KPMG

Investment Fund Directors

Webinar Series

Your Partner For What's Next

Investment Fund Directors

Webinar Series:

Wednesday 11 November, 2pm
Taxation & Regulation

Wednesday 18 November, 2 pm
ESG & Valuation

Tuesday 24 November, 2pm
Accounting & Auditing

Speakers

Moderator

Jorge Revilla
Head of Asset Management ESG
Head of Valuations

t: +353 1 410 2776
m: +353 87 744 2776
e: jorge.revilla@kpmg.ie

Panellists

Conor Holland
ESG Asset Management
Director

t: +353 1 700 4335
m: +353 87 050 4335
e: conor.holland@kpmg.ie

Francisco Jimenez
Financial Instruments
Director

t: +353 1 700 4092
m: +353 87 050 4092
e: francisco.jimenez@kpmg.ie

Contents slide

ESG Update

Conor Holland

Director
ESG Asset Management

ESG Trends….

In 2019 Ireland became the world's first country to divest from fossil fuels from our national investment fund.

Research shows that there is an propensity amongst millennials to invest responsibly

71%

of CEOs feel it is their personal **responsibility** to ensure that the organization's environmental, social and governance (ESG) policies reflect **the values of their customers**

55%

of CEOs believe that their organizations **must look beyond purely financial growth** if we are to achieve long-term, sustainable success

#1

Climate Change and Environmental risks considered by global CEOs **number one risk factor**.

$90tn

Cost of investment needed by 2030 to meet the goal of limiting the global temperature increase to 1.5 °C (2.7 °F)

76%

of global CEOs recently interviewed by KPMG say that their organisation's growth will depend on their ability to navigate the shift to **a low-carbon, clean- technology economy**

81%

of millennial millionaires want to know more about responsible investing

$82tn

AUM of PRI signatories at end 2019 (40% of global equities & bonds)

2x

Millennials are twice as likely as older generations to **want their pension to be invested responsibly**

Does COVID-19 de-prioritise this? …

'Social' and 'Governance' are dialled up – businesses will be judged on how they behaved in the crisis

'Environmental' has not gone away…

COVID has been a case study for radical scenario planning to inform the exit strategy

Fundamental transformation provides opportunity to drive changes which are harder in steady state

The **new model** must reflect:

- **Regulatory** Requirements
- **Financial** Risk
- Transition to **Low Carbon**
- **Investor** preference and **ratings**

Reaction
Responding to immediate challenges

Resilience
Managing through uncertainty

Recover
Resetting and identifying opportunities

New Reality
Adapting to a new world

Where do ESG risks stand globally?

