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New Solvency II rules on Infrastructure Investment by Insurers

OVERVIEW

The EU is proposing to amend the Solvency II rules that, from 1 January 2016, will apply to infrastructure investments held by EU insurers. The proposal follows the publication of a final report by EIOPA, which is itself the result of a consultation that has been ongoing since February 2015.

EIOPA recommended relaxing the capital requirements for infrastructure investments, provided certain criteria are satisfied. In its draft legislation, the EU Commission has adopted the EOIPA proposals and has, in some respects, adopted an approach which is even more favourable to insurers than EIOPA had proposed.

The proposed changes are likely to encourage greater investment by insurers in infrastructure assets than the original Solvency II rules would have done. EIOPA provided some risk-based economic justifications for relaxing the capital requirements, but the changes are also motivated by the European Commission's policy objective, included in its Investment Plan for Europe announced in November 2014, which aims to encourage investment in infrastructure of at least €315 billion by the end of 2017.

The European Parliament and the European Council now have a three month period in which to review the proposed legislation. If neither of them propose any amendments then the Commission's proposed legislation will become effective on 1 January 2016, at the same time that EU insurers begin to comply with all of the other Solvency II rules.

By their terms, the new rules will only apply to insurers who will calculate their SCR according to the standard formula. However, it seems likely that the rules will be taken into account when regulators are assessing internal model applications of insurers which hope to calculate their SCR using internal models. The proposed new rules should therefore be considered by all insurers, as well as those working on infrastructure transactions in which they hope insurers will invest.

REDUCED CAPITAL CHARGES

The proposed legislation will introduce a new concept of "**qualifying infrastructure investments**". This concept is divided, by reference to the form of the investment, into two categories: "qualifying infrastructure investments in bonds or loans" and "qualifying infrastructure equities". There are a number of criteria that must be satisfied for an asset to constitute a qualifying infrastructure investment.

Where the criteria are satisfied, the asset will receive a more favourable capital charge, meaning that the insurer will be permitted to hold less capital in respect of the asset than would otherwise have been required. In particular:

(a) **Infrastructure Debt**: Where the asset takes the form of bonds or loans issued by an infrastructure project entity, it will not be treated as a securitisation (for which capital charges are much higher than for corporate bonds), and it will benefit from a lower capital charge than a corporate bond of the same credit rating and duration.

For example, a BBB-rated qualifying infrastructure investment of 3 years duration would have a capital charge of 5%, whereas an ordinary corporate bond of the same duration would have a capital charge of 7.5%.

Unrated qualifying infrastructure investments are treated as if they were BBB-rated. By comparison, unrated corporate bonds which are not qualifying infrastructure investments are subject to higher capital charges than BBB-rated corporate bonds.

EIOPA considered whether bonds or loans guaranteed by regional governments or local authorities should be treated as though they were guaranteed by a central bank (which would result in very low capital charges). It decided against this suggