Green Funds: Business Trends & Regulatory Developments

The Inevitable Act
#sustainability #innovation

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/1 The Concept of Sustainability

In general, sustainable finance captures the process of including environmental, social and corporate governance (ESG) considerations into decision making and investment advice processes. Environmental considerations include climate change mitigation and adaptation, the preservation of biodiversity, pollution prevention and circular economy. Social considerations include equality, inclusiveness, labour relations, investment in human capital and communities and human rights issues. Firms with ESG policies aim at minimizing their negative impact on the environment or companies that focus on governance principles and transparency.

In the same spirit, sustainable finance is one of the key considerations in CySEC's policy making and strategic planning (the terms ESG and sustainability/sustainable financing are sometimes used interchangeably and/or are used in common policy areas and projects). As ESMA notes, in just the first half of 2021, EU sustainable fund assets increased by 20%, to €1.5 trillion, marking the 39th consecutive month of net inflows for these funds. This trend reflects the increasing appetite of investors and professional market participants to incorporate environmental, social and governance (ESG) factors into their decision making.

In light of the aforesaid, the establishment of a sustainable fund is expected to have a positive impact on its value and performance. Sustainable funds are those that use environmental, social, and corporate governance criteria to evaluate investments or assess their societal impact. They may pursue a sustainability-related theme or explicitly aim to create measurable social impact. ESG funds are portfolios of equities and/or bonds for which environmental, social and governance factors have been integrated into the investment process.

/2 Background / Trends in the Market

Policy-making

At the policy-making level, there are numerous initiatives which, either collectively or individually, provide for and press for sustainability (by way of reference and important examples, 2016 Paris Agreement on climate change, United Nations 2030 Agenda for Sustainable Development, Action Plan: Financing Sustainable Growth and associated Renewed Sustainable Finance Strategy). These initiatives have still only recently been introduced, yet, they provide a strong impetus and are of increasing relevance. As such, early planning and adoption of sustainability metrics/policies/goals is advised.

At a market level and as a general note, there is a growing number and class of investors shifting towards sustainable and ESG-compliant markets and products. Even where such markets or products are not sustainability or ESG-focused themselves, environmental and social considerations are assuming a growing importance in the risk calculations of investments and profit projections. In the same spirit, and as the OECD rightly notes, growing societal attention to the risks from climate change, the benefits of globally-accepted standards of responsible business conduct, the need for diversity in the workplace and on boards, suggests that societal values will increasingly influence investor and consumer choices may increasingly impact corporate performance.

The Chairman of CySEC, George Theocharides, has also noted that while we have not yet experienced a "large-scale shift towards responsible investments" in Cyprus, certain AIFs have indeed employed a portfolio of investing in line with ESG factors and CySEC has repeatedly communicated its commitment to sustainable finance. In this regard, CySEC will be cascading the measures and policies adopted at the EU level, with the European Council, European Commission and ESMA driving the initiatives in promoting sustainability and green financing. These bodies are key actors in so far as they set not only these initiatives, but also the pace of their adoption and implementation at the Member States level.

Asset classes

At the European level, equity is the main asset class for ESG funds. With regards to specific instruments, we have observed that green bonds (i.e. bonds whose proceeds are used for projects that pursue specific environmental objectives) have grown rapidly, such that they now pose the largest sustainable debt category. Green bonds are mainly used in the industries of renewable energy, real estate, green transport and sustainable water management.

According to the EU Commission, annual worldwide issuances have increased from €6.5 billion in 2013 to €72 billion in 2016, €185 billion in 2019 and almost €250 billion in 2020. The EU is a leading player in the green bond market, as more than half of the global issuance in 2020 came from EU companies and EU public bodies. At the international level, the Green Bond Principles (GBP) and the Climate Bonds Standard (CBS) serve as widely acceptable standards by which market actors can certify how eligible and complaint a bond is with their "green" standards. Nonetheless, there are still certain divergencies in the methodologies used to determine the "greenness" of financial instruments, which the