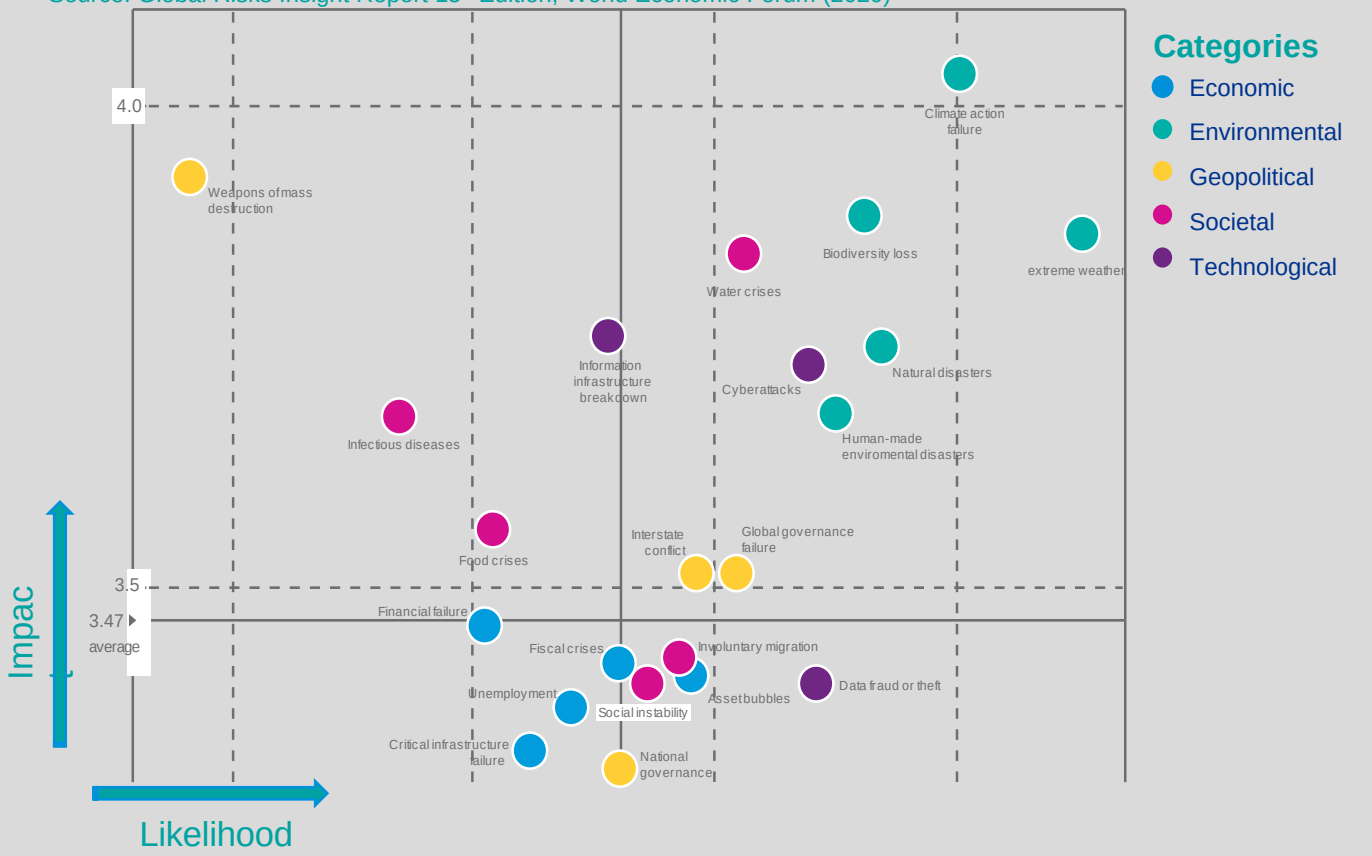
The World Economic Forum identifies the topic Global risks in terms of likelihood and impact as:

- Climate action failure
- Biodiversity loss
- Extreme weather
- Water crisis
- Natural disaster
- Cyber-attacks
- Human-made environmental disasters (pollution)
- Global governance failure
- Interstate conflict
- Involuntary migration

However, many of the environmental risks continue to represent the dominant global risk factors — hence the strong focus on the 'E' of ESG

Global Risks Landscape 2020

Source: Global Risks Insight Report 15th Edition, World Economic Forum (2020)



Tackling Climate Change is now at the core of EU policy

Policy Drivers

- Climate science
- Paris Agreement
- UN 2030 Agenda for Sustainable Development

Action Plan on Sustainable Finance

1) Re-orient capital flows through sustainable investments
2) Mainstreaming sustainability risk into risk management
3) Foster transparency and long-termism in markets

Globally or Asia

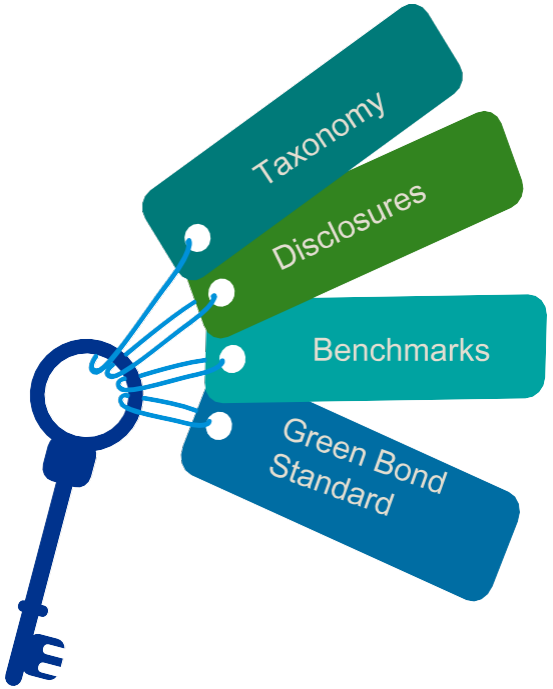
?

