Position Paper

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

Our reference:	ECO-LTI-16-035	Date:	16 May 2016
Referring to:	Consultation Paper No. CP_16_005 on the request to EIOPA for further technical advice on the identification and calibration of other infrastructure investment risk categories i.e. infrastructure corporates		
Related documents:	CP-16/005		
Contact person:	Economics and Finance Department Cristina Mihai, head of investments	E-mail:	ecofin@insuranceeurope.eu mihai@insuranceeurope.eu
Pages:	9	Transparency Register ID no.:	33213703459-54

General comments

Insurance Europe welcomes the opportunity to comment on EIOPA's work to provide advice to the European Commission on the identification and calibration of infrastructure corporates in Solvency II.

As noted in the past, Insurance Europe strongly supports the inclusion of corporate structures in the scope of the infrastructure asset class under Solvency II and very much welcomed the Commission's request for advice.

Like many other stakeholders, Insurance Europe favours 1) the application of the criteria for infrastructure project finance to infrastructure corporates, with necessary modifications to the requirements for the contractual framework and 2) the extension of the capital treatment for infrastructure projects to qualifying infrastructure corporates. Where qualifying infrastructure corporates and infrastructure project entities have similar risk profiles, applying the same capital treatment is justified.

Regarding EIOPA's proposals in the current consultation, and also acknowledging that the recalibration of capital requirements is still a work in progress, Insurance Europe notes that:

- It broadly supports EIOPA's approach on the identification of infrastructure corporates as part of the infrastructure asset class in Solvency II. Insurance Europe would propose very few suggestions, aimed at better reflecting market reality in the regulatory definition.
- It has strong concerns about EIOPA's approach to the calibration of the capital requirements and would strongly argue that the capital approach of project finance should be extended to qualifying corporates.

Identification of infrastructure corporates in Solvency II

Insurance Europe welcomes the extension of the scope of qualifying infrastructure from project entities to the broader range of infrastructure corporates, as it believes that: 1) the current limitation to infrastructure project SPVs fails to capture a large part of the infrastructure universe and 2) the current calibration is based on normal

Insurance Europe aisbl
Rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

corporates, and there is proof that these are more risky than infrastructure corporates, which makes the current calibration unnecessarily conservative and punitive.

Insurance Europe therefore supports EIOPA's proposal to amend the scope of the infrastructure asset class for the infrastructure corporates with risk profiles similar to infrastructure projects by removing the restriction to SPV financing and by applying the relevant amendments to the security package requirements, while keeping unchanged the risk management.

Insurance Europe would recommend a few changes to the current proposal, including:

- Reflection of the revenues of the ancillary activities in the stress scenarios, as long as the insurance undertaking can demonstrate that the stress on the non-infrastructure cash flows is severe enough and takes into account the more volatile profile of such activities in a worst case scenario.
- Removal of the word "project" from the identification of the infrastructure assets/entity, as the assumed limited life of a "project" is not suitable for long-term infrastructure operating activities nor refinancing of such infrastructure activities.

Insurance Europe believes that EIOPA's analysis of the wide infrastructure spectrum would support follow-up work on the recalibration of infrastructure corporates that do not fulfill the definition and qualifying criteria, but that do, based on data, exhibit lower risk than other corporates. From this perspective, Insurance Europe sees value in EIOPA's investigation of diversified infrastructure corporates' debts and equities, based on bespoke indices or portfolios made of carefully selected public issuances of corporates getting most of their revenues from core low volatile non-cyclical infrastructure activities. It also understands that a separate set of criteria should be defined for this (as noted in section 8 of the consultation). More specifically, EIOPA's ongoing analysis should be used to inform:

- A more tailored, risk-based capital charge for non-qualifying infrastructure corporate equity, where "non-qualifying" should be read as non-qualifying with the revised set of criteria for project finance and corporates.
- A more tailored, risk-based capital charge for non-qualifying infrastructure corporate debt, where "non-qualifying" should be read as non-qualifying with the revised set of criteria for project finance and corporates.

