Position Paper

Response to EIOPA consultation on the identification and calibration of infrastructure corporates

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Referring to:	Call for evidence concerning the request to EIOPA for further technical advice on the identification and calibration of other infrastructure investment risk categories i.e. infrastructure corporates		
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Key messages

Insurance Europe appreciates the opportunity to provide input to the EIOPA advice on infrastructure corporates and would like to thank EIOPA for organising a call for evidence. Insurance Europe welcomed the Commission's delegated act that created infrastructure as an asset class and it supports the recognition that infrastructure investments are less risky than implied by the charges for corporates under Solvency II. However, Insurance Europe also believes that the scope of the new asset class is too narrow to achieve the Commission's objectives for growth in the European Union.

Insurance Europe supports the inclusion of infrastructure corporates in the scope of the infrastructure asset class under Solvency II. The distinction between special purpose vehicles (SPVs)/limited purposes entities (LPEs) and corporate-like entities is independent of the underlying infrastructure assets, meaning that both can develop and operate the same type of infrastructure activities and meet the criteria of qualifying infrastructure. Therefore, substance over form should prevail in qualifying eligible infrastructure transactions. The following points are relevant for the investigation pursued by EIOPA:

- The infrastructure definition should not depend on the legal form, ie SPV/LPE vs traditional forms of corporates.
- Underlying infrastructure assets would not need comply with the criteria for qualifying infrastructure as adopted by the Commission.
- Much more relevant than the legal form is the protection of investors: the insurer should have senior-priority access (excluding the super senior counterparties as per the EIOPA definition) to the underlying infrastructure cash flows.
- The protection of the insurer as investor should be assessed on a case-by-case basis within the robust risk assessment and stress-test analysis required under the criteria for qualifying infrastructure.
- Eligible transactions should include situations where one single infrastructure asset or multiple infrastructure assets are financed.

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- The financing of ancillary activities should be included in the scope of eligibility provided that the following conditions are met:
  - The ancillary activities relate to a primary infrastructure activity, ie the ancillary activities would not exist without a primary infrastructure activity.
  - The ancillary activities do not materially reduce the stability, predictability and robustness of the cash-flow generation by the primary infrastructure activity.
- The proposed calibration for infrastructure project finance should also be applied to infrastructure corporates.

Responses to the questions in the consultation document

Q1: What are the reasons for choosing a corporate instead of a project structure for infrastructure investments? Are there certain sectors for which a corporate structure is more prevalent and, if so, why is this the case?

The infrastructure borrowers/debtors' universe is divided into two types of entities, LPEs or SPVs and corporate-like entities. This distinction is independent of the underlying infrastructure assets, meaning that both types can develop and operate the same infrastructure activities and meet the criteria of qualifying infrastructure. Therefore, substance over form should prevail in qualifying eligible infrastructure transactions.

Infrastructure corporates are common and well-established means of carrying out infrastructure investments. A project can often be established either as a corporate or a project entity with the same level of security for the investor. This decision is based on a range of business and capital efficiency considerations. The regulatory framework should avoid incentivising one over the other.

Therefore, the form of the company/entity in charge of operating or constructing the infrastructure assets should not be part of the definition. Depending on the jurisdiction and the maturity of the infrastructure activity, there are some infrastructure sectors for which the corporate structure is more prevalent, such as: transport, utilities, energy.

The corporate structure, as opposed to an LPE/SPV structure, is often used to operate or develop multiple infrastructure assets together rather than on a stand-alone basis. This often gives more financial capacity or is simply much easier from an operating and legal standpoint. From this perspective, eligible transactions should include situations where one single infrastructure asset or multiple infrastructure assets are financed.

Q2: What types of infrastructure corporates do you think have a more favourable risk profile than implied by their standard formula treatment?

Infrastructure entities as defined in the response to question 4 and which meet the qualifying criteria have a more favourable risk profile than implied by the standard formula treatment for traditional corporates.

As the risk profile of a traditional, non-infrastructure corporate will closely depend on underlying business activities (cyclicality, business volatility), the risk profile of an infrastructure corporate depends to a large degree on the underlying infrastructure assets.