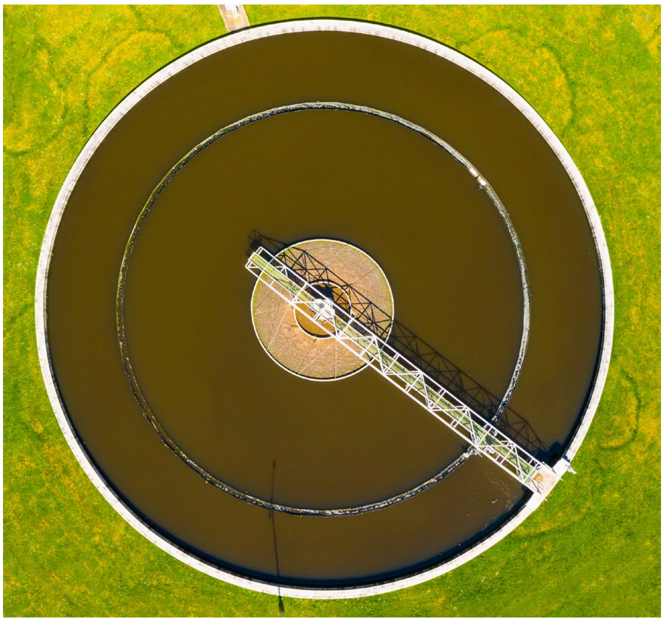
European Commission has sought to streamline in EuGBR, the proposal for a Regulation of the European Parliament and of the Council on European Green Bonds. This will be a voluntary standard, but one which, as per the ECON's recommendations to the European Parliament, can apply across social, sustainable and sustainability-linked bonds as well (as opposed only across "green" bonds).

In the same spirit, the amendment to MiFID II requires investment firms providing financial advice and portfolio management to carry out a mandatory assessment of sustainability preferences of their clients or potential clients. In turn, investment firms will need to take these sustainability preferences into account in the selection process of the financial instruments that are recommended to those clients. Further, the proposed Draft Alternative Investment Fund Managers Directive seeks to clarify the current obligation of AIFMs to integrate sustainability risks and disclose information with regard to the consideration of adverse sustainability impacts.

/3 Legal Framework

An overarching aim of the legal framework being developed in the areas discussed is to connect finance with sustainability. It is heavily influenced by the policy documents already mentioned and is guided by the need to reorient capital flows towards sustainable investment, manage financial risks stemming from climate change, environmental degradation and social issues, and foster transparency and long-termism in financial and economic activity.

Core pillars of this legal framework rest on disclosure obligations, the introduction of the



necessary methodologies for classifying activities as green, sustainable or otherwise, and the setting of standards for the development of sustainable solutions.

Disclosure framework

The EU's disclosure framework applies both to non-financial and financial entities which provide investors with the necessary information to make sustainable investment choices. The evolving regime introduces new disclosure obligations on top of the already appliable sector legislations. On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which will enhance the obligations of large companies in disclosing non-financial and diversity information. Further, the EU Sustainable Finance Disclosure Regulation (SFDR) came into force in early 2021, introducing sustainability disclosure obligations for manufacturers of financial products and financial advisers vis-à-vis investors. Such manufacturers and advisers must integrate sustainability risks in their investment processes, and disclose information on how their investment decisions or advice may have an adverse effect on sustainability, both at the entity and product level. As an example, from June 2023 onwards, financial market participants will need. At the general level, these obligations extend to several entities operating in the financial services markets, including fund managers, pension funds and insurance companies.

It should be kept in mind that the calculation of such sustainability risks, especially environmental risks, and the recording, depicting and disclosing of sustainability metrics is a technical exercise. Hence the three European Supervisory Authorities (European Banking Authority, the European Securities Markets Authority and the European Institutes and Occupational Pensions Authority) have jointly drafted a set of Regulatory Technical Standards which serve as guidelines for compliance, for the entities to which these new disclosure obligations apply.

EU Taxonomy

The aim of the EU is to introduce a unified common classification framework, which will allow the qualification of certain economic activities as environmentally sustainable. The Taxonomy Regulation (Regulation 2020/85 on the establishment of a framework to facilitate sustainable investment) aims to foster transparency and consistency and reduce the risk of greenwashing and sets out disclosure obligations which are complementary to those obligations imposed under the SFDR.

In order for an economic activity to qualify as environmentally sustainable, it will need to meet a number of criteria. Firstly, to contribute substantially to one or more of the Regulation's environmental objectives, secondly; it must not significantly harm any of the said objectives, thirdly, to be carried out in compliance with certain minimum safeguards as set out in the Taxonomy Regulation and comply with technical screening criteria established by the European Commission pursuant to the Taxonomy Regulation. Similarly to the disclosure framework, the EU Taxonomy regime is accompanied with technical screening criteria, in the form of Commission Delegated Regulations, which are taken into account in determining whether these four criteria are met.

The Taxonomy Regulation essentially addresses the scenarios where different classification systems might have otherwise been used to determine which activities qualify as sustainable. This would in turn lead to divergencies as to metrics and factors used for identifying those activities and products which could qualify as sustainable, and discourage the flow of funds towards these activities and products, because of the difficulty and confusion associated with comparing different investment opportunities. This allows for the manufacturing and issuance of financial products which are identified as sustainable across the entirety of the EU (and the orientation of investors' funds specifically to these projects).

