CONSULTATION ON ESTABLISHING POLICY INCENTIVES FOR SUSTAINABLE FINANCE INSTRUMENTS (SFIs)

FinanceMalta

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Overview

This White Paper seeks to widen the process of consultation on how a policy incentive package for Sustainable Finance Instruments in Malta is best achieved. The primary objectives of this paper are to:

1. Explain and give an overview of Sustainable Finance Instruments;
2. Explain the benefits of introducing incentives in this space; and
3. Propose three kinds of incentives that would preferably be introduced concurrently to enhance the issuance and take-up of Sustainable Finance Instruments (SFIs).

How to Respond

Over the past months, various stakeholders were approached and their views are included in this document. Nonetheless, further feedback may be sent to FinanceMalta via email on: **sficonsultation@financemalta.org**

Feedback may be submitted **by not later than 31st January 2024.**

DISCLOSURE UNDER THE FREEDOM OF INFORMATION ACT (CHAPTER 496)

As we are a public authority all documents we hold, including documents related to this public consultation process, may be released following a request to us under the Freedom of Information Act (Chapter. 496), unless such request may be subject of an exemption arising from the same Act.

Chapter 1

INTRODUCTION

The sustainable finance market has grown rapidly over the past years, and both market participants and national authorities are increasingly recognizing the importance of sustainable finance instruments in conveying capital to address climate change and support other Sustainable Development Goals (SDGs).

Many firms and Small and Medium Size Enterprises (SMEs) continue to face important challenges in accessing the growing yet relatively small sustainable finance market. And even where these instruments are available and accessible, developing countries and SMEs are challenged with high financing costs. Looking into these gaps will be instrumental in achieving the Paris Agreement and 2030 Agenda goals.

Introducing policy incentives such as guaranteed co-lending schemes, interest rate subsidies, and fiscal subsidies for sustainable activities, is crucial. In this regard, FinanceMalta, a public-private partnership, has been requested to develop this White Paper. Consultation with stakeholders including the MFSAC Capital Markets and Sustainable Finance Working Groups, leading officials from the Ministry for Finance and Employment, the Ministry for the Economy, European Funds and Lands, the Malta Development Bank, representatives from the Opposition, and the Commissioner for Revenue has already taken place. This White Paper now serves to open up the consultation to financial services industry leaders and other stakeholders.

What are Sustainable Finance Instruments (SFIs)?

The term "sustainable finance" is generally used to refer to a range of financial products connected to ESG-related aims, which include green, social, sustainable and sustainability-linked financial products. The International Capital Markets Association has defined such terms in its Guidance Handbook (2023) as follows:

a. **Green Bonds** are any type of bond instrument where the proceeds - or an amount equal to the net proceeds - will be exclusively applied to finance or re-finance projects with clear environmental benefits and which are aligned with the Core Components of the **Green Bond Principles (GBP)**. Eligible Green Project categories include (but are not limited to): renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, terrestrial and aquatic biodiversity conservation, clean transportation, sustainable water and wastewater management, climate change adaptation, circular economy and/or ecoefficient projects, and green buildings.

b. **Social Bonds** are any type of bond instrument where the proceeds - or an amount equal to the net proceeds - will be exclusively applied to finance projects that directly aim to address or mitigate a specific social issue and/or seek to achieve positive social outcomes, especially but not exclusively for a target population(s) and are aligned with the Core Components of the **Social Bond Principles** (SBP). Social Project categories include (but are not limited to): providing and/or promoting, affordable basic infrastructure, access to essential services, affordable housing, employment generation, food security, and socioeconomic advancement and empowerment.

https://sdgfinance.undp.org/news/scaling-sustainable-finance-instruments-focus-accessibility-and-affordability-improvement

c. **Sustainability Bonds** are any type of bond instrument where the proceeds - or an amount equal to the net proceeds - will be exclusively applied to finance or re-finance a combination of Green and Social Projects and which are aligned with the Core Components of the GBP and SBP.

