Comments Template on EIOPA-CP-15-003 Discussion Paper on Infrastructure Investments by Insurers		Deadline 26.April.2015 23:59 CET
Company name:	The Investment Association	
Disclosure of comments:	EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential. Please indicate if your comments on this CP should be treated as confidential, by deleting the word Public in the column to the right and by inserting the word Confidential.	Public
	Please follow the instructions for filling in the template: ⇨ Do **not** change the numbering in column "Reference". ⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph, keep the row empty. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. o If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies. o If your comment refers to sub-bullets/sub-paragraphs, please indicate this in the comment itself. **Please send the completed template to CP-15-003@eiopa.europa.eu, in MSWord Format, (our IT tool does not allow processing of any other formats).** The paragraph numbers below correspond to Consultation Paper No. EIOPA-CP-15-003.	
Reference	**Comment**	
Question 1	The most significant barrier to insurers investing in infrastructure remains the capital requirements under Solvency II. The Investment Association welcomes: • the European Commission's call for advice from EIOPA on whether it would be appropriate to amend the Solvency II standard formula for the calculation of the solvency capital requirement regard investment in infrastructure; and	

	• work that EIOPA is doing in response to this call for advice.
	
	Other barriers to infrastructure investment include:
	
	• Withholding tax in certain European jurisdictions:
	  ○ We welcome the steps that that the UK government has taken to address this issue by introducing a withholding tax exemption for qualifying private placements which would include privately placed infrastructure debt. However, issues in countries such as Italy and Belgium persist.
	• Lack of project pipeline:
	  ○ The limited number of viable investment opportunities in infrastructure is a significant barrier preventing insurers from increasing investment in this asset class.
	  ○ The Investment Association welcomes the work that is currently being undertaken under the Junker Investment Plan to establish a transparent and regularly updated pipeline as part of the European Fund for Strategic Investment.	

Question 2	It is important to reflect the underlying rationale insurers have when investing in infrastructure. Infrastructure assets are held by insurers on a buy-to-hold basis and the key economic risk that investors face is not that of liquidating the investment but rather counterparty default risk. From a credit perspective these assets are attractive due to the higher yields and credit diversification benefits. The current treatment of infrastructure debt under Solvency II overstates the risk and volatility of these assets. This is because: 1. There is a materially lower default rate for infrastructure investments compared to corporate bonds in the same rating category due to the ability to manage directly and pro-actively the relationship with the borrower and also a more granular quantum of covenants and control regarding the operation of the borrower's business to manage event risk to a greater extent than is possible in corporate bonds 2. The average level of recovery for infrastructure loans is materially higher for infrastructure loans compared to corporate bonds in the same rating category due to the positive risk management characteristics and strong business profiles present in the infrastructure sector.	

	3. The recovery rates for infrastructure loans over the last 20 years have shown that infrastructure loan default rates are uncorrelated with the economic cycle. In contrast, for corporate debt the default rates are negatively correlated with the economic cycle and start at a significantly lower level than infrastructure default rates. For infrastructure debt, Moody's Default Study published in March 2015 (*Default and Recovery Rates for Project Finance Bank Loans and Infrastructure Default and Recovery Rates 1993-2004)* provides a comprehensive data set.	
Question 3	Most insurers are interested in infrastructure as a buy-and-hold investment that they can hold to maturity and use to match their long-term liabilities. In addition, insurers are able to extract an illiquidity premium that enhances portfolio performance to the benefit of policy holders. Liquidity could be beneficial for insures as investors as it assist with pricing and makes it easier to sell their position should their investment requirements change. We would caution EIOPA against calibrating solvency capital requirements that places any emphasis of the liquidity or illiquidity of infrastructure as an asset class. This is likely to undermine the prudent person principle which effectively places the responsibility on the insurer to decide wither the nature of the investment is appropriate and in the best interests of the policyholder. In any case, insurers will be required reflect liquidity risk as part of their written policy on risk management and in their Own Risk and Solvency Assessment reports under Solvency II.	
Question 4	The definition of infrastructure debt should not be based on whether the project is rated by an ECAI or not. It should be based on the nature of the project. Where infrastructure debt does not have an ECAI rating, there should be a basis for accepting private ratings as a proxy, provided that they have been assigned by an institution (bank or insurance company) whose ratings process has already been reviewed by their regulator. Investments that have internal ratings should have the same capital requirements as those that have an equivalent external credit rating provided by an ECAI.	
Question 5	The Investment Association would urge EIOPA to adopt a principles based approach to defining infrastructure investments as no two projects will be the same. Adopting a precise defintion of project	

	finance would create a risk that some infrastructure investments would be excluded, and that the definition would become out of date as technology advances. Therefore, we do not believe that EIOPA should link the criteria for investments in infrastructure to an existing defintion of project finance. See our response in Q7 below.	
Question 6	The Investment Association is not aware of any other legal definitions.	
Question 7	The Investment Association's preferred option of infrastructure would be a combination of option A and option B. We agree that Option A, which is a wide definition based on existing definitions, would be open to interpretation. Whilst option B would be too narrow and may exclude relevant sectors.	
Question 8	The Investment Association proposes the following definition for infrastructure. (i) A **definition** of infrastructure assets *'Infrastructure' means assets including networks, facilities, utilities and installations that support the current or future functioning of a community or society and exhibit specific economic and financial features relating to credit risk, demand and competition as a result of the function provided and restrictions on use of the assets.* *(ii)* **Recital:** wording would include the following sectors: • *Public institutional buildings (including corrective institutions and prisons, defence accommodation and training facilities, fire stations, schools, student accommodation, universities and other public buildings);* • *social or retirement housing,* • *car parking structures,* • *combined heat and power plants and district heating systems,* • *desalination plants,* • *energy generation and power transmission, [renewable energies* • *distribution and metering (including gas, hydro, nuclear, wind & solar power installations,*	

waste to energy conversion plants, interconnectors, pipelines),

- *environmental facilities (parks, flood or tidal protection including dredging),*
- *health care (including long-term care centres, mental health facilities, primary care and health care centres – including hospitals),*
- *information technology and communication systems (including broadband and cable, broadcast infrastructure including broadcast towers, telecom towers),*
- *Large-scale civil engineering projects,*
- *storage facilities,*
- *street lighting,*
- *transportation and associated technologies (including airports, bridges, ports, roads, rail including high-speed lines, rolling stock and locomotives),*
- *Waste,*
- *Research and development activities, water including waste water.*

(iii) A tailored treatment should apply to '**long term infrastructure exposures'**, which are infrastructure assets that fulfill the following **characteristics**:

a) the exposure is to an entity that was created specifically to finance or operate infrastructure assets;
b) if the exposure has the form of equity, then the exposure is not listed;
c) the collective of investors have a substantial degree of control over the assets as long as the asset is not controlled by a public institution;
d) the primary source of payments to the investors is the income generated from the assets being financed or by revenues from public sector institutions or are contractually specified;
e) the initial maturity at issuance is 5 years or longer;
f) if the exposure is to green field investment in the construction phase, the construction risk is appropriately mitigated and passed through under a comprehensive engineering, procurement and construction (EPC) contract or an alternative/equivalent structure;
g) the assets are located in member state of the Union or the OECD.

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Question 9	The Investment Association is not aware of any existing definitions.	
Question 10	The Investment Association believes that the vast majority of infrastructure do provide stable revenues. This is because revenues are set through: • reference to regulation; • government procurement (ie. Availability based PPP/PFI projects); aor • long term contracts that offer stable reveneues. Revenue stability comes from the fact that assets are generally essential businesses/services that are subject to much lower demand fluctuations through the economic cycle. Whilst there are some assets that carry technological risks, these risks are often mitigated through the financing structure. This can include seeking guarantees and warantees from the technology provider to mitigate the risk of technical failures.	
Question 11	The Investment Association notes that a criteria based approach risks classifying infrastructure investments as ‘good’ or ‘bad’. EIOPA should seek to adopt a principles based approach. This, coupled with the qualitative requirements under pillar 2 of Solvency II that imposes a higher standard of risk management on insurers in recognition that an asset class can be heterogeneous in its risk profile, should allow for a better solvency capital requirement under the standard formula. Further, we would recommend a focus on the key principles of the Moody’s Default Study explanations of why infrastructure investments are materially more robust than those in other sectors e.g. corporates and financials. This is due to the strength of the business profile, the level of financial risk and the pro-active management of the borrower relationship and strong covenant packages	
Question 12	Please see Q.11 above.	
Question 13		
Question 14	Basel II provides a useful generic description of the sector. The Basel II criteria for project finance and proposals for “slotting” investments according to risk would be a useful method of improving the risk capital requirements of insurers and pension funds. However, Basel II does not include several key risk features of infrastructure (such as those identified in the Moody’s Default Study and in our response to Question 2).	

