

Comments Template on EIOPA-CP-15-003 Discussion Paper on Infrastructure Investments by Insurers		Deadline 26.April.2015 23:59 CET
Company name:	NATIXIS	
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<p>Please follow the instructions for filling in the template:</p> <ul style="list-style-type: none"> ⇒ <u>Do not change the numbering</u> in column "Reference". ⇒ Please fill in your comment in the relevant row. If you have <u>no comment</u> on a paragraph, keep the row <u>empty</u>. ⇒ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. <ul style="list-style-type: none"> ○ 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. ○ If your comment refers to sub-bullets/sub-paragraphs, please indicate this in the comment itself. <p>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).</p> <p>The paragraph numbers below correspond to Consultation Paper No. EIOPA-CP-15-003.</p>		
Reference	Comment	
Question 1	We let insurers respond to this question	
Question 2	While the availability of public data on the past performance of infrastructure investments is limited, there is evidence from a Moody's study published in March 2015 (Default and Recovery Rates for Project Finance Bank Loans, 1983-2013) and S&P Capital IQ Project Finance Consortium database that unrated loans used to finance projects are a resilient class of specialized lending (under basel II definition.) and are	

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	<p>structured to be highly robust to a wide range of potentially severe risks and to minimize post-default losses.</p> <p>In particular, unlike for corporate debt, default rates for project finance loans improve markedly over time. Furthermore, recovery rates on project finance loans are largely independent of the economic cycle, unlike recovery rates for corporate loans that tend to fall when default rates rise.</p>	
Question 3		
Question 4	<p>In our opinion, the rated/unrated by an ECAI criteria is not relevant as it does not give any indication of the riskiness of the transaction. ECAI rated projects are quite rare in project finance because of the role of banks in this sector.</p> <p>As evidence the S&P capital IQ project finance consortium database was consisting of 462 projects in the rated universe for a total of 7 596 projects¹ and the proportion of defaulted projects between rated and unrated are almost identical.</p> <p>Those projects are indeed rated but not by an ECAI but by its lenders. Each bank individually had to access the credit quality and recovery based on its internal credit and recovery models and procedures.</p>	
Question 5	<p>BCBS definition could definitely be used as it has been employed by banks since their validation in IRB, ie for a number of years, roughly 7 years or more. The articles 219, 221 and 222 (June 2006 text) provide a definition of Infrastructure Project Finance which appropriately reflects those transactions.</p> <p>Indeed we consider that this asset class is characterised by the combination of :</p> <ol style="list-style-type: none"> 1) a structure that meets the criteria listed in paragraph 219 and enables lenders to control cash flows generated by the asset financed, and 2) underlying assets which are infrastructure ones, of which some examples are provided in paragraph 221. 	

¹ S&p Capital IQ Project Finance Consortium database-October 17, 2014

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Indeed, Infrastructure Project Finance is an asset class where lenders rely on cash flows generated by the assets financed which are infrastructure assets providing essential products or services, and operated in organized/regulated markets, generating sustainable cash flows over the long term. They comprise large long-term infrastructure assets such as social and transportation, natural resources, telecommunication and power infrastructures. The control of Cash Flows is obtained with various collateral packages and covenants.

CRR could also be used, in addition to BCBS definition, but is less specific than BCBS one.
In conclusion, BCBS definition could be used, adding a more exhaustive list of infrastructure assets, ie using the OECD list of infrastructure assets.

Question 6

See Council Directive 2008/114/EC,

Question 7

Our preferred option is the combination of:

An Infrastructure Asset OECD definition	and +	A Project Finance Structure Basel II definition (art 219,221)
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Art 219: Within the corporate asset class, five sub-classes of specialized lending (SL) are identified. Such lending possesses all the following characteristics, either in legal form or economic substance:

- The exposure is typically to an entity (often a special purpose entity (SPE)) which was created specifically to finance and/or operate physical assets;
- The borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;
- The terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates; and