Insurance Europe agrees with the suggestion by EIOPA that decisions to amend Solvency II will have to reflect a balance between changes in the capital requirements and complexity of the standard formula. Such an analysis would have to be considered once EIOPA finalises the necessary work.

Calibration of qualifying infrastructure corporates in Solvency II

Insurance Europe notes that the capital charges developed for infrastructure are already conservative compared to the true economic risks to which insurers are exposed, namely exposure to default losses for bonds and the real risk of long-term underperformance of equity infrastructure. In addition, the recently developed qualifying criteria for infrastructure project entities, on top of the comprehensive due diligence conducted by insurers, are very strict and ensure that only very low risk profile investments get to fulfil all the criteria.

As a consequence, Insurance Europe believes that the current capital charges for non-corporate infrastructure are very conservative for the subset of infrastructure corporates meeting all qualifying criteria. This should give comfort that, even if there were some differences between the risk profiles of the average infrastructure corporates and average project finance, the current calibration would not underestimate the risk of insurers' investments because the qualifying criteria ensure the calibrations are only applied to the lowest risk segment.

Insurance Europe has strong concerns about EIOPA's intention to calibrate capital requirements for infrastructure corporates based on a selected sample of available market data, for at least the following reasons:

- The available data mainly represents public entities and is therefore not representative of the private deals that insurers also engage in. No relevant listed bonds or listed equities indices/portfolios can be entirely representative of the infrastructure spectrum. Moreover, publicly listed entities often exhibit traditional corporate risks such as management and growth risks, which insurers aim to avoid with many of the private deals that they invest in. This is in particular true for infrastructure corporates that simply bundle various infrastructure projects. It is in fact difficult to find a sufficiently representative and relevant set of data on which to base a targeted calibration. In fact, one of the key elements that triggered the Commission's call for advice on infrastructure assets was precisely the limited availability of these investments and the aim to increase their supply.

- Part of the valuation of such listed instruments involves factoring in the cyclicality of the public traditional corporate bonds markets, while project-like infrastructure investments are not cyclical given the stability and predictability of their cash flows.
- A market data based calibration encompasses the systematic nature of public markets, while insurers' infrastructure project-like corporate portfolios are largely made of investments that are held for the long-term.

Insurance Europe believes that an extension of the capital treatment of project finance to qualifying infrastructure corporates is a sensible approach, for at least the following reasons:

- EIOPA has not come up with a persuasive argument why corporate structures entail more risk than projects (or SPVs).
- Introducing separate capital requirements entails the risk that, when choosing the legal vehicle for an infrastructure project, there will be a bias towards the vehicle that is "cheaper" in terms of capital requirements (organisational arbitrage). Prudential regulation should avoid pushing infrastructure business in the direction of one type of legal set-up unless there is very clear evidence that the legal set-up does in fact make a difference. EIOPA does not present such evidence.
- It should be considered that, over time, an infrastructure project may become incorporated — either as the result of a decision by the owners or as a consequence of the project being sold off to an entity that prefers the corporate set-up. It is very important to avoid "cliff edges", where capital charges change from one day to the next simply because of a change in legal set-up. It should be kept in mind that the insurer may not always be in a position to influence a change of legal set-up. Consequently, as a result of a change in capital charges due to a change in legal set-up, an insurer might be forced to pull out of the investment at very short notice. This cannot be the intention of prudential regulation.
- In addition, the work conducted by EIOPA in 2015 recognised that insurers invest in infrastructure with a long-term holding perspective and their risk exposure is a combination of liquidity risk and credit default risk. Recalibrating infrastructure corporates based on the behaviour of a selected sample of companies would not be in line with these findings and therefore cannot be justified in a risk-based framework. Insurance Europe is not aware of any new findings or economic basis that would justify taking an approach for corporate infrastructure different from the approach taken for non-corporate infrastructure.

Insurance Europe therefore believes that a pragmatic approach, based on the safeguards outlined above and aimed at applying the same relevant criteria and capital treatment to both infrastructure project finance and corporates, is needed at this stage. Further investigations could be done at a later point in time, during the Solvency II review, when it is also likely that more targeted data will become available.