Coalition of the willing, gathering Central Banks and Supervisors, working on climate and green finance issues

ESMA EIOPA EBA

EU Action Plan on Sustainable Finance

Key challenges	Actions
No common definition of “sustainable investment”	EU classification (taxonomy) for sustainable activities
Risk of “greenwashing” of investment products	Standards and labels for ‘green’ financial products give investors certainty
Banks and insurers often give insufficient consideration to climate and environmental risks	Study if capital requirements should reflect exposure to climate change and environmental risks
Investors often disregard sustainability factors or underestimate their impact	Clarify institutional investor duties to consider sustainable finance when allocating assets
Too little information on corporate sustainability-related activities	Enhancing non-financial information disclosure



EU Action Plan at a glance

1.

Regulation creating “green” classification system for economic activities (“Taxonomy Regulation”)

2.

Regulation on disclosures relating to sustainable investments and sustainability risks (”Disclosures Regulation”)

3.

New low-carbon benchmark indices (via amendment to Benchmarks Regulation)

4.

Integration of sustainability in risk management, organisational requirements, operating conditions and target market assessments

5.

Better advice to clients on sustainability

The Disclosures Regulation

Disclosures Regulation

- The **Disclosures Regulation** requires AIFMs and UCITS management companies (amongst others, but for the purposes of these slides, we focus on investment funds and their managers) to consider and disclose in a consistent and harmonised manner how ESG factors are adopted in their decision making processes. It aims to harmonise disclosure standards among EU member states to facilitate the comparability of different financial products and services. **Many of the provisions of the Disclosures Regulation apply to all asset managers, whether or not they have an express ESG or sustainability focus.** The Disclosures Regulation applies different requirements and implementation timeframes in respect of disclosures on websites, in prospectuses and in periodic reports.

When will the Disclosures Regulation apply?

- The main provisions of the Disclosures Regulation apply from **10 March 2021**. The requirements relating to disclosures in the **periodic reports of ESG- focused** products are stated to apply from **1 January 2022**, which would appear to suggest that reports published after that date (as opposed to reports relating to periods starting on or after that date) should include the required disclosures, but this may be clarified in the technical standards.

Disclosures Regulation

Disclosure Obligations Applicable to All Funds

Website	What's required?
Sustainability risk policies	Information about their policies on the integration of sustainability risks in the investment decision-making process.
Adverse sustainability impacts	Publish and maintain on website: • a statement on due diligence policies regarding the principal adverse impacts of investment decisions on sustainability factors; or • clear reasons why they do not consider the adverse impacts of investment decisions on sustainability factors.*
Remuneration policies	Include in remuneration policies information on how those policies are consistent with the integration of sustainability risks and publish this information on website.

Prospectus Disclosures

Sustainability risks and sustainable investments	Firms must disclose: • the manner in which sustainability risks are integrated into their investment decisions; • the results of assessments of the likely impacts of sustainability risks on the returns of the financial products they make available; and • where the manager considers principal adverse impacts of investment decisions on sustainability factors, whether, and if so how, each financial product considers principal adverse impacts on sustainability factors.**

Marketing communications must not contradict any information disclosed under the Disclosures Regulation.

* From 30 June 2021, financial market participants with more than 500 employees or which are parent undertakings of large groups with more than 500 employees must publish and maintain on their websites a statement of their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors.

** This requirement applies from 30 December 2022.

Disclosures Regulation

Additional Disclosure Requirements for Expressly ESG Focused Products	
Products promoting environmental and social characteristics	**Prospectus** should disclose: ▪ **information on how those characteristics are met**; ▪ where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics; and ▪ information as to where the methodology used for the calculation of the reference index can be found.
Products that have sustainable investment as their objective	Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the following will need to be included in the prospectus: ▪ information on how the designated index is aligned with the objective; ▪ an explanation as to why and how the designated index aligned with that objective differs to a broad market index; and ▪ information as to where the methodology used for the calculation of the reference index can be found. Where no index has been designated, pre-contractual disclosures will include an explanation of how the sustainable investment objective is to be attained.
Products promoting environmental and social characteristics and products that have sustainable investment as their objective	**Website to provide** the following information: ▪ a description of the environmental or social characteristics or the sustainable investment objective; ▪ **information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets**; and ▪ the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product. **Periodic reports to include the following information** ▪ the extent to which environmental and social characteristics are met; ▪ the impact of sustainable investments by means of relevant sustainability indicators; and ▪ where an index has been designated as a reference benchmark, a comparison will be needed between the overall sustainability-related impact of the financial product with the impacts of the designated index and of a broad market index through sustainability indicators.

