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Briefing note

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Infrastructure Corporates – a proposed new treatment under Solvency II

On 30 June 2016 the European Insurance and Occupational Pension Authority ("**EIOPA**") published its recommendations to the European Commission in relation to the treatment of infrastructure corporates under Solvency II. The recommendations are aimed at helping insurers increase their portfolio diversification and, if the new criteria are met, insurers can benefit from a lower risk charge for equity investments. This briefing contains an overview of these recommendations.

Qualifying infrastructure investments

In September 2015 the European Commission announced new legislation to modify the Solvency II Delegated Regulation to "create better incentives for insurers to invest in infrastructure projects" by introducing a new asset class of qualifying infrastructure investments – see our briefing "*Infrastructure – a new asset class for insurers*" for more detail on this. Following this, the European Commission sought further advice from EIOPA in relation to the treatment of infrastructure corporates.

Many market participants had previously argued for an expansion to bring corporate entities operating infrastructure assets (e.g. ports, airports and utilities) within the scope of the new asset class, provided that the assets or cashflows pertaining to the infrastructure assets were appropriately ringfenced.

EIOPA undertook a new consultation with stakeholders in relation to the treatment of infrastructure corporates, the results of which fed into its final recommendations.

The key recommendations made by EIOPA are as follows:

- Expansion of the qualifying infrastructure investment asset class (previously limited to special purpose vehicles ("**SPVs**")) to also cover certain project–like infrastructure corporates where there is an equivalent level of risk. (This asset class is referred to in this note as "**Qualifying infrastructure project investments**" or "**infrastructure projects**").
- A new asset class to cover equity investments in high quality corporate infrastructure investments with a different risk profile to those mentioned above ("**Qualifying infrastructure corporate equity investments**" or "**infrastructure corporates**");

Expansion of the infrastructure projects asset class

The principal differences between the old Qualifying infrastructure investments definition and the new Qualifying infrastructure projects investments definition are:

1. the definition now encompasses a corporate group (rather than a single entity only) which derives the substantial majority of its revenues from infrastructure assets (previously the primary source of payments was required to be the income generated by the assets being financed);
2. previously provisions were required protecting debt providers and equity investors against losses resulting from a decision by the purchaser of the goods and services to terminate the project, unless the revenues of the project were funded by payment from a large number of users. In the revised definition such provisions are also not required if the revenues are

subject to a rate-of-return regulation;

3. the requirement for security has become more flexible, allowing for the use of other security mechanisms where it can be demonstrated that security in all assets and contracts is not essential for debt providers to effectively protect or recover the vast majority of their investment; and
4. EIOPA has proposed to clarify that the requirement for consent of the existing debt providers to the issue of new debt can be addressed by the inclusion of contractual provisions permitting the issuance of new debt over a certain threshold.

Comparison of the infrastructure projects and the infrastructure corporates asset classes

- The infrastructure projects asset class covers both debt and equity investments whereas the infrastructure corporates definition covers equity investments only.
- A prescribed list of sectors applies to infrastructure corporates only. Infrastructure projects are required to have a contractual or regulatory framework that meets certain criteria. There is an additional list of requirements for unrated debt and equities.
- The only notable differences between the revenue predictability and predictability of cash flows elements of the definitions are (1) the infrastructure projects definition requires "*all except an immaterial part of the revenues*" to satisfy the conditions whereas the infrastructure corporate definitions does not contain this wording, referring simply to "*The revenues*"; and (2) there is a requirement for the infrastructure corporates' revenues to be diversified unless the revenues are subject to a rate-of-return regulation.
- The stress testing for infrastructure projects takes into account risks arising from non-infrastructure activities but does not take into account any revenues generate by such activities. The infrastructure corporates definition is silent on the question of stress testing.
- Infrastructure corporates must be located in the EEA or OECD. Only where investments are in equities, or bonds or loans for which a credit assessment by a nominated ECAI is not available are infrastructure projects required to be located in the EEA or OECD.
- For infrastructure corporates a credit quality step of at least 3 is required OR that it has been active/in operation for at least 3 years. For infrastructure projects debt investments must have a credit assessment of at least credit quality step 3 OR be senior or *pari passu* to all claims other than statutory claims and claims from liquidity facility providers, trustees and derivatives counterparties.