Question 15	In contrast to Solvency II, Basel II provides a definition that recognises the stability of revenues from infrastructure assets and the high levels of recovery in infrastructure debt. However, a detailed criteria approach is not helpful unless it refers to the overall level of risk in the transaction and is based on appropriate risk mitigation and management methods. The experience of the complexity of implementation in the banking sector is a further powerful reason supporting a high-level approach.	
Question 16	We are not aware of any.	
Question 17	The criteria described go too far and would lead to some assets being excluded. The Investment Association urges EIOPA to adopt a principles based approach that would allow investments to be reviewed on a case by case basis.	
Question 18	As noted in Q.11 a criteria based approach risks fragmenting infrastructure investments as 'good' or 'bad'. Rather EIOPA should seek to adopt a principles based approach.	
Question 19		
Question 20	The risks associated with the construction and ramp up period typically focuses on allocating those risks to those best placed to mitigate or manage them. Construction risk can be managed or mitigated through specific contractual protections, such as: • fixed price turn-key contracts, • liquidated damages for delay in delivering material elements of the construction project, • sufficient time and capital contingency as verified by an independent technical advisor, or • appropriate assumptions in the ramp-up period. In addition, investors will look at whether there are additional protections afforded in the drawdown mechanism or escrow accounts for undrawn funds. Ratings also publish criteria for minimum standards that are required to achieve an investment grade	

	rating during the construction phase. These relate to: • subcontracting arrangements, • the size, resources and experience of the contractor, • the technical challenges of the project, • availability of guarantees and bonding facilities, • amount of liquidity available, • the stage of development, etc.	
Question 21	These tend to be very project specific. There should be no effort to define universally-applicable requirements.	
Question 22	It is of critical importance that EIOPA does not require the existence of a credit enhancement or guarantee to allow an infrastructure project it to qualify for tailored treatment under Solvency II. The Investment Association believes that guarantees from public bodies should be only used: • where there is a genuine market failure - i.e. where there is extreme market disruption and adverse credit conditions; and • as a subsidy for otherwise “unbankable” projects, appropriate when the broader societal benefits of the asset/activity exceed the revenue commercially available to that asset/activity • in any case, limited only to situations where there is inadequate funding available from the private debt market to avoid the risk of crowding out private sector investment;	
Question 23	The risk of any project and portfolio is a function of both the characteristics of the underlying business (including the revenue risk) and the financing structure itself. We acknowledge that a project can become unstable if it is overleveraged. However, a business with low leverage can accommodate more revenue risk whilst remaining very stable. The robustness of individual projects and portfolios need to be considered on a case by case basis as the amount of leverage and nature of the risks is often project rather than structure or sector specific. Overall, the proposals on Revenue Risk set out in the Annex are too prescriptive and would limit the type of infrastructure projects that insurer could invest in as they do not capture the characteristics and considerations taken into account in a specific project, portfolio or project class and may not	

	focus on the key considerations for a specific project or portfolio under consideration In particular, we note that narrowing the definition of low revenue risk to those where there is a regulatory regime that guarantees fixed prices for a number of years (but not the whole life of the project) at which point it would no longer qualify for favourable capital treatment: • will make insurers forced sellers at the end of the regulated period; and • does not take into account the different ways that different jurisdictions guarantee prices. As a result, insurers would only be able to invest in availability based PPP projects. This would be an undesirable outcome.	
Question 24	The revenue risk of each investment should be assessed on its own merit and appropriate sensitivity testing should be undertaken to assess how robust its cash flows are. The individual assessment will ultimately feed in to the credit rating that the investment is assigned.	
Question 25		
Question 26	Many projects rely on off-take arrangements with regulated utilities. These are generally considered to be reliable, subject to the utility maintaining the relevant credit ratings. In addition, there are circumstances in which private off-takers can be replaced, therefore reducing the probability that the project will default.	
Question 27	Investors use different financial ratios depending on the type of project, the sector and the phase of the project. Some of the financial ratios used include: • minimum and average annual debt service cover ratios; • loan live cover rations and project life cover ratios; • operating cost cover ratios. Operating infrastructure business will use: • financial leverage; • EBITDA/ net debt multiples; • Funds from operations/ debt multiples Therefore, financial ratios would need to be considered on a case by case basis.	
Question 28	As noted above, investors use different financial ratios depending on the type of project, the sector and the phase of the project. Therefore it would be difficult to set minimum ratio levels for	