The Taxonomy Regulation

Proposal

- The proposal to create a sustainability taxonomy was devised to provide market clarity on what economic activities should be considered "sustainable".
- The Taxonomy Regulation aims to develop a taxonomy for climate change and environmentally sustainable activities so that the classification system can be used with respect to labels, standards and benchmarks recognising compliance with environmental standards across the EU.
- Importantly, the Taxonomy Regulation does not establish a label for sustainable financial products. It sets out criteria for determining if an activity (not a company or asset) is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives.

Scope

- The Taxonomy Regulation applies to a broad range of financial market participants, defined to include AIFMs, UCITS management companies, and financial products (including AIFs and UCITS).
- For the most part, the Taxonomy Regulation will be relevant to asset managers who make available a financial product, such as an investment fund, which either: (a) has an objective of environmentally sustainable investment; or (b) "promotes environmental characteristics". However, even managers of out-of-scope financial products will need to make the negative disclosure set out overleaf confirming that the product is out of scope of the regulation.

When will the Taxonomy Regulation apply?

- Political agreement on the Taxonomy Regulation was reached in December 2019 and the agreed text was published on 18 December 2019.
- The Taxonomy Regulation will apply, with respect to activities that substantially contribute to **climate change mitigation and adaptation, by 1 January 2022.** The regulation will apply with respect to activities that substantially contribute to the **other environmental objectives by 1 January 2023.**

The Taxonomy Regulation

Interaction with the Disclosures Regulation

- The Taxonomy Regulation is closely linked to the Disclosures Regulation. While the Taxonomy Regulation provides a common language for firms and investors to identify which economic activities are "**environmentally sustainable**", it also includes supplemental disclosure obligations to those set out in the Disclosures Regulation.

What additional disclosures are required by the Taxonomy Regulation?

- Where a financial product has "**sustainable investment**" as its objective within the meaning of the Disclosures Regulation, the information to be disclosed in the prospectus and annual report must include:
  - information on the environmental objective or environmental objectives to which the investment underlying the financial product contributes; and
  - a description of how and to what extent the investments underlying the financial product are invested in environmentally sustainable activities. This description must specify the share of investments in environmentally sustainable economic activities, including details on the respective proportions of enabling and transition activities, as a percentage of all investments underlying the financial product.

Where a financial product "**promotes environmental characteristics**", the prospectus and annual report should include the following statement: "*The "do no significant harm" principle is applied only for the investments underlying the product that take into account the EU criteria for environmentally sustainable investments. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable investments."*

Where a financial product is not: (a) a financial product with sustainable investment as its objective; or (b) a financial product that promotes, among other characteristics, environmental or social characteristics within the meaning of the Disclosures Regulation, the prospectus and annual return must include this statement:

"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments."

FMPs are defined in Article 2(1) Disclosure Regulation

Uses and Users of the Taxonomy		
	Disclosure Obligations	**Optional Additional Uses**

Asset Management	▪ UCITS Funds:
	  ▪ Equity funds
	  ▪ Exchange-traded funds ("**ETFs**")
	  ▪ Bond funds
	▪ Alternative Investment Funds ("AIFs"):
	  ▪ Fund of funds
	  ▪ Real estate funds
	  ▪ Private equity or SME loan funds
	  ▪ Venture capital funds
	  ▪ Infrastructure funds
	▪ Portfolio management	

