST.

CySEC (and other NCAs) may at their discretion request submission of the manager's LST to help demonstrate that a fund will be likely to comply with the applicable rules.

Finally, fund managers are expected to notify NCAs of material risks and actions taken to address them.

The Future of Ship Financing

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Traditionally, ship financing has been dominated by low interest loans from European commercial banks and private equity investments. With changes in the global risk appetite, especially after the 2008 financial crisis, more stringent regulations have led banks to largely withdraw from the shipping industry.

Regulations enforcing tighter capital requirements, the signing of the Poseidon Principles, International Maritime Organization (IMO) regulations and expectations of the upcoming Basel IV protocols have urged banks to reorganize portfolios. In addition, investment capital seems to increasingly favour and prefer businesses with a high environmental, social and governance (ESG) ranking, with shipping unfortunately ranking very low in ESG terms.

The last decade has witnessed the end of banks being the backbone of shipping finance, as they actively seek "greener", low risk and high yield investment alternatives. Any remaining financial support from banks is accessible only to top-tier, diversified companies in the shipping industry. The retreat of banks has also prompted hedging operations involving distressed shipping assets, with the speculative nature of such

operations having a significant impact on market prices. Thus, there is a growing need to find stable alternate sources of finance in the shipping industry, especially to accommodate smaller companies.

Expected Trends in Ship Finance

Positive outlook in the medium term

In the medium term, shipping markets are expected to fare well, as a consequence to rising demand for advanced vessels that comply with newly introduced emissions standards and due to the high cost of capital the size of the orderbook for new vessels will likely shrink further. This can create favourable supply-demand dynamics for shipowners, with a possibility of higher freight rates. Given that demand returns to pre-pandemic levels, the shipping industry will continue strong in the medium term.

Shipping also provides an investor-friendly tax environment, which will increase in relevance as US and European tax rates increase and central banks maintain low interest rates. Hence, shipping may observe a wave of positive investor sentiment.

Deleveraging balance sheets

With new regulations for risk and environmental standards settling in and expectations of similar regulations in the future, shipping companies are expected to tweak their processes and operations in order to adapt to the changing market conditions. The modifications will also aid in improving their market valuation and create a brand that fits well with the investors' ideal portfolio.

A prime focus for shipping companies would be to deleverage their balance sheets. This can be done through issuing equity to reduce the risk associated with the company's assets, attracting the attention of the direct lending market, which is expected to become more competitive following the exit of European commercial banks previously leading traditional lending. Despite lower risk, the cost and terms of debt financing are expected to remain relatively stable. Thus, shipping may prove to be a safer, more profitable investment for lenders as compared to other hard assets.

Alternative Sources of Finance

Rise of leasing companies

Shipowners have increasingly resorted to vessel leasing in order to fill the void created by the withdrawal of banks from ship financing activities. Companies sell their vessels only to lease them back, with an option of buy back at maturity. Leasing options are being actively provided by Chinese and Japanese leasing houses, public leasing companies and institutional investors. A look at the Lloyd's List ranking of top 10 financiers in shipping for 2019, reveals the growing relevance of leasing companies in ship finance - Bocomm Financial Leasing and ICBC Financial Leasing, two bank-backed Chinese lessors now occupy the top two spots.

Growing relevance of Export Credit Agencies (ECAs)

ECAs are quasi-governmental institutions that provide government-backed financial support to domestic shipping companies. They mostly focus on funding the purchase and construction of new vessels. They serve as important financiers at a time when the shipping industry remains subdued and there is reluctance from private players to fund shipping operations.

The Export-Import Bank of China (CEXIM), the largest ECA in the world, had a loan book worth $17.5 billion by the end of 2018, consistently ranking as one of the largest finance providers in shipping.

Capital markets and the emergence of preferred equity

There is an expected resurgence of share offerings by shipping companies in the public markets, as shipping companies have been waiting for the right stock price relative to their Net Asset Value (NAV). Issuing equity provides shipping companies with multiple benefits including higher market capitalization and a better liquidity position. Although initial public offerings (IPOs) are unlikely to make a comeback, more companies are expected to opt for direct listings or undergo mergers with already listed companies. Thus, public markets will likely remain an important source of finance for shipping.

Preferred equity may also gain prominence. It shares features of bond instruments, having a fixed dividend usually lower than common stock, while also providing benefits of asset appreciation, high liquidity and de-risking of assets.

Alternative Investment Funds (AIFs)

Fund structures provide another approach to obtaining financing, by attracting investors that would usually be interested in smaller investment ticket sizes and would normally not have direct access to maritime real assets investments. Alternative investment funds, in the form of AIFs or RAIFs, managed by a fund manager with the appropriate expertise, can create value for their investors by timely acquisition, cost-efficient operation and profitable sale of vessels. Given the non-liquid nature of such private equity funds, fund structures can also be used for listing purposes at a later stage, thus enabling funds to raise further capital and providing an easier exit route to investors.

Such operations in Cyprus, specifically benefit from advanced maritime operational expertise, robust legal, financial and professional services infrastructure and a favorable tax system geared towards maritime investments. As a fund jurisdiction, Cyprus is also developing into a competitive fund management center, particularly for structures aiming to benefit from a regulated regime in the European Union.

The Way Forward

By its very nature, shipping remains a volatile sector with a pro-cyclical behaviour, making investments in the sector prone to risk, more so for the small and mid-sized shipping firms, which was previously undertaken and dealt with by banks and private equity. However, poor faring bets in shipping along with climate issues and a low-risk preference have reduced the involvement of banks, as well as private equity, in ship finance. Thus, shipping requires a restructuring, which is much needed to attract and maintain alternate sources of lending – a change that is already underway, with shipping companies growing more conscious of debt restructuring, deleveraging assets and running more efficient and compliant businesses.

The growing consolidation of shipping companies may give new life to private equity, by providing an effective exit strategy for many investors. Mergers may also provide necessary support to second and third tier firms, which are usually not favoured by public markets, by improving their credit worthiness.

Unless a major regulation change follows that attracts more banks to return to shipping, alternative sources of finance like vessel leasing and ECAs are here to stay and flourish. Moreover, Chinese influence over shipping is likely to increase with the progress of their Belt and Road initiative, aiming to connect international maritime networks to further support the Chinese shipbuilding industry.

Depending on how shipping companies cope with the changing demands of the modern market, their ability to embrace cleaner technologies and refined business operations, shipping will likely undergo a reform creating new market opportunities and allowing the entry of new players. How ship finance evolves ultimately depends on the performance and evolution of the shipping industry.

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