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	<p>- As a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.</p> <p>Art 221: Project finance (PF) is a method of funding in which the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security for the exposure. This type of financing is usually for large, complex and expensive installations that might include, for example, power plants, chemical processing plants, mines, transportation infrastructure, environment, and telecommunications infrastructure. Project finance may take the form of financing of the construction of a new capital installation, or refinancing of an existing installation, with or without improvements.</p> <p>Those criteria are well known by market participants (Sponsors, Lenders, Rating Agencies) and benefits from historical data. Effectively it's by the combination of those two criteria that project finance is currently defined by the bank regulation and by rating agencies and it's the same definition that are used by S&P and Moody's for their statistical default and recovery studies.</p>							
Question 8	<p>Here we can refer to the "infrastructure investment narrative" (see Blanc-Brude 2013), that is, the notion that infrastructure projects uniquely combine the following characteristics:</p> <ul style="list-style-type: none"> • Low price-elasticity of demand for service, hence low correlation with the business cycle • Monopoly power, hence pricing power, hence an inflation hedge • Predictable and substantial free cash flow • Attractive risk-adjusted cash flows, available over long periods • Access to unlisted, illiquid financial assets, 							
Question 9	<p>Yes, see details below:</p> <table border="1" data-bbox="371 1326 1603 1396"> <tr> <td data-bbox="371 1326 618 1362">Legislation</td> <td data-bbox="618 1326 752 1362"></td> <td data-bbox="752 1326 1603 1362">Text</td> </tr> <tr> <td data-bbox="371 1362 618 1396">Council</td> <td data-bbox="618 1362 752 1396">Article</td> <td data-bbox="752 1362 1603 1396">'critical infrastructure' means an asset, system or part thereof located</td> </tr> </table>	Legislation		Text	Council	Article	'critical infrastructure' means an asset, system or part thereof located	
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	<p>Directive 2008/114/EC</p> <p>http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:345:0075:0082:EN:PDF</p>	2(a)	<p>in Member States which is essential for the maintenance of vital societal functions, health, safety, security, economic or social well-being of people, and the disruption or destruction of which would have a significant impact in a Member State as a result of the failure to maintain those functions;</p>		
Question 10	<p>In our opinion complete sectors cannot be excluded. For example you have stated that the port sector is of higher risk, this is potentially true for container terminals which have been strongly affected by the shipping crisis but this is definitely not the case for ports which benefits from diversification of revenues or benefit from a strong competitive advantage based on their location.</p> <p>As an example, Associated British ports is benefiting of a recent upgrade by Fitch from BBB+ to A- with the following statement on its analysis :</p> <p>“ ABPA's dominant market position in a captive island market, its diversity - both in terms of client-base and geographical spread - and the strategically sound location of its facilities near key industrial facilities that underpin key cargo lines point to a 'Stronger' assessment of volume risk. Volumes were up 4.1% yoy for 1H14, driven primarily by throughput volume growth in biomass, import/export vehicles and increased container volumes following the opening of a new berth at the terminal at Southampton.</p> <p>Revenue - Price: Stronger ABPA's "landlord" business model features protective contractual arrangements with key customers and flexibility with respect to price. This enables them to minimise volatility related to operating risk, which leads to fairly stable cash flow comprising mostly contracted payments.</p>				

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	<p>Customers are strategically 'locked in' by joint project investments on or near ABP land; nearly 50% of revenue is either contractually fixed or subject to minimum guarantees as of 2014. “2</p> <p>You are also mentioning technological risk, those risks could be mitigated by the project finance structure of the transaction through different and often combined ways: Guarantees, Reserve accounts, Scenario analysis.</p> <p>Therefore we recommend not to exclude complete sector but to set principles like the necessity of stable cash flow but to let the investor to analyze if this criteria is fulfilled on a case by case basis.</p>	
Question 11	Not to our knowledge	
Question 12	Projects will rarely fulfilled all criteria identified therefore there should room for expert judgment	
Question 13	<p>Criteria indicated in Basel II text in articles 219, 221 and 222 regarding the definition of PF, and as well the Slotting Criteria method indicated in appendix 6 of Basle II text for the PF risk assessment, would respectively be useful to distinguish the PF infrastructure asset class and to assess the risk of the different projects.</p> <p>We underline that the current revision of the Standard Method by EBA does not at this stage provide relevant criteria for risk assessment of project finance. The Standard Approach, too simplistic by nature, is not appropriate for Project Finance which risk has to be assessed on the basis of a number of qualitative and quantitative criteria. At this stage, the proposed criteria are leverage (defined as Total Assets / Total Equity) and revenues. Clearly, revenues are not relevant as Project Finance repayment depends on Cash Flows Available for Debt Service, which are different from revenues and equal to revenues minus supply costs, operating expenses, maintenance capital expenditure costs and taxes. For an equivalent amount of revenues, the level of cash flows available for debt service can be very different between two projects. Leverage also is not sufficient. The level of equity injected is one of the risk drivers of Project Finance but it has to be analyzed in light of the analysis of the risks of the project. The more risky a project is, the more equity is needed. For the same level of equity proportion, two projects can have a very different final level</p>	

² Fitch Upgrades ABP Finance PLC’s ratings to A—08 Dec 2014

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	<p>of risk.</p> <p>Finally, as they are too simplistic, not discriminating the projects according to their risks, the proposed criteria for the revised Standard method would have a perverse effect as, given the fact that regulatory capital would not reflect the risks taken, it would lead to the choice of the most risky transactions which are the most remunerative ones.</p>	
Question 14	<p>The criteria of the Slotting Criteria are useful and cover the different types of risk. We underline that the risk on a Project Finance should be assessed as a whole, as the level of risk of a PF results from a combination of different risks and their mitigating features, together with the amount of debt granted. In other words, the final risk on a project finance results from the capacity of the financed asset to generate cash flows over the long run and from the amount of debt granted. Therefore structure and quality of a project can only be assessed taking into account the different criteria altogether.</p>	
Question 15	<p>Banks have defined more specifically criteria for PF in their IRBA models. Proposals of additional criteria, in top of BCBS Slotting Criteria ones for risk assessment would be based on those models.</p> <p>Should the regulator aim to get a rather simple approach of the risk assessment, we would propose the following combination of criteria :</p> <ul style="list-style-type: none"> ○ Quantitative criteria : <ul style="list-style-type: none"> ○ DSCR : observable in terms of forecasted and realized DSCR, through certificates of DSCR, thus enabling to assess the volatility of DSCR of the asset class. (DSCR is the Debt Service Cover Ratio and is equal to the Cash Flow Available for Debt Service divided by the principal and interest to be paid on a given year). ○ LLCR , PLCR : PLCR takes into account the cash flows of the “ tail” period, ie the cash flows generated after loan maturity until the end of the asset life and which enable lenders to postpone maturity in case of restructuring. (PLCR is equal to the sum of discounted cash flows available for debt service generated by the project company over the project life, divided by the debt amount). LLCR is the same ratio but takes into account only cash flows generated over the life of the loan. ○ Indemnity to be received in case of a concession 	

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	<ul style="list-style-type: none"> ○ % of debt which is hedged ○ Swap rate ○ margin ○ Qualitative criteria : <ul style="list-style-type: none"> ○ Greenfield (construction period) /Brownfield (operating project) project ○ Contracted/partially contracted/merchant cash flows ○ (possibly percentage of cash flows contracted) ○ Country ○ Quality of the sponsors : implication and financial strength ○ Quality of off-takers ○ Quality of suppliers ○ Percentage of debt covered by a comprehensive Export Credit Agency cover 	
Question 16	Not to our knowledge	
Question 17	<p>Political Risk: EIOPA suggests that one way to limit political risk in transactions would be to restrict investment to those only from OECD countries. We think this approach as too simplistic. This criteria should rather rely on a real assessment of the legal environment of the country and allow for mitigants to be applied such as the presence of multilateral entities in the financing, political risk insurance for example.</p> <p>Ratings agencies (ex: Fitch Country-Specific Treatment of Recovery Ratings), political risk insurer providers (Ex: Euler Hermes Country Risk Ratings, Aon political risk map, Coface) - or information providers (The Economist Infrascopie) are providing good indication on the political and country risks.</p> <p>Structural Requirements – legal separation: EIOPA suggest that public credit performance data indicate that one of the main indicators of defaults is the lack of structural separation from the sponsor. From a structural point of view, typically lenders and investors on a non-recourse project would seek to ringfence the loan to the SPV from the sponsor’s credit even if the sponsor has a controlling interest in the project</p>	