To conclude, Insurance Europe believes that impeding investments in corporate infrastructure through excessive capital charges restricts unnecessarily options for insurers. Capital treatment based on the real risks faced by insurers will allow the industry to invest where appropriate, generating additional returns for policyholders and at the same time helping to stimulate much needed economic growth.

Finally, Insurance Europe would like to stress that any changes to the capital requirements for infrastructure investments should also be reflected in the derivation of the Fundamental Spread within the Matching Adjustment calculation. This could be done either by changing the default and downgrade rates or more holistically through an increase in the recovery rate.

Responses to the questions in the consultation document

Q1: unlisted assets
(a) Do you agree that in the absence of publicly available data on unlisted infrastructure assets; the data on listed entities analysed by EIOPA are an appropriate proxy?

No.

Insurance Europe does not agree with EIOPA's approach to use data on listed entities in order to measure the risk of infrastructure corporates.

- For debt, publicly listed bonds often do not provide the same protection to lenders through security packages or covenants sets. This is not reflected in the market performance of these bonds.
- Project-like infrastructure equity portfolios are made of unlisted companies, where the controlling rights of the shareholders provide an additional layer of comfort on the underlying activities, including when it is relevant the ancillary activities. The valuation of listed equity is affected by a range of factors that have nothing to do with the underlying investment. Using listed equity as a proxy introduces a lot of issues around filtering out the effects of general market behaviour in order to focus on the essential: the risk to corporate infrastructure.

In addition, the aim/objectives of the investment may materially differ: insurers are investing in unlisted projects like infrastructure corporate debt or equity the same way they invest in project companies: to benefit from the stability and the predictability of the cash flows over the long term.

(b) If not, please provide a comprehensive justification and supporting evidence, including data, International Securities Identification Numbers (ISIN) codes and examples.

While it is difficult to find publicly available granular data to support the fact that listed instruments may not be the best proxies for the reasons mentioned above, using some relevant infrastructure indices such as the Cambridge index for equity clearly demonstrates a much lower volatility of the unlisted European (or worldwide) infrastructure equity market than the listed equity markets.

For debt, EIOPA used the Moody's default and recovery rates study to take some additional comfort that infrastructure corporates exhibit a lower risk profile than the conventional corporates. However, there is no evidence that the infrastructure corporate debts analysed in such study are listed. The only tangible evidence of such study is that the infrastructure corporate expected loss profile is far closer to the infrastructure projects' one than the non financial corporates' one. Given the size and the depth of the study, this should be enough evidence to justify expanding the treatment of infrastructure projects to corporates.

Q2: telecoms
(a) Do you agree with the assessment of the risks of telecom investments as evidenced by the historical price data?

No.

Insurance Europe does not agree that telecom operators operating under concession should not be treated as infrastructure corporates since their underlying activities exhibit the same features as the regulated infrastructure corporates. Insurance Europe believes that communication towers and other mass telecom networks, such as optic fibre and mobile networks, should be considered as core infrastructure assets and included in EIOPA's analysis, in the same way that EIOPA has excluded airlines but included airports.

In addition, past volatility is an insufficient guide to possible future volatility due to the development of the industry.

Similarly, Insurance Europe does not agree with the idea that telecom investments bear a different risk to other infrastructure investments that justifies a different capital charge for telecoms. It strongly advises that EIOPA refrain from introducing a very granular capital charge structure where different kinds of infrastructure have different charges. It will lead to a very complex set-up, and the benefits are highly questionable.

(b) Are there any segments within the telecom industry that are safer than other segments, which deserve further granular analysis? If yes, please provide a comprehensive justification and supporting evidence including data, ISIN codes and examples.

Yes.

Communication towers and other mass telecom (eg optic fibre, mobile) networks as well as satellite systems financing should be considered as core infrastructure assets.
Some other infrastructure sectors are not listed because they usually do not have any publicly traded bonds or equities, but this does not mean they are not part of the core infrastructure universe. These include:

- Strategic electrical or non-electrical energy storage
- Water irrigation systems
- Waste management

Q3: debt without an ECAI rating
(a) What is the volume of infrastructure corporates without an ECAI rating?

-/-

(b) What is the typical amount of a corporate debt issuance? How does this relate to the cost of obtaining an ECAI rating?

-/-

(c) What criteria could be used to identify suitable debt without an ECAI rating and to eliminate unsuitable investments? Please provide specific proposals.

Insurance Europe believes that compliance with the additional criteria (revised to allow the inclusion of corporates) is enough and no further criteria are needed.

Q4: definition of infrastructure corporate
(a) Do you have specific examples of infrastructure sectors and corporate structures that would inadvertently fall outside this definition?

Yes.

The following sectors would fall outside the current scope but should be included:

- Telecom operators operating under concession
- Communication infrastructure such as towers and other mass telecom (eg optic fibre, mobile) networks as well as satellite systems financing should be considered as core infrastructure assets
- Strategic electrical or non-electrical energy storage
- Corporates that generate, transmit or distribute heat
- Water irrigation systems
- Waste management

Insurance Europe supports the inclusion of social infrastructure in its broadest sense in the scope of the work. More specifically, social infrastructure should include both social housing and other types of social infrastructure like national stadiums, parks.

(b) *What volumes would such examples represent?*

-/-

(c) Regarding the requirement for a minimum number of years of operation or for an external credit assessment specifically, are there cases where would this lead to the exclusion of safer infrastructure corporates? If so, how would you propose to appropriately limit the construction or operating risks; would the requirements for infrastructure projects be appropriate for example?

-/-

Q5: Other criteria for infrastructure corporates Are there other criteria not covered by this section (Section 8.4) that are used by investors to identify safer infrastructure corporates?

-/-

Q6: identifying different revenue streams
Do you envisage any difficulties to distinguish between revenues stemming from infrastructure compared to non-infrastructure activities? Please justify your response.

No.

Insurance Europe believes that having a clear understanding of the various sources of revenue for a given infrastructure corporate is even a strong prerequisite before investing. A set of stress tests will be applied in order to ensure that the robustness of the primary infrastructure activity(ies) is not jeopardised by any of the ancillary activities.

Q7: security and negative pledge
(a) Would option 1 (compared to option 2) lead to the exclusion of arrangements which provide an equivalent level of protection to asset security and an equity pledge? Please provide specific reasons and examples.

Not necessarily, but Option 2 should be preferred.

Insurance Europe is of the view that Option 2 should be preferred, as a direct pledge of equity is not always granted or legally permitted in infrastructure projects, in particular in continental Europe. In addition, the "security package" does not prevent an infrastructure project going into default (perversely a too extensive security rights package could induce higher leverage levels at the expense of financial stability) and there are various remedies that could be put in place to protect debt holders and help improve the expected recovery rates in case of default. The other conditions of Qualifying Infrastructure in Article 164a, such as cash flows being sustainable under stressed conditions, and the predictability of cash-flows, are good ways to reduce the probability of default of the asset class, which is key to allowing for a reduced capital charge under Solvency II.

Insurance Europe also supports the flexibility provided by option 2, as it introduces different remedies. Option 2 in particular allows for the financing to be considered in the context of the local jurisdiction in which the Qualifying Infrastructure operates.

(b) Do you consider that a "negative pledge" clause can provides equivalent protection to the security arrangements required by the proposals in Section 9.3?

No.

A negative pledge per se is a good convenant, but should be combined with some privileged access right to the underlying assets/cash flows or contracts or indebtness limitations/controlling rights depending on the nature of the underlying infrastructure activity.

(c) If yes, please provide specific reasons and examples of infrastructure sectors and countries where a "negative pledge" should be allowed without compromising the safety and recovery of your investment.

-/-

Q8: risk management

(a) In view of the proposed change to the scope of the infrastructure project asset class, do you agree that the risk management requirements remain appropriate?

Yes, Insurance Europe agrees that the risk management requirements remain appropriate.