Corporate-type structures are common in a number of sectors, including transport and energy distribution. The underlying assets ensure stable cash flows and enhanced predictability for the long term, which reflects in a better risk profile of these assets compared to traditional corporates.

The regulatory treatment should be based on substance, rather than form, to prevent distortions. Insurance Europe therefore strongly believes that projects with the same characteristics and risk profiles should be treated in the same way, irrespective of whether one is structured as project finance and another as a corporate.

Q3: With respect to the types of infrastructure corporates you listed in the previous question, please answer the following:
a. What kind of infrastructure services is provided?

See response to question 2.

b. Where is the infrastructure located?

Infrastructure can be found in all OECD countries.

c. What is the legal form?

The legal form depends on the local jurisdiction's legal framework.

d. Does the debt have a rating by an External Credit Assessment Institution?

Not all infrastructure corporates have a rating. Some countries such as the UK, Canada and Australia have many rated infrastructure bonds. Others, such as those in continental Europe, have few rated infrastructure bonds. Therefore the vast majority of the debt is not rated. Many of the projects are also too small in order to justify the cost of a rating by an ECAI.

e. What is the volume of the debt and equity instruments currently outstanding? How will these quantities evolve in the future? Why?

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f. What is the volume of investments by insurers? How will this evolve in the future? Why?

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g. Are there any other relevant properties?

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Q4: Are there definitions of infrastructure corporates in existing legislation or other sources that could be used?

Insurance Europe supports the following definitions:

- 'Infrastructure assets' mean physical structures or facilities, systems, or networks that provide or support essential public services. – This is definition 55a of the Solvency II Delegated Act, adopted by the European Commission on 30 September 2015.
- 'Infrastructure entity' means an entity that owns, finances, develops or operates infrastructure assets, where the primary source of payments to debt providers and equity investors is the income generated by such infrastructure assets being financed. – This should replace definition 55b of the Solvency II Delegated Act. Any reference to infrastructure project entity should be replaced with a reference to infrastructure entity.

Q5: Which criteria from the EIOPA advice in response to the first call for advice, or from the amendments to the delegated regulation adopted by the European Commission would the infrastructure corporates you suggested not satisfy?

- In order to avoid any ambiguity, Insurance Europe refers to the [delegated act] adopted by the Commission on 30 September. The definition 55b ("infrastructure project entity") requires that the infrastructure project entity may only engage in owning, financing, developing or operating infrastructure. Insurance Europe believes that this criterion is not needed. In the contractual framework, the criterion c) (of Q6) may be not applicable, as some infrastructure corporates may be listed. Therefore, an equity pledge granted to the debt providers may not be as relevant as for a privately held company, if at all technically possible.
- Similarly, criterion d) may be adjusted so that the infrastructure corporate may use its financial resources to pay the equity investors. The set of the covenant and cash sweep mechanism will protect the service of the debt by diverting the cash flow from the equity investors if such covenants are triggered.
- Finally, the sufficient coverage (see criterion f)) for the service of the debt may not be insured by a reserve fund *per se* in a corporate-type entity, but by the cash coming from its operating infrastructure activities.

Q6: Do you think that the criteria referred to in the previous question could be modified so that a similar outcome is achieved from a risk perspective but the infrastructure corporates you suggested would qualify? Areas of particular interest would be:

a. Predictability of cash flows
b. The privileged access of investors to cash flows or assets
c. The use of covenants
d. Restrictions on the ownership of assets
e. The use of Licensing or permitting restrictions
f. The ability of the entity to withstand relevant stress scenarios
g. Refinancing risk

See response to question 5.

Q7: For questions 5 and 6, is it relevant to make a distinction between new, compared to existing, debt and equity issued by infrastructure corporates?

No additional distinction between new or existing, debt and equity issued by infrastructure corporates is needed as long as they meet the qualifying criteria and the proper set of covenants are in place so that the lenders have senior-priority access to the underlying infrastructure asset cash flows.

Q8: Infrastructure corporates may engage in activities not or only indirectly related to the provision of infrastructure services. What would be appropriate criteria to ensure that such activities are of only limited importance or not material in relation to the payments to investors?