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	<p>equity and the credit rating agencies consolidate the project debt at the sponsor level for ratings purposes of the parent. There will be both structural and contractual separation, for example in dividends that the sponsor can take. Lenders and investors would normally have security over the sponsors' shares in the SPV issuance vehicle so that the lender or investors can enforce the share security in the event of a default and take over the SPV and the project. We agree that this is an important issue, however, it is not clear whether the degree of legal separation can be quantified for capital charge calibration purposes. We believe that the degree of structural separation is already reflected</p> <p>.</p> <p><u>Structural Requirements – use of derivatives:</u> EIOPA suggests that a limitation on the use of derivatives solely for risk mitigation purposes could be use in reducing overall risk. We agree with this approach.</p> <p><u>Structural Requirements – monitoring agent:</u> Typically in a loan agreement there is an agent who normally undertakes a monitoring role and passes the information on to the various lenders or investors. The agent, normally acting on the instructions of a majority of the lenders or investors, will have the rights to contract an independent consultant depending on the specific issue/problem. There will also be a security trustee who manages the security. In mixed bank loan/bond transactions there will typically be an intercreditor agreement which the security agent will monitor and act upon.</p> <p>In the case of a bond-only transaction, in addition of the normal issuing and paying agent there will also need to be a security agent. Monitoring agents are available to perform this function for non-bank investors as well as banks.</p>	
Question 18	No further comment	
Question 19	No further comment	

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Question 20	<p>Construction risk perception in project finance is greatly exaggerated evidence demonstrates that in project finance “construction risk is always very effectively passed on to the builder and very rarely returns to haunt the project company”³</p> <p>Construction risk in project finance is managed through a network of contracts and passed on to construction firms under fixed price date certain contract. Those construction companies are bearing the real construction risk. Therefore one of the critical aspects is the assessment of the contractor’s quality both in its technical capacity to deliver but also in its financial capacity to support the financial consequences of cost overruns and delays. If the contractor financial strength is considered weak by the lenders a higher level of liquid guarantees (1st demand bond guarantee) will be requested by the lenders in order to cover the liquidated damages due by the contractor to the SPV in case of delays.</p> <p>The level of complexity of the construction is also a criteria, the financial strength of the contractor requirements will increase with the degree of complexity as well as the level of cap of liability of the contractor and the level of guarantee as it is considered more difficult to substitute the contractor for complex construction works.</p> <p>The ramp-up period is usually mitigate through contingency funding (ex some transactions includes a ramp-up reserve account which allows the SVP to pay its interest even if the expected traffic is taking longer to materialize.</p>	
Question 21	The construction must be delegated to an experienced contractor or group of contractors (this will be confirmed by an independent technical advisor opinion) through an EPC fixed price date certain contract.	
Question 22	First of all, the best mitigants for construction risk is good structuring of the project. Credit enhancement is no longer contemplated in transactions (or only on very specific case) both because Monolines are not	

³ How much construction risk do sponsors take in project finance-Blanc Brude- Makovsek Edhec-Risk Institute- August 2014

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	<p>longer in business following the financial crisis but also because investors have now realised the interest to finance the construction period ⁴.</p> <p>Credit enhancement (such as the EFSI will provide under the Juncker plan) could have benefit when the construction risk could not be taken by banks and investors because of the credit rating of the contractor, the nature or the not yet proven technology or design.</p>	
Question 23	<p>A restriction to PPP type transactions is undesirable as it is representing an extremely small sample of the project finance universe, it is not compliant with the investment focus of the Juncker plan which is clearly targeting riskier project than project usually financed by EIB.</p> <p>Revenue risk need to be captured by using minimum ratio figures (i.e DSCR) per sub sector with a different ratio threshold if the revenues are contracted or merchant. For example an availability toll road should fulfilled a minimum ratio of 1,17 and a traffic risk exposed toll road should fulfilled a minimum ratio of 1,40.</p>	
Question 24	No	
Question 25	In addition to the contractual arrangements already identified you can also consider price regulation of monopolistic companies (ex: Water, Gas, Airports) where the regulator is allowing a return on investment by adjusting the tariff. This is usually refers as regulatory asset base model (RAB).	
Question 26	An individual non-public off taker should be Investment grade and the size of the transaction should not represents a too important size compared to its turnover.	
Question 27	As already mentioned, the DSCR ratio is the most relevant ratio as it reflect the ability of the company to pay its debt. It should be supplemented by the LLCR and PLCR to capture the ability of the project to repay its debt on the long run. The difference between the PLCR and LLCR reflect the importance of the tail (the length of the period between the loan final repayment date and the end of the concession or revenue contract).	