d. **Sustainability-Linked Bonds** are any type of bond instrument for which the financial and/or structural characteristics (e.g. coupon, maturity, repayment amount) can vary depending on whether the issuer achieves predefined Sustainability/Environmental and/or Social and/or Governance (ESG) objectives within a predefined timeline, and which are aligned with the Core Components on the SLBP. While the proceeds of Sustainability-Linked Bonds are typically designated for general corporate purposes, (or for general budgetary needs for sovereign SLBs) it is possible to combine a "use of proceeds" approach with a Sustainability-Linked Bond approach, if an issuer chooses to earmark the proceeds of their sustainability-linked bond to specific projects, and where these are eligible green and/or social projects, by aligning their bonds simultaneously with all the Core Components of the GBP/SBP/**Sustainability Bond Guidelines** and the **Sustainability-Linked Bond Principles.**

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CONTEXT ANALYSIS

Why Incentivise Sustainable Finance Instruments (SFIs)?

SFIs are designed to raise capital for projects and activities with environmental benefits. Here are some key reasons why incentivizing SFIs is valuable:

Environmental Conservation: SFIs are a means to finance projects that aim to mitigate climate change, protect natural resources, and promote sustainability. By incentivizing these instruments, governments and organizations can encourage investment in environmentally beneficial projects, such as renewable energy, energy efficiency, water conservation, clean transportation, and ecosystem conservation.

Climate Change Mitigation: One of the most pressing global challenges is climate change. SFIs provide a channel for financing projects that reduce greenhouse gas emissions and help transition to a low-carbon economy. Incentives for SFIs can accelerate these efforts and support Malta in meeting its climate goals, such as those outlined in the Paris Agreement and the EU.

Sustainable Development: SFIs align with the United Nations' Sustainable Development Goals (SDGs), which include objectives like clean energy, clean water, and responsible consumption and production. By incentivizing SFIs, our government can support progress toward these goals, fostering a more sustainable and equitable future

Economic Growth: SFIs can stimulate economic growth by creating jobs and driving investment in green industries. Incentives for SFIs can attract investors, including institutional investors, to participate in green projects, which can spur economic development and innovation in clean technologies.

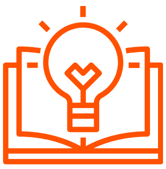
Risk Mitigation: Investing in green projects can reduce the long-term environmental and climate risks associated with traditional, resource-intensive industries. Incentives for SFIs can help organizations manage these risks, making the financial sector more resilient.

Access to Capital: Many sustainable projects, such as renewable energy installations, may require substantial upfront capital investment. SFIs provide an avenue for governments, corporations, and institutions to access the necessary funding. Incentives can make these financial instruments more attractive to issuers and investors, potentially lowering borrowing costs.

Investor Demand: An increasing number of investors are incorporating ESG considerations into their investment strategies. By incentivizing SFIs, government can cater to this growing demand and encourage investors to allocate capital towards projects with strong ESG credentials.

Reputation and Branding: Issuing SFIs can enhance Malta's as well as the organization's reputation and demonstrate a commitment to environmental responsibility. Incentives for SFIs can further encourage organizations to engage in sustainable practices, which can positively impact their brand image.

Regulatory Compliance: By issuing SFIs, companies can demonstrate their commitment to sustainability and meet regulatory requirements.



Education and Awareness: Incentivizing SFIs can also raise awareness about the importance of environmentally friendly investments. It can educate the public and financial sector about the value of sustainable finance and encourage more responsible investment decisions.

The Local Context

The experience with the first Green Bond Issue in Malta makes it very clear that without effective policy intervention, Malta will not manage to concretise any momentum on the Green Bond or a wider SFI market.

Malta's first green bond issued by Clearflowplus p.l.c., a subsidiary of WSC Group, would not have been successful had it not been for its guarantee (making it quasi-sovereign), and from an Issuer's perspective, it would not have been feasible had it been priced higher than 4.25% per annum. Corporate Issuers are currently looking at interest rates ranging from 5.5% to 7%. ESG initiatives are, in their vast majority, not feasible at these interest rates.

The increasing interest rate scenario that we are already experiencing, and which is expected to continue for the foreseeable future, is not going to make the launch of SFIs any easier.