Insurance	▪ Insurance-based investment products ("IBIP") ▪ Institution for occupational retirement provision ("IORP")	▪ Insurance (selected non-life LOBs)
Corporate & Investment Banking	▪ Securitisation funds* ▪ Venture capital and private equity funds ▪ Portfolio Management ▪ Indices funds	▪ Securitisation ▪ Venture capital and private equity ▪ Indices ▪ Project finance and corporate financing
Retail Banking		▪ Mortgages ▪ Commercial building loans ▪ Car loans, Home equity loans

Update from the European commission - October 2020

Letter from the European Commission dated 20 October 2020 to EBA, EIOPA and ESMA

These bodies were charged with developing draft regulatory technical standards (RTS) by 30 December 2020 in advance of SFDR coming into force on 10 March 2021

Letter acknowledges that the unprecedented economic and market stress caused by Covid-19 necessitated an extension of the deadline for public consultation on the draft RTS

However, it also states the "*in terms of substance, the application of the Regulation is not conditional on the formal adoption and entry into force or application principles of sustainability-related disclosures in three distinct areas.*"

So what does this mean?

What needs to be done by March 2021?

SFDR Level 1 Provision	Applicable as at 10 March 2021	Scope of SFDR requirement
Article 3- Transparency of Sustainable risk policies WEBSITE	✓	Financial market participants shall publish information on policies on the integration of sustainability risks in the investment decision-making process.
Article 4- principal adverse sustainability impact ("PASI") statement WEBSITE	✓	Where principal adverse impacts of investment decisions are considered a financial market participant shall inter alla, publish on its website, (i) description of the principal adverse sustainability impacts (ii) a statement on its sue diligence in relation to PASI and (iii) a brief summary of engagement policies. Compliance is on a "comply or explain" basis.
Article 5- Renumeration Policies: the integration of sustainability risks WEBSITE.	✓	The renumeration policies of the financial market participant must contain information on how renumeration policies are consistent with the integration of sustainability risks.
Article 10- Transparency on websites. WEBSITE	✓	Financial market participants shall publish and maintain on their websites the following information: A list of each Article 8 Fund together with the information referenced above in respect of Article 8 fund: A list of each Article 9 Fund together with the information referenced in respect that Article 9 Fund: Information on the methodologies used to assess, measure and monitor the E or S characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the E or S characteristics or the overall sustainable impact of the financial product.

What needs to be done by March 2021?

SFDR Level 1 Provision	Applicable as at 10 March 2021	Scope of SFDR requirement
Article6- The integration of sustainability risks in pre-contractual disclosures	✓	Description of the manner in which sustainability risks are integrated in investment decisions in respect of financial market participants. Assessment of likely impact on the returns of the financial products. Compliance is on a “comply or explain” basis.
Article 8- Funds which promote E&S characteristics (“Article 8 Fund”)	✓	For Article 8 Funds, the financial market participant must disclose information consistent with: How the environmental € and social (S) characteristics are met: If an index is used, information on whether the index used is consistent with the E or S characteristics: and Inclusion of disclosure consistent with Article 6 above.
Article 9 – Funds with sustainable objective (“Article 9 Fund”)	✓	For Article 9 Funds, the financial market participant/financial adviser must disclose information consistent with: Where an index has been designated as a reference benchmark (a) how that designated index is aligned to the objective: and (b) an why the designated index is aligned with that objective differs from a broad market index. Where no index has been designated as a reference benchmark an explanation on how the sustainable investment objective is to obtained. For an Article 9 Fund with a reduction in carbon emissions as it’s objective the financial market participant/financial adviser must include information how low carbon emission exposure in view of achieving the long term global warming objectives of the Paris Agreement.

What needs to be done by March 2021?

SFDR Level 1 Provision	Applicable as at 10 March 2021	Scope of SFDR requirement
Article 7-Disclosure of the PASI at financial product level	✗	Article 7 does not apply until 30 December 2022- i.e. the first full year of application of SFDR.
Article 11-Transparency in Periodic Reports	✗	Obligations in 11(1)-11(3) will not apply until 1 January 2022, being the first full year after implementation of the SFDR.
Article 12-Review of disclosures	✗	Obligation to keep the website disclosures required by Article 3, Article 5 and Article 10 up to date.
Article 13-Marketing communications	✗	Imposing obligations on financial market participants and financial advisors to ensure that their marketing materials do not contradict the information disclosed pursuant to SFDR.