⁴ See Blanc Brude- Who is afraid of construction risk- Edhec Risk institute-July 2013

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	The DSCR and its volatility is at the center of the Valuation model developed by the EDHEC Risk Institute ⁵ .	
Question 28	Ratio analysis is just one section of credit analysis in project finance. There is no one fit all ratios at it depends on the analysis of the nature of the revenues risk.	
Question 29	Junior debt can also been considered naturally the rating of the Junior tranche should be lowered by one or two notches and the LGD must by higher to reflects the subordination nature of the exposure.	
Question 30	The existence of a refinancing risk should be part of the credit risk analysis and should not be excluded per se. Some projects are financed on medium term basis (7 years) as this period could correspond to the normal cycle of capex investments or to the length of tariff review (ex: OFWAT regulatory period in the uk for water companies). Given the stable revenues nature of infrastructure the risk of being unable to refinance debt is reduced.	
Question 31	Infrastructure loans can be structured in various ways, with calls, puts, and prepayment penalties for early repayment. In some cases there is a full mark to market of a prepaid position (a "spens" clause) or in some cases there is a preagreed prepayment penalty.	
Question 32	This assessment should be made by the technical advisor	
Question 33	Banks are historically the analysers of project finance transactions. They have the internal skills and teams to structure and more importantly to monitor transactions notably through covenants and to restructure them if needed. One solution could be to rely on the expertise of the banks but it could work provided that the structuring bank have an alignment of interest with the investors.	
Question 34	The basic nature of long-term investments is that they are invested long term, i.e. investors in principle will hold those assets from origination to either maturity or restructuring in the default event. This is why there is no (liquid) secondary market with observable traded prices of those assets during its lifetime. Consequently in the absence of traded prices during the maturity of those assets available data do not fit with the structure of the standard formula as available data purely focus on default frequencies and loss	

⁵ Valuation and Performance of Unlisted Infrastructure Debt- Edhec Risk- Blanc Brude, Ismaïl, Hasan- 2014

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	<p>given default ratios.</p> <p>The calibration should reflect those characteristics therefore we think that infrastructure debt should be treated via the counterparty default risk module. This treatment could also be justified by great similarities (Long term, illiquid, high recovery, secured exposures) between infrastructure debt and mortgages investments which are already treated through this module.</p>	
Question 35	We don't think internal models are the right approach as it will not allow small and medium size investor to participate into this asset class.	
Question 36	Edhec Risk Institute is currently in the process of collecting investor and bank cash flow data spanning 20 years and will have assembled a sample of 200 projects by the summer 2015. Beyond it will continue to grow this sample to 2000 projects by 2017.	
Question 37	We are not covering Equity, please refer to works from Edhec Risk Institute chair on Infrastructure Equity.	
Question 38		
Question 39		
Question 40		
Question 41		
Question 42	Project bonds represent a small proportion (estimated <10%) of all project financing in OECD countries and are not actively traded or regularly priced therefore their use as a proxy (when available) for all project financing is more than doubtful.	
Question 43		
Question 44	Infrastructure corporate debts are different as they are not satisfying with the project finance structure criteria and recovery rates are very much different therefore it should be excluded as a proxy.	
Question 45	Long-term investment when hold to maturity are not exposed to any spread risk coming from the volatility of the risk premium. This is why spread risk shall not be considered at all. So the adjustment factor should be derived such that all spread risk is eliminated.	