Qualifying infrastructure corporate equity investments

The new definition of Qualifying infrastructure corporate equity investments refers to specific qualifying sectors[1], not including telecom infrastructure. The rationale provided for the choice of sectors listed is that only sectors where there is evidence of better performance (on average) than non infrastructure corporates have been included. The definition also imposes conditions in relation to revenue predictability (which replicate the criteria for Qualifying infrastructure project investment), rating levels and geographies.

A reduced equity risk charge of 36% is recommended for well-diversified portfolios of Qualifying infrastructure corporate equity investments (which compares to 30% for equity Qualifying infrastructure project investments). It is recommended that these will also have a correlation coefficient with equity type 1 of 75% and with equity type 2 of 100% (i.e. that they would be treated like type 2 equities for the purpose of aggregation).

EIOPA has stated that it has not found sufficient evidence to conclude that the risk charges for debt investment in infrastructure corporate should be lower than that foreseen by the Solvency II framework. This asset class is therefore relevant to equity investments only.

The definitions proposed by EIOPA have been reproduced in full in the boxes on pages [4 – 7].

EIOPA has indicated that it expects the European Commission to issue an amendment to the Solvency II Delegated Regulation on the basis of these recommendations. This has not yet been confirmed by the European Commission.

Additional EIOPA recommendations

EIOPA has also recommended that insurance and reinsurance undertakings be required to:

- conduct adequate due diligence prior to making a qualifying infrastructure investment;
- regularly monitor and perform stress tests on the cash flows and collateral values supporting any qualifying infrastructure investments;
- establish written procedures for an active monitoring of any material qualifying infrastructure investments during the construction phase and for a maximisation of the amount recovered from any qualifying infrastructure projects in the case of a work-out scenario; and
- set up their asset-liability management to ensure that they are able to hold any qualifying infrastructure project investments in bonds or loans to maturity.

Similar requirements are already included in the Solvency II Delegated Regulation in respect of qualifying infrastructure investment.

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[1]
- 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.

EIOPA recommended definitions

General definition

"Infrastructure assets' means physical assets, structures or facilities, systems and networks that provide or support essential public services.

Infrastructure corporate

Qualifying infrastructure corporate equity investments are recommended to include those investments that meet the definition and criteria requirements set out below*:*

Definition

'Infrastructure corporate' means an entity or corporate group which derives the substantial majority of its revenues from owning, financing, developing, or operating infrastructure assets in the EEA or OECD 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 assessment whether the conditions above are met should be based on the last reporting period for which figures are available or a financing proposal.

In case a general credit assessment or an assessment for senior secured or unsecured exposures issued by an ECAI for the infrastructure corporate exists it shall be assigned to a credit quality step of at least 3. Otherwise, the infrastructure corporate has been active in these lines of business for at least three years or in the case of an acquired business it has been in operation for at least three years.

Revenue predictability

The revenues generated by the infrastructure assets shall meet the following conditions:

1. One of the following criteria is met:
   (i) The revenues are availability-based;
   (ii) The revenues are subject to a rate-of-return regulation;
   (iii) The revenues are subject to a take-or-pay contract;
   (iv) The level of output or the usage and the price shall independently meet one of the following criteria:
      a. it is regulated;
      b. it is contractually fixed;
      c. it is sufficiently predictable as a result of low demand risk;
2. Where the revenues are not funded by payments from a large number of users of the service, the party which agrees to purchase the goods or services provided by the infrastructure corporate shall be at least one of the following:
   (i) an entity listed in Article 180(2) of this Regulation;
   (ii) a regional government or local authority listed in the Regulation adopted pursuant to Article 109a(2)(a) of Directive 2014/51/EU;
   (iii) an entity with an ECAI rating with a credit quality step of at least 3;
   (iv) an entity that is replaceable without a significant change in the level and timing of revenues.
3. The revenues shall be diversified in terms of activities, location, or payers, unless the revenues are subject to a rate-of-return regulation.

Infrastructure projects

Qualifying infrastructure project investments are recommended to include those investments that meet the definition and criteria requirements set out below.

Requirements are intended to apply to all investments (i.e. rated and unrated debt and equity) unless otherwise stated.

Definition

'Infrastructure project' means an entity or corporate group which derives the substantial majority of its revenues from owning, financing, developing or operating infrastructure assets.