Many foreign jurisdictions have introduced various incentives to support SFIs. However, the most attractive incentives for government are tax incentives as they can provide a boost to investment in SFIs with low impact on public finances.

Essentially, such incentives can be classified in one of the following forms:

1. Tax credit instruments - investors receive tax credits instead of interest payments, so issuers do not pay coupon interests and instead accrue phantom taxable income and tax credits.

2. Direct subsidy instruments - issuers receive cash rebates from the government to subsidise their net interest payments.

3. Tax-exempt instruments - investors do not have to pay income tax on interest from the SFIs they hold. Hence, the Issuer would afford to offer a lower interest rate.

PROPOSAL

The proposed incentive package for Sustainable Finance Instruments in Malta would include the following features:

3.1 **A Guaranteed scheme providing a guarantee for a significant portion of the borrowed amount;**

3.2 **An EU-funded interest rate subsidy; and**

3.3 **The lowering of final withholding tax on SFI interest payable.**

3.1 A Guaranteed scheme providing a guarantee for a significant portion of the borrowed amount

It is hereby being proposed that the existing instruments are extended to this scheme to support the issuance of SFIs on the local stock exchange. In summary, SFIs will have to follow the normal issuance procedure as prescribed by the MFSA and the MSE. **In the case of Green Bonds, such procedures are prescribed by the Green Bond Bye Laws of the Malta Stock Exchange, which regulates the Issuers further and expects that an independent external accredited reviewer certifies that the Issuer is abiding by strict ESG rules.** It is being proposed that a guarantee covering a portion of the indebtedness is offered to Issuers of these instruments.

3.2 EU-funded interest rate subsidy

To further incentivise SFI Issues it is being proposed that funds available under European Regional Development Fund, Cohesion Fund, and Just Transition Fund are allocated to issue an interest rate subsidy to Issuers of SFIs.

The projects that fall within the scope of SFIs are eligible for the interventions that the Authorities have listed as priority projects in its National Programme.

This incentive is widely resorted to in a number of foreign jurisdictions. It is highly effective because of the multiplier effect that it creates, as shown in the table below:

Term of the Bond	Interest Rate Subsidy	Annual Cost Over the entire term (€m)	Total funding supported (€m)	Multiplier
5 years	1%	5	100	1:20
5 years	2%	10	100	1:10
5 years	3%	15	100	1:6.7
7 years	1%	7	100	1:14.3
7 years	2%	14	100	1:7.1
7 years	3%	21	100	1:4.8
10 years	1%	10	100	1:10
10 years	2%	20	100	1:5
10 years	2.5%	25	100	1:4

3.3 Reduction in Final Withholding Tax on SFI Interest

Most SFI holders elect to be charged at the rate of 15% Final Withholding Tax on interest they earn from their investment portfolio. However, residents have the option to request the payment of investment income without withholding tax, in which case they will be required to report it in their tax return and will be liable to tax, if any, at their normal rates.

To incentivise SFIs it is being proposed to **consider reducing the tax rate**.

CONCLUSION

In the current scenario of ever-increasing interest rates, SFIs including Green Bond issues by Corporate Issuers are increasingly unfeasible.

The proposed incentives are expected to reduce the interest cost, with a view of making it an attractive proposition. It is estimated that the proposed incentives would reduce interest rates by at least 2% and at most 3.5% per annum. These are considered to be highly effective and it is believed that they could serve as a catalyst for Corporate Issuers to start seriously acting in a more sustainable manner.

This White Paper therefore calls for a consultation of the proposed SFI incentives. The recommended proposals are expected to pave the way for developing an effective SFI regime in Malta in 2024. Furthermore, the proposal offers an efficient and effective means of mobilising EU funds to unlock substantial ESG investments by Maltese businesses. This collaborative endeavour would help to address the urgent challenges posed by increasing interest rates, which could hinder ESG investments.

In essence, incentivizing Sustainable Finance Instruments (SFIs) is a multifaceted approach to address pressing environmental and sustainability challenges while also supporting economic growth and responsible investing.

By promoting these financial instruments, the government can help redirect capital toward projects that have a positive impact on Malta and our society.

Such proposals, however, need to have wide support from the key stakeholders.