- In practice the delay of the regulatory technical standards may require scope firms to adopt a two step compliance.

Challenges & developments for EU Corporates

Adequacy of disclosures by Investee Undertakings

- One of the potential challenges identified by industry in relation to the fulfilment of the Action Plan's objectives is the lack of reliable and comparable ESG data from investee companies.

- The Taxonomy Regulation includes provisions regarding the transparency of undertakings that come within the scope of the Non-Financial Reporting Directive ("NFRD"), which would require large companies (public interest entities with more than 500 employees) and parent undertakings of large groups with more than 500 employees subject to the EU Accounting Directive (Directive 2013/34/EU) to include in their non- financial statement, or consolidated non-financial statement, information on how and to what extent the company's activities are associated with environmentally sustainable economic activities.

- The Commission will publish the detailed disclosure requirements by **1 June 2021** and the **requirements will apply from 30 June 2021.**

Considerations for Valuation

Francisco Jimenez

Director
Financial Instruments

Current Market Developments

Decrease in Market Liquidity

Decrease in number of price quotations
Loss in consistency across established pricing services.
Increased Bid/Offer spreads
Widening of Bond/CDS-spread basis and CCP basis (EUR and JPY swaps)

Increase of Market Volatility & Uncertainty in Dividends Projections

Market volatility reached levels of the global financial crisis 2008. Interest rate implied volatilities have spiked
Companies postpone or cancel dividend payments

Increase in Credit Risk

Credit spreads for investment grade and non investment grade entities increased on average by 40 and 340 bps respectively.
Structured finance assets' and leveraged loans discount spreads have doubled and tripled

Impacted Markets

- Fixed Income
- Interest Rate
- FX
- Credit

- Fixed Income
- Interest Rate
- FX &Equity
- Credit

- Fixed Income
- Credit

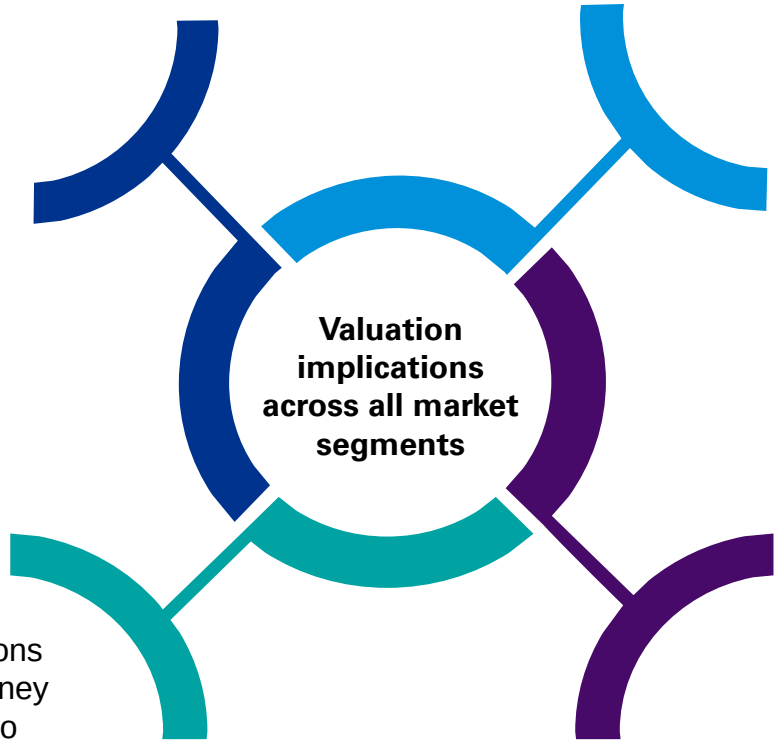
Growing Valuation Challenges

Fixed Income

- Determining a robust fair value due to deteriorating external price quality
- Tendency towards model based valuation and maintaining of consistency
- Rising uncertainty and implications on the prices for structured finance assets (e.g. CLOs)

Interest Rate

- Model stress due to low interest rates levels and high volatilities
- One sided exposure leading to unobservable inputs (option volatilities)
- Challenges in curve construction processes and increasing importance of multicurve valuation