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Question 46	The condition which ensures that an insurer is in a position to hold the infrastructure investments to maturity is that an insurer is not exposed to fire-sale risk by the structure of its asset-liability profile but Insurers must keep some flexibility to manage risks appropriately therefore no strict hold to maturity requirement should be imposed.	
Question 47	Corporate debt like SME loans are exposed to additional risk compared to infrastructure project debt. Corporates are operating companies with material entrepreneurial risk whereas in projects management is constrained by contracts and therefore generate a different risk profile. This is why a special category for project in general and infrastructure projects in specific could be justified.	
Question 48	<p>As the infrastructure debt is illiquid, there is no price to implement a specific calibration for SCR spread. Moreover, the insurers invest in Infrastructure debt because that matches their long term liabilities so the rationale behind is to hold it to maturity which is consistent with the very poor secondary market and with the long term sustainable cash flows provided by underlying assets of Infrastructure Project Finance.</p> <p>When a position is hold to maturity there is no spread risk, there is only a counterparty risk (loss risk). These two risks belong to the default counterparty risk. The infrastructure debt could be considered as a type 2 exposures.</p> <p>Our suggestion would be to create a new category in the type 2 exposures as a loan secured thanks to the common security package by the cash flows generated by the SPV.</p>	
Question 49		
Question 50	We consider that Infrastructure debt should be considered as a type 2 exposures.	
Question 51	A potentially interesting alternative could be the use of internal ratings produced by banks: insurers may invest alongside a bank. The bank underwrites the loans and the insurer invests in the loan portfolio. This allows the insurer to achieve a higher degree of diversification and to benefit from the expertise of the bank. If the bank uses an internal model approved by the banking supervisor to measure the risk, this rating could then also be used for Solvency II purposes. A similar approach is followed in EMIR, for which the draft consulted last year proposes to allow non-banks to use the IRB model of a bank to assess the credit quality of collateral collected in OTC derivative transactions.	

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	Natixis has developed a co-operation offer. This product allows the Insurer to co-lend in transaction originated by Natixis. As Natixis keeps a part of the transaction in its books, the full initial risk analysis is done for Natixis credit committee and is share with the Insurer. The Natixis analysis includes the rating and the LGD (Natixis is IRBA with internal model validated by ACPR) of the transaction which is updated on a yearly basis and share as well with the Insurer. Natixis shares as well all the waiver requests received from the Borrower. This allows the insurers to have a full fundamental analysis and the credit metric at the investment decision making and during the whole life of the transaction.	
Question 52	Generally insurers should be expected to go through the same sort of upfront and ongoing risk management processes that a bank experienced in project finance would go through, albeit the insurer is likely to need to out-source some of these activities (and/or partner with experienced banks) unless it builds its own dedicated team. When outsourcing part of the risk management function the undertaking needs to take care of a proper alignment of interest with the third party.	
Question 53	Financial models are usually provided by project sponsors or by the lead financier (often an experienced bank). As the credit quality of an infrastructure project lending exposure whether equity or debt is mainly driven by the ability of the project to generate (stable) cashflows a financial model is a key input for risk evaluation. Such models can be used to run valuation of the exposure (expected case) stress scenarios (downside cases).	
Question 54	Financial models (generally produced by the financial adviser of the sponsors and check by the modelling bank) need to be able to generate full financial statements (balance sheet, profit & loss, cash flow) from a variety of scenarios. They would often be audited by a third-party (often an accounting firm) to confirm formulae consistency and the key assumptions (e.g. technical, tax, market, insurance) would normally be checked for accuracy/reasonableness by independent advisors.	
Question 55	The EDHEC Risk Chair has already published a reporting template for data collection ⁶	
Question 56	This requirement will facilitate data collection and improved the transparency of the asset class.	
Question 57	Regarding reporting EDHEC Risk Institute and EFR have produced very similar template	

⁶ Unlisted Infrastructure Debt Valuation & Performance Measurement- Edhec Risk Institute-Blanc Brude, Hasan, Ismaïl_ July 2014

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Question 58		
Question 59		
Question 60		