Sustainable investment solutions

The EU Climate Benchmarks and the European Green Bond Standard provide the framework for developing those investment tools (benchmarks, standards, labels) which are necessary for aligning investors' interests with the EU's climate and environmental objectives.

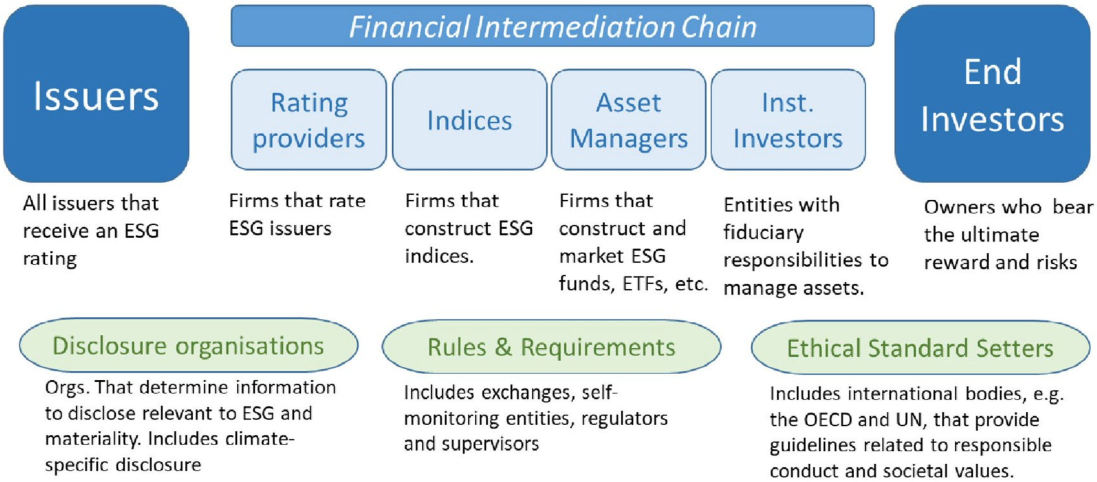
The green bond market in particular has been rapidly expanding in recent years, yet its expansion

has been limited because of the absence of a common definitions and taxonomies; a problem which is being combatted by the EU via a number of initiatives and the drafting of EuGBR in particular, as already highlighted.

As indicative of the levels of market size of the green bonds market, the EU has expressed its intention, in accordance with the 2021-2027 Multiannual Financial Framework (MFF) and Next-Generation-EU (NGEU), to inject €605 billion in projects combatting the climate crisis and €100 billion in biodiversity-related projects. The Commission intends to issue green bonds to raise a substantial portion of the funds under the NGEU, with the Commission issuing the first NGEU green bond of €12 billion, with a fifteen-year maturity, towards the end of 2021. Considering the increasing push for sustainability and the new market opportunities that related sectors can provide, the issuance of sovereign bonds Is predicted to increase further. At the same time, there are commentators linking the issuance of private green bonds with the increase of company valuations and share prices. This is in particular with regards to publicly listed companies, the share price of which is transparent and more easily measurable than that of private companies. Nonetheless, private companies are expected to reap similar benefits, in light of the value opportunities noted below.

/4 Market Overview

An overview of the market actors operating in the ESG financial ecosystem is provided by the OECD. The OECD adopts a top-down approach highlighting the role of both the private actors operating in this ecosystem and the role of public and supervisory/regulatory authorities involved. This overview is not necessarily tailored to the EU markets, but it is serves as a useful mapping out of the different actors which operate in the ESG space and can serve as a reference point as to the similarities and difference between traditional and ESG-focused markets and products.



Source: OECD staff illustration

Financial issuers are any issuers that supply equity or debt to the financial markets – either public or private – and demand capital from investors. In this respect, issues from sovereigns to SMEs are increasing providing information regarding environmental, social and governance at the request of investors, ESG ratings providers, credit rating agencies, and other motivated stakeholders (e.g. climate or human rights NGOs).

ESG ratings providers include those firms that are providing assessments of equity and debt issuers based on their disclosures that explicitly or implicitly offer sustainability metrics and information that help determine ESG scores.

ESG index providers. Several providers are also index providers, such as MSCI, FTSE Russell, Bloomberg, Thomson Reuters, Vigeo Eiris, etc. The use of such indices is growing rapidly as means to track relative performance of various ESG tilted market portfolios, from which institutional investors can benchmark performance. By virtue of their growing use as benchmarks for ESG investing, the ways in which indices are created, including exclusion, extent of tilting portfolios toward issuers with higher ESG scores, and other forms such as thematic indices (e.g. high "S" issuers), is currently highly influential in guiding overall ESG portfolio management.