FX and Equity

- Increased valuation uncertainty due to options shifting deep in the money or out of the money
- Model stress especially on calibration due to volatility levels
- High divergence in dividend projections
- Snapshot valuations requiring closer monitoring due to high intraday movements

Credit

- Decline in quotes for CDS compared to December leading to deteriorating observability of inputs.
- Impact on valuation adjustments (CVA/DVA) and increasing wrong way risk.
- Maintaining hedge ineffectiveness

Expected Fair Value Hierarchy Movements

- **Reduction in market observability of valuation parameters (e.g. volatility)**
- **Decrease in the number of market quotes and increase in price dispersions among them**
- **Decrease in collateral quality and cash diversion triggers impacting the sensitivity of CLO prices towards unobservable inputs**
- **The transition from mark-to-market to mark-to-model approach will impact the levelling of the investments**
- **High volatility levels and low interest rates can cause higher model uncertainty**

SEC's New Valuation Practice Framework

On 21 April 2020, the Securities and Exchange Commission (SEC) voted to propose a new Rule 2a-5 under the Investment Company Act of 1940 establishing a framework for funds' fair value determinations (Proposed Rule). The public comment period will remain open until July 21, 2020.

Determining Fair Value in Good Faith 1

Who Performs Fair Value Determinations? 2

Determining Fair Value in Good Faith

1. Periodically assessing and managing material risks associated with fair value determinations, including material conflicts of interest
2. Selecting, applying and testing fair value methodologies
3. Overseeing and evaluating any pricing services used
4. Adopting and implementing written policies and procedures addressing fair value determination and maintaining certain records

(Source: https://www.sec.gov/news/press-release/2020-93)

Who Performs Fair Value Determinations?

The proposed rule would permit a board to assign the determination to the fund's investment adviser, subject to additional conditions and oversight requirements.

1	Board oversight of the adviser
2	Periodic and prompt reporting
3	Clear specification of responsibilities and reasonable segregation of duties among the adviser's personnel
4	Keeping additional records relevant to the assignment for the adviser

(Source: https://www.sec.gov/news/press-release/2020-93)

IBOR Reform Updates

Monitoring the current situation
The FCA, Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates have discussed the impact of the coronavirus on firms' LIBOR transition plans over the coming months.

Key Takeaway
Firms cannot rely on LIBOR being published after the end of 2021. This assumption has not changed in this current unprecedented situation and many preparations for the transitions will be able to continue.

COVID-19 impact
COVID-19 has however impacted the timeline of the transition for many firms. Some sectors like the loan market in the UK are still reliant on LIBOR and transition saw less progress.

Continued Progress on Transition
Current market instabilities present a challenge to the transition away from LIBOR, however, continued progress on the transition was recognized.

Transition Progress 2020

- The FASB issues an Accounting Standards Update that provides temporary optional guidance to ease the potential burden in accounting for the reference rate reform.
- New York Fed publishing 30-, 90- and 180-day SOFR averages as well as a SOFR Index
- LCH and CME switches to SOFR discounting and LCH and Eurex switches discounting from EONIA to €STR for cleared trades
- The Alternative Reference Rate Committee (ARRC) releases updated recommended hardwired fallback language for syndicated loans, new bilateral business loans, and use of SOFR for new student loans
- International Swaps and Derivatives Association (ISDA) launches the IBOR Fallbacks Supplement and IBOR Fallbacks Protocol
- The International Accounting Standards Board (IASB) publishes 'Interest Rate Benchmark Reform — Phase 2' with amendments that address issues that might affect financial reporting after the reform of an interest rate benchmark.

Questions & Answers

Speakers

Moderator

Jorge Revilla
Head of Asset Management ESG
Head of Valuations

t: +353 1 410 2776
m: +353 87 744 2776
e: jorge.revilla@kpmg.ie

Panellists

Conor Holland
ESG Asset Management
Director

t: +353 1 700 4335
m: +353 87 050 4335
e: conor.holland@kpmg.ie

Francisco Jimenez
Financial Instruments
Director

t: +353 1 700 4092
m: +353 87 050 4092
e: francisco.jimenez@kpmg.ie

kpmg.ie

Produced by: KPMG’s Creative Services. Publication Date: Nov 2020.