	infrastructure assets. However, credit ratings agencies publish broad financial metrics and ratios for different asset classes. This could provide generic guidance for infrastructure debt.	
Question 29	Non-senior debt may be required where there is a large equity requirement in a project. The ability to raise funding for a project may be constrained by the ability to obtain an investment grade rating for senior debt. Extra funding, in the form of non-senior debt may be appropriate and assist the equity sponsor in executing the transaction. Given the proposals are to establish risk adjustments for both equity and debt; we believe eligibility should not be restricted to senior debt.	
Question 30	No, it is not. Given that the refinancing risk is considered as part of the overall credit rating, we do not believe that it should be a standalone criterion.	
Question 31	As noted in a publication by JP Morgan Asset Management[1], although borrowers have this option, prepayment rates have historically been extremely low. Full prepayment rates for infrastructure, as defined by Standard & Poor's, and maintained on a bank consortia database have been 1.6% in total in western Europe and virtually 0% in the UK since the database's inception in the 1980. The key concern for insurers seeking to invest in infrastructure will not be the prepayment risk, but the terms of the prepayment. The inclusion of a negative prepayment risk criterion will reduce the capacity of insurers to provide investment into this market. Requesting a make-whole in a transaction is often unpalatable to a borrower seeking to retain some flexibility in their financing arrangements. Therefore, we do not believe that a criterion should be developed for prepayment risk.	
Question 32	Where unproven technology is used in a project this will also be captured in the credit rating assigned to a project. Investors will typically seek to mitigate this technological risk in various ways such as, requiring guarantees from the contractor providing the technology. Given that this risk can be appropriately mitigated in the structuring, we do not believe that it	

[1] J.P. Morgan Asset management, 2012, Infrastructure debt strategy - prepayment/refinancing risk, http://cameronmckenna.jpmorganassetmanagement.co.uk/Institutional/_documents/JPM5396-Infrastructure-debt-strategy.pdf

	warrants a stand alone criteria.	
Question 33		

Question 34	The Investment Association is supportive of the proposals put forward by Insurance Europe in their response to this discussion paper. Namely, that alternative charges should be as follows:
	• For infrastructure equities
	    ○ Listed infrastructure equities should remain type 1.
	    ○ Unlisted infrastructure equities should become a new sub-module of market risk, with a 22% charge and a zero-correlation with other market risk sub-modules.
	• For infrastructure debt
	    ○ We would recommend a treatment under the counterparty default risk module, similar to type 2, but with adjusted factors depending on the ratings.
	
	We do not believe that infrastructure debt should be considered under spread risk module as this does not reflect the lower default rates and higher recovery rates exhibited by infrastructure when compared to other core fixed income assets.	

Question 35	The Investment Association is strongly against any changes to the requirements for the use on an internal model. This would not encourage additional investment in infrastructure but would act as a disincentive for insurers with established and tested internal models that would need to adapt to new and potentially prescriptive requirements only to facilitate investment in one asset class.	
Question 36		
Question 37		
Question 38		
Question 39		
Question 40		
Question 41		
Question 42		
Question 43		
Question 44		