ESG users: asset managers, institutional investors, and public authorities. The users of ESG ratings and information include, at the very least, types of investors across private and public entities. While many of these investor types also perform their own due diligence and forms of ESG integration, the use of externa scores often forms a part of their overall assessment.

Asset managers / investment funds create segregated portfolios, and investment products such as investment funds and ETFs, are using ESG ratings and information to derive their own ratings, to make portfolio composition decisions.

Institutional investors (e.g. insurance companies and pension funds) may incorporate ESG ratings for portfolio management, and to align with their fiduciary duty to incorporate forward-looking material information in their investment process.

Public sector institutions, including central banks and public debt issuers, have begun to consider the importance and need for ESG integration. A key reason is that central bank reserve managers increasingly seek long-term financial sustainability of their portfolios, and are striving to assess climate transition risks and the market impact of investors' shift toward lower carbon-intense industries.

Oversight authorities, such as markets regulators, and insurance and pensions supervisors, are increasing engaged in assessing ESG taxonomies and disclosure. While over 60% of market regulators state that their regulatory mandates do not include any specific references to ESG matters, many of them consider that ESG issues are relevant to their work. This is because ESG market products can affect investor protection and financial stability, and more than half of securities regulators are responsible for the registration and authorisation of investment firms that provide ESG financial products.

/5 Funding Opportunities

There are different funding opportunities on which the contemplated Fund can rely on to attract funding/investments, at the European and national level. There are some notable sectors in which we identify that significant grants are provided.

At the EU level, there are a series of funding opportunities for Small and Medium Enterprises (SMEs). In this regard, the European Commission has also pledged to propose legislation to support the financing of certain economic activities mainly in the energy sector, that help to reduce greenhouse gas emissions. The European Commission has also asked the EBA for an opinion on the definition of and support for green loans and mortgages, explore options to facilitate their uptake by 2022, and increase access of citizens and SMEs to sustainable finance advisory services. Depending on the corporate structure and expertise of an ESG fund, as well as the envisaged project and requirements set out therein for the granting of funding, it can be possible to access such funding via investing in an intermediary company to which the funding has been granted or access the funding in its own right.

Substantial grants are also provided via the Horizon Europe funding programme, which extends through the period of 2021 – 2027, with a total budget of €95,5 billion. Horizon Europe targets the sectors of research and innovation more generally and covers multiple thematic categories. These include the sectors of culture, energy, environment and climate change, health, Information Technology (IT), natural and cultural heritage, public administration, regional development, SMEs and competitiveness, space, telecommunications, transport, urban development, management of water resources, research, technological development and innovation.

Other funding opportunities are also available at the national level. As an example, the Cyprus Research & Innovation Foundation (RIF), the national authority in charge of supporting and pr omoting research, technological development and innovation in Cyprus, currently offers funding opportunities on "Green Transition", and invites participation from a number of stakeholders, depending on the specific opportunity.

/6 Value Opportunities

- There are a number of benefits which can flow from the establishment of an ESG fund. A strengthened approach to ESG investing and sustainable finance can facilitate access to growing sectors and new expansion opportunities in sectors in which it also operates.
- Can attract a larger and more diverse investors-base, leverage on a good social and market profile by attracting socially conscious employees and strengthening a fund's and AIFM's brand (and that of other stakeholders and/or service providers).
- Strategically placed in a better position to access financing which is increasingly allocated to projects which are "green" and/or "innovative".
- Can leverage on investments which will likely produce larger profits in the long-run, as regulation and policymaking rapidly shifts towards sustainable finance and the combatting of the effects of global warming.
- Guards against risks, especially reputational whereby investments are made in sectors which have harmful effects on the environment and supervisory fines for non-compliance with reporting obligations on ESG obligations, which disclosure and reporting obligations have been increasing in recent years.
- Risk-monitoring will increasingly and inevitably need to take into account ESG factors, as the prevalence of environmental and social risk in particular will affect the risks associated with individual investments.

/7 Concerns to Take Into Account

There are concerns which also need to be considered and combatted:

- A suitable balance must be maintained between promoting sustainability and achieving returns for investors. The latter remains the most important proposition for the majority of investors. As such, an attractive return for investors must be achieved within the parameters which comply with a fund's ESG policies.
- The ESG policies must provide transparency and be meaningful. Otherwise, the reputational benefits that would otherwise ensue may instead lead to adverse media and allegations of greenwashing.

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