(b) In particular, will the information required to comply with the risk management requirements for infrastructure projects be available to insurers?

-/-

(c) If not, how would an insurer satisfy itself regarding the safety of the investment, without an excessive or mechanistic reliance upon external ratings?

-/-

Q9: impact assessment

(a) Do you agree with the assessment of benefits? Are there other benefits that have not been identified?

-/-

(b) Do you agree with the assessment of costs? Are there other costs that have not been identified?

-/-

(c) Regarding policy issue 1, what would be the volume of qualifying infrastructure investments under the different policy options?

-/-

Additional comments on the consultation document

Comments on Section 4 - What is the difference between infrastructure projects and corporates?

Insurance Europe understands that the differences between the risk profile of infrastructure projects and corporates cannot be directly linked to the legal structure and these differences can in fact translate into lower or higher risk for corporates vs projects. Against this background, Insurance Europe believes that a decision to calibrate the capital requirements for corporates based on observable market data would lead to a clear conclusion that corporates are riskier than projects, simply because market data reflects market volatility, and this would in fact contradict EIOPA's analysis that risk can be higher, but can also be lower.

Insurance Europe also notes that EIOPA recognises that in many cases infrastructure corporates are in fact very close in terms of investment profile to infrastructure projects so, by taking a significantly different calibration approach, EIOPA basically covers only those cases of corporates that significantly deviate from projects and are close to normal corporates — such an approach is unnecessarily restrictive and similar safeguards could in fact be covered in the identification of corporates and not in an unnecessarily punitive calibration.

In addition, as far as diversified corporates are concerned, and as mentioned by EIOPA in paragraphs 1.73&1.75, there is evidence that cash flows and revenues stemming from infrastructure corporates' activities are significantly less volatile than traditional corporates of similar size, leverage and profitability. This is an additional reason why the calibration of infrastructure corporates should reflect this much lower volatility than for traditional corporates, and this cannot be achieved by the approach proposed by EIOPA, which is based on selected market data exhibiting full market volatility.

Comments on Section 6.1 - Analysis of existing infrastructure equity indices

Insurance Europe believes that EIOPA's analysis of the wide infrastructure spectrum would support follow-up work on the recalibration of infrastructure corporates that do not fulfill the definition and qualifying criteria, but that do, based on data, exhibit lower risk than other corporates. More specifically, EIOPA's ongoing analysis should be used to inform both:

- i) A more tailored, risk-based capital charge for non-qualifying infrastructure corporate equity, where "non-qualifying" should be read as non-qualifying with the revised set of criteria for project finance and corporates
- ii) A more tailored, risk-based capital charge for non-qualifying infrastructure corporate debt, where "non-qualifying" should be read as non-qualifying with the revised set of criteria for project finance and corporates

Insurance Europe agrees with the suggestion by EIOPA that decisions to amend Solvency II will have to reflect a balance between changes in the capital requirements and complexity of the standard formula. Such an analysis would have to be considered once EIOPA finalises the necessary work.

Comments on Section 6.2 - Analysis of a portfolio of listed infrastructure corporate equity

Insurance Europe does not agree with the conclusion that the correlation between infrastructure corporates and other listed equity (MSCI World Index) is equal to 100%, ie perfect correlation. In fact, the evidence in Figure 4 seems to suggest that the one-year correlation has varied between 45% and 97%. A more appropriate assumption would therefore be a correlation coefficient lower than 100%. Insurance Europe therefore appreciates the fact that EIOPA has not yet reached its final conclusion but will continue to analyse this issue (paragraph 1.70). However, Insurance Europe finds it peculiar that EIOPA is ready to consider perfect correlation with both Type 1 equity and Type 2 equity as stated in paragraph 1.71, especially as the correlation between these has been set at 75%.

It is not clear whether EIOPA has taken dividends into account. Given that insurers often argue that more stable, predictable and higher cash flow dividends is a key reason for investing in infrastructure (be it project or corporate), Insurance Europe believes that the analysis should (at least) take dividends into account.