Stress testing

The cash flows generated by the infrastructure assets allow for all financial obligations to be met under sustained stresses that are relevant for the risks of the project;

The stress testing shall consider risks arising from non-infrastructure activities, but the revenues generated by such activities shall not be taken into account when determining whether the financial obligations can be met.

Predictability of cash flows

The cash flows generated for debt providers and equity investors are predictable;

The cash flows generated for debt providers and equity investors shall not be considered predictable unless all except an immaterial part of the revenues satisfies the following conditions:

(a) one of the following criteria is met:

- (i) the revenues are availability-based;
- (ii) the revenues are subject to a rate-of-return regulation;
- (iii) the revenues are subject to a take-or-pay contract;
- (iv) the level of output or the usage and the price shall independently meet one of the following criteria:
  - – it is regulated;
  - – it is contractually fixed;
  - – it is sufficiently predictable as a result of low demand risk;

(b) where the revenues are not funded by payments from a large number of users, the party which agrees to purchase the goods or services provided by the infrastructure project shall be one of the following:

- (i) an entity listed in Article 180(2) of this Regulation;
- (ii) a regional government or local authority listed in the Regulation adopted pursuant to Article 109a(2)(a) of Directive 2009/138/EC;
- (iii) an entity with an ECAI rating with a credit quality step of at least 3;
- (iv) an entity that is replaceable without a significant change in the level and timing of revenues.

Contractual framework

The infrastructure project is governed by a regulatory or contractual framework that provides debt providers and equity investors with a high degree of protection including the following:

(a) provisions that effectively protect debt providers and equity investors against losses resulting from a decision to terminate the project by the party which agrees to purchase the goods or services provided by the infrastructure project unless one of the following conditions is met;

 (i) the revenues are funded by payments from a large number of users;

 (ii) the revenues are subject to a rate-of-return regulation;

(b) there are sufficient reserve funds or other financial arrangements to cover contingency funding and working capital requirements of the project;

 Where investments are in bonds or loans, this regulatory or contractual framework shall also include the following:

 (i) Debt providers have security or the benefit of security to the extent permitted by applicable law in all assets and contracts that are critical to the operation of the infrastructure project.

 (ii) Notwithstanding point (i), where undertakings can demonstrate that security in all assets and contracts is not essential for debt providers to effectively protect or recover the vast majority of their investment, other security mechanisms may be used. In that case, the other security mechanisms shall comprise of one or more of the following:

  (a) pledge of shares,

  (b) step-in rights,

  (c) lien over bank accounts,

  (d) control over cash flows,

  (e) provisions for assignment of contracts.

 (iii) the use of net operating cash flows after mandatory payments from the project for purposes other than servicing debt obligations is restricted;

 (iv) restrictions on activities that may be detrimental to debt providers, including that new debt cannot be issued without the consent of existing debt providers in the form agreed with them;

Credit quality step (rated debt only)

Where the investments are in debt for which a credit assessment by a nominated ECIA is available, the instrument shall have a credit assessment of at least credit quality step 3

Financial risk (unrated debt only)

Where investments are in debt for which a credit assessment by a nominated ECAI is not available, the investment instrument and other pari passu instruments are senior to all other claims other than statutory claims, and claims from liquidity facility providers, trustees and derivatives counterparties.

Other requirements for unrated debt and equities

Where investments are in equities, or bonds or loans for which a credit assessment by a nominated ECAI is not available, the following criteria are met:

(i) the infrastructure assets and infrastructure project are located in the EEA or in the OECD;

(ii) where the infrastructure project is in the construction phase the following criteria shall be fulfilled by the equity investor, or where there is more than one equity investor, the following criteria shall be fulfilled by a group of equity investors as a whole:

 – the equity investors have a history of successfully overseeing infrastructure projects and the relevant expertise;

- the equity investors have a low risk of default, or there is a low risk of material losses for the infrastructure project as a result of their default;
- the equity investors are incentivised to protect the interests of investors;

(iii) where there are construction risks, safeguards are established to ensure completion of the infrastructure project according to the agreed specification, budget or completion date;

(iv) where operating risks are material, they are properly managed;

(v) tested technology and design is used;

(vi) the capital structure allows all of the debt to be serviced;

(vii) the refinancing risk is low;

(viii) derivatives are only used for risk-mitigation purposes.

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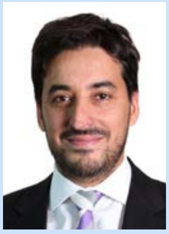

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