A comprehensive covenant package should be in place. This ensures that the risks stemming from ancillary activities are not material for the infrastructure investor:

- The ancillary activities relate to a primary infrastructure activity, ie the ancillary activities would not exist without a primary infrastructure activity.
- The ancillary activities do not materially reduce the stability, predictability and robustness of the cash flow generation by the primary infrastructure activity.

Q9: Infrastructure corporates may comprise the construction or operation of different infrastructure assets with different risk profiles. In case a "look through" approach was applied for the identification of eligible *infrastructure corporates (i.e. the properties of the underlying infrastructure assets are taken into account): What could be suitable criteria for allowing a corporate entity with some higher risk assets to be eligible provided such assets or activities are not material?*

Ancillary activities should be subject to the same standards as the core business of the infrastructure corporate, ie the stress scenarios and risk-management requirements apply.

As a general principle, the protection of the insurer as investor should be assessed on a case-by-case basis within the robust risk assessment and stress-test analysis required under the criteria for qualifying infrastructure.

Q10: In their responses to CP 15/004 some stakeholders proposed that the assets pertaining to infrastructure activities could be effectively ring-fenced. Are you able to provide further detail on such arrangements and their legal nature?

Insurance Europe agrees that there should be some kind of privileged access to the cash flows or the asset pertaining the infrastructure activity in place for investors. However, there are many ways to legally structure this privileged access and the choice will depend on the specifics of the local legal framework. Insurance Europe believes that the existing qualifying criteria for the contractual framework are sufficient with the modifications mentioned in the response to question 5.

Q11: In their responses to the CP 15/004 some stakeholders proposed that very strong internal risk assessment and modelling capacities were necessary to distinguish between infrastructure corporates and conventional corporates; what are the components of such capacities?

It is sufficient to require the investor to verify the compliance of the investment with criteria for qualifying infrastructure.

Q12: What is the empirical evidence that the infrastructure corporates you identified have a lower risk profile than suggested by their current standard formula treatment?

See response to question 13.

Q13: Regarding the Moody's study on default and recovery rates for infrastructure corporates, do you think this data represents a suitable proxy for the infrastructure investments you have identified, and if so, why?

Moody's study on infrastructure corporates is a very good starting point. The study contains evidence that infrastructure corporates perform better than other corporates. Since the infrastructure corporates study includes infrastructure project finance, there is some overlap between the data sets for the infrastructure corporates study and the data set for Moody's project finance study, which EIOPA referred to in its final advice on infrastructure published on 29 September. Insurance Europe therefore believes that the same calibration can be used for infrastructure project finance and for infrastructure corporates.

Q14: Do you think that the calibration EIOPA proposed in response to the first call for advice could be used for the infrastructure corporates you suggested? If so, please provide quantitative or qualitative evidence that the criteria you proposed would result in a similar risk profile to the eligible infrastructure investments in the EIOPA advice?

Insurance Europe notes that corporates would need to meet the qualifying criteria set out by EIOPA in order to benefit from the lower capital charges. This includes the criteria relating to the contractual framework and the predictability of cash flows, which should help to address EIOPA's concerns about the creditors' position. For example, creditors' rights should be secured through a covenants package.

Insurance Europe does not expect there to be concerns about the restriction/delineation of activities if the corporates have to meet the definition above (the business model entails the financing or operation of infrastructure assets) for the duration of the investment (whether in debt or equity). This restriction could be the result of a covenant, regulation, law, statute or another means. Indeed, it is quite common for corporates' activities to be restricted to infrastructure and ancillary activities by their contractual covenants, licensing requirements or other means. However, there is no need to require this in the prudential framework.

Q15: What is the empirical evidence for the infrastructure corporates you identified with respect to adequate correlation parameters? Can you suggest a concrete approach to derive these parameters from the data?

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Q16: Where you have referred to evidence in the form of cash flows in your previous answers, can you please provide the following:

a. a concrete proposal for how this evidence could be translated into a calibration

b. explain how EIOPA could access this evidence.

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Q17: Can you provide data on spreads for bonds issued by infrastructure corporates? Are there any indices for bonds of infrastructure corporates?

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