

Technical Advice on the identification and calibration of infrastructure investments risk categories, i.e. infrastructure corporates

- ✓ EIOPA advises to enhance the asset class for high quality infrastructure investments under Solvency II.
- ✓ High-quality investments in infrastructure corporates to qualify under infrastructure asset class.
- ✓ Risk charges for investing in qualifying infrastructure corporates have been carefully calibrated to the respective risks leading to a different treatment.
- ✓ To benefit from a differentiated treatment, insurers should conduct due diligence and have adequate risk management systems.

Questions & Answers

1. What did EIOPA advise in September 2015 (previous call for advice on infrastructure)?

EIOPA recommended the introduction of a new asset class of qualifying infrastructure investments. Qualifying investments were limited to infrastructure projects where a special purpose vehicle (SPV) is used.

An SPV is a legal entity that is established for a specific purpose (e.g. building a bridge or a hospital) and therefore usually has a limited lifetime. Qualifying conditions also needed to be met relating for example to the predictability of the cash flows and the robustness of the contractual framework. The risk charges proposed for qualifying investments were significantly lower than for debt and equity investments in other (non-infrastructure) companies.

2. What is an infrastructure corporate?

An infrastructure corporate is an entity or corporate group, which carries out infrastructure activities (energy generation, social housing, healthcare/hospitals etc.). The term "corporate" essentially means that it is a "regular" company, which would not normally have a fixed lifetime. In contrast, for project finance a special purpose vehicle (SPV) is used and investors often have specific control rights.

3. How are infrastructure corporates currently treated under Solvency II?

Infrastructure corporates are currently treated in the same way as any other company. For equity investments their treatment depends essentially on whether and where the company is listed. For debt, the treatment essentially depends on the ratings and duration of the investment.

4. What is the proposed treatment of infrastructure corporates in EIOPA latest Technical Advice?

EIOPA recommends addressing the issue in two ways:

- To allow certain infrastructure corporates to qualify for the treatment for qualifying infrastructure projects currently in the Solvency II regulation (i.e. according to the amendments to the Solvency II Delegated Regulation which entered into force on 1 April 2016, based on EIOPA's September 2015 advice) provided that there is an *equivalent level of risk*. For this, EIOPA's proposals are to change the definition of infrastructure project to provide some flexibility in the financing structure and the contractual framework requirements to allow relevant infrastructure corporates to qualify. In the advice such investments are still referred to as "qualifying infrastructure projects" (even though some corporates may now fall into this definition).
- To create a separate differentiated treatment for other types of high-quality corporate infrastructure investments, which have a different risk profile. For this, the proposals are to identify suitable infrastructure corporates through a number of qualifying criteria, such as a minimum number of years of operation and diversified revenues. Equity investments in qualifying infrastructure corporates would have a reduced risk charge. Similar risk management requirements (as for qualifying)

infrastructure projects) also need to be met. In the advice such investments are referred to as "qualifying infrastructure corporates".

5. Why did EIOPA suggest a separate category for investments in infrastructure corporates with different qualifying criteria?

The changes to the definition of infrastructure projects are intended to allow "project-like" corporates with an equivalent risk profile to high-quality infrastructure projects, but which simply have a different legal or financing structure (i.e. a corporate form), to qualify. EIOPA expects that this will capture only a part of the infrastructure corporate asset class.

Since EIOPA identified that equity investments in other types of infrastructure corporates, although they have a different risk profile to infrastructure projects, still have a better risk profile than implied by the current treatment in the Solvency II standard formula, it was prudentially justified to recommend a separate differentiated treatment for such investments.

6. What are the main criteria to identify infrastructure corporates with a better risk profile?

The criteria were derived from the properties of the entities analysed. The main criteria are that the corporate must derive the substantial majority of its revenues from specified infrastructure sectors and that there must be sufficient revenue predictability. In addition, the corporate must have a credit quality step of at least 3, or where there is no external rating at least 3 years operational history and an appropriate capital structure.

7. Why does EIOPA propose a list of qualifying sectors?

Qualifying infrastructure corporates are restricted to those operating in the following lines of business: generation, transmission or distribution of electrical or thermal energy; distribution or transmission of natural or petroleum gas; provision of water or wastewater services; waste management or recycling services; transport networks or the operation of transport assets; social infrastructure.

The recommended approach is to include only sectors where there is evidence of better performance, on average, compared to non-infrastructure corporates including financials. Since for qualifying infrastructure corporates there are relatively few criteria, this provides an additional safeguard that in general companies operating in the sectors listed are those that have performed reasonably well.

In addition, the responses to the public consultation indicated that the approach captures most existing infrastructure sectors. The main exclusion that was noted by stakeholders that was not included in the final advice is the telecoms sector (see question 8).

8. Why did EIOPA not include telecom infrastructure in its advice?

EIOPA analysed the risk profile of a portfolio of listed infrastructure corporate equity. The result for telecoms was that the risk of those listed entities analysed was similar to or even higher than corporates in general (i.e. including both infrastructure and non-infrastructure).

In the consultation paper (CP) EIOPA therefore proposed not to include telecoms in the list of qualifying sectors. In response to the CP, stakeholders provided input on the risk profile of the telecoms sector, mainly of a qualitative nature, arguing for example that most listed companies are "integrated" telecom companies (i.e. combining infrastructure with "end user" services), and that "core" infrastructure companies, which are generally unlisted, are considered to be safer investments. However, EIOPA does not have data for the unlisted companies and for the limited number of companies that stakeholders identified as "core" infrastructure that are listed, the equity prices did not perform well according to the analysis conducted.

As EIOPA states in the consultation feedback, whilst there are some arguments why certain (non-integrated) telecom companies that provide the infrastructure for the networks (e.g. fibre, telecom towers) may have low volume risk and represent lower risk investments, there is a lack of historical evidence to support a preferential treatment. Therefore, whilst EIOPA is aware of the importance of the sector for the European infrastructure initiatives, it can base its conclusions and in particular any calibration proposal only on robust evidence (i.e. historical data).

9. Why does EIOPA suggest a restriction to EEA and OECD countries?

The restriction to EEA is based on the context of the call for advice from the European Commission which is the European Union Capital Markets Union (CMU).

During the public consultation, stakeholders questioned why OECD countries were not permitted, since they were in EIOPA's previous advice on infrastructure projects. In this respect EIOPA reviewed its position in the final advice, since generally within the Solvency II framework OECD countries are treated as being of an equivalent risk to those in the EEA. Therefore, in the final advice, the substantial majority of revenues from the infrastructure corporates must be derived from activities in the EEA or OECD. Thus, this provides consistency between infrastructure projects and corporates.

10. What exactly do the suggested calibration for infrastructure corporate equity mean?

They mean that in case a (re)insurer invests in the equity of a qualifying infrastructure corporate, it will need to hold 36% of the value according to the Solvency II balance sheet as a capital buffer. (As per the current Solvency II framework the capital charge for such investments is 39% or 49%). It is worth mentioning that the calibration is based on the assumption of a diversified portfolio.

11. Why did EIOPA not propose new calibrations for the investments in the infrastructure corporate debt?

This is because EIOPA has not found sufficient evidence to conclude that the risk charges for investments in infrastructure corporate debt should be lower than currently foreseen by the Solvency II framework.

12. What are the next steps regarding this Technical Advice?

The Technical Advice has been submitted to the European Commission (EC) and we expect that the EC will issue an amendment to the Solvency II Delegated Regulation on the basis of this Advice.