Comments on Section 7.3 - Analysis of the iBoxx Utilities indices

Insurance Europe does not agree with using observable spreads from listed infrastructure corporate bonds. Volatility in market spreads only partially relates to credit risk. Other factors impacting spreads are, for example, central bank intervention, relative value to other asset classes and general market sentiment. As a consequence, public corporate bond spreads are often more volatile than justified by observable default rates. Insurers invest with the intention and ability to hold infrastructure long-term or until maturity and therefore do not regard credit spread volatility as a good investment guide.

Comments on Section 8.4 - Qualifying criteria

Definition

ECAI credit quality step 3 should be considered only for lenders, not at equity level.
Regarding paragraphs 1.134&1.138, Insurance Europe seeks clarification on why the reference to OECD has been removed, as this approach does not seem consistent with the project entities approach in terms of geographical scope.

Insurance Europe does not support requirement 3 (*ie The revenues shall be diversified in terms of activities, geographical location, or payers, unless the revenues are subject to a rate-of-return regulation*), as it is unnecessarily restrictive and would disqualify almost any investment. In fact, the requirement goes beyond the requirements of the Solvency II Directive which is based on the prudent person principle. It is not consistent with the Directive to set up separate requirements for individual assets or even for a sub-group of assets, as is done here. Besides, from a risk perspective, it is more important to consider diversification for the asset portfolio as a whole, and not for separate assets or assets classes.

Financial structure:

Regarding paragraph 1.151, Insurance Europe seeks clarification on the rationale for equity investors, namely why EIOPA considers that a higher grade debt would make an equity investment safer.

Comments on Section 9.2 - Proposed revisions to the qualifying criteria

Insurance Europe agrees with the need to be able to identify the various sources of revenues of a given infrastructure corporate. Especially for large utility companies, it is often not easy to properly distinguish between revenues stemming from infrastructure and revenues from non-infrastructure activities. However, it is not sensible to remove all the revenues coming from the ancillary activities as they are also generating operating and potential capital expenses that have to be taken into account to measure the robustness and sustainability of a balance sheet. Securities and convenants provided to the lenders on such non-infrastructure activities should be enough to protect the lenders/shareholders in case of very adverse scenarios. If not, the investment may not qualify as an infrastructure corporate.

Comments on Section 9.3 - Draft advice

Contractual framework

Insurance Europe believes that option 1 is too tight. Generally a pledge of shares might be provided for BBB infrastructure corporates, especially in cases where leverage is high. But this requirement would only make highly leveraged infrastructure corporates eligible.

Option 2 would require some fine-tuning, especially with regard to:

- iii) the use of net operating cash flow might be restricted if certain trigger levels are reached — Insurance Europe would welcome more clarity on this requirement
- iv) this criterion needs refinement as, while the indebtedness can often be limited to leverage levels (FFO/debt, Debt/RAB or EBITDA multiples), a lender consent will almost never be achieved.

Financial risk

Insurance Europe would welcome clarification that the debt can be pari passu with other senior debt but that no other debt is senior.

Comments on Annex I

Insurance Europe seeks further clarity on the assessment of costs and the related outcome highlighting that listed infrastructure companies' equities should remain under the existing Type 1 listed equities calibration.

Comments on Annex VI

Insurance Europe recommends the removal of the word "project" from the reference to the "Infrastructure project entity" in the Delegated Regulation. Given the perception of the temporary nature/limited lifetime of a "project", which in fact fully makes sense when one is referring to the financing of the construction/development of an infrastructure asset, it seems sensible to remove this word when it comes to the operating of such assets over a very long period of time, where anyway the word "project" is not meaningful. Insurance Europe therefore proposes the following definition (55b) "Infrastructure entity means an entity or group that derives the vast majority of its revenues from owning, developing or operating infrastructure assets."

Similarly, in article 164a, Insurance Europe proposes the removal of "project". In addition, the revenues of ancillary activities should also be included in the stress testing, next to the risk and the associated costs. Finally, in paragraph c), "infrastructure project" should be replaced by "infrastructure underlying assets".