Question 45		
Question 46	The Investment Association does not support any approach that seeks to ensure that insurers hold their infrastructure investments to maturity. Insurers should not be prohibited from selling infrastructure assets when it is appropriate for them to do so from a risk management or optimal capital allocation perspective. In addition, we note that under Solvency II, insurers are subject to strict risk management requirements including those on: • asset-liability management; • liquidity risk management; • investment risk management; and • the prudent person principle. Further, insurers are required to reflect these issues in their written policies on risk management and in their ORSA reports. Any further requirements will introduce needless complexity into the current regulatory regime.	
Question 47	While the risk profile of infrastructure debt investments differs from that of SME loans, we would argue that SME loans could be subject to an adjustment factor due to the level of covenant protection. We see limited scope however for broadening this approach beyond infrastructure and SME lending.	
Question 48	The majority of insurance companies that invest in infrastructure are long-term oriented due to their long-term liabilities and are interested in infrastructure as a buy-and-hold investment that delivers attractive risk-adjusted yields for the benefit of policyholders. The most important consideration for such investors would be counterparty risk. Any economic consideration that assets should be classified under 'Counterparty Risk' should be driven by a consideration of investment strategy, Asset Liability Matching requirements and liquidity, rather than the specific nature of the underlying asset. Therefore, we believe such a treatment could apply to a range of 'Hold to Maturity' assets.	
Question 49		

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Question 50		
Question 51	Minimum quality for unrated infrastructure debt can be ensured by taking into account the internal rating methodologies developed by institutional investors with specific scoring models. We note that there are no minimum quality requirements under Solvency II for unrated corporate debt. Therefore any additional requirements would be inconsistent with the approach adopted in the Delegated Acts.	
Question 52	The Investment Association is concerned about EIOPA's very prescriptive areas for attention which ignore the already existing requirements of Solvency II's pillar 2. Indeed, these listed areas of attention (having a comprehensive understanding, performing an adequate due diligence, written policies, internal reporting) are already covered extensively under the existing regulation, such as guidelines on system of governance, articles 259, 260 and 261 of the Delegated Acts and the requirements regarding the ORSA. These existing pillar 2 regulations are also the reason why other illiquid non-routine investments such as private equity do not have specific risk management requirements.	
Question 53	Yes, project sponsors do provide financial models which can be used to evaluate the resilience of a project.	
Question 54	There is no industry standard for financial models. But there are a number of modelling principles that most models would follow.	
Question 55	It is our view that the availability and content of prospectuses should be encouraged through different policy measures, namely the Prospectus Directive, and not through Solvency II. A number of project bonds have been issued with detailed offering document in the UK and US private placement market. In Europe, infrastructure funds are subject to detailed disclosure requirements under the Alternative Investment Fund Managers Directive.	
Question 56	A level of standardisation would be helpful. This would increase ease of accessing information and would assist the due diligence process when considering the available investment opportunity. We would welcome regulatory assistance in encouraging standardisation of disclosure eg. Investor reports or prospectuses. However, we do not believe that the prudential treatment of infrastructure investments should be contingent upon the availability of a specified list of information. This is because:	

	• any predefined list imposed by Solvency II is unlikely to take into account the specificities of particular infrastructure projects; and • there is a risk that a predefined list may over simplify the transaction. Further, we note that there is no specific information requirements under Solvency II for other illiquid asset classes such as corporate loans or private equity.	
Question 57		
Question 58		
Question 59	Insurers will need detailed information on every project to analyse the risk and to assess the risk/reward profile of each investment proposal. More standardisation and transparency would make it easier for insurers to perform the necessary pre-investment analysis of the opportunities available. However, we note that any standarisation of disclosure or increased transparency requirements would not be within EIOPA's regulatory remit. Further, The Investment Association does not believe that standarisation of any aspect should be part of the criteria for infrastructure projects receiving a specific prudential treatment.	
Question 60	Standardisation of investor information and contractual elements would provide investors with easily understandable documentation that would indirectly increase the tradability and therefore liquidity of the asset class. On principle, The Investment Association would welcome standardisation of investor reports. However, EIOPA **<u>should not</u>** include standardisation of disclosures on infrastructure projects as part of any criteria for receiving a specific prudential treatment. In addition, regulators should not seek to standardise any contractual elements of an infrastructure project. Contractual flexibility is key to ensuring that a project is tailored to the needs of the parties of the transaction, taking into account the different jurisdictional specificities. Further, standardisation of contractual terms is a market issue. If there is appetite among the market participants for more standardisation of contractual terms, market practice will evolve to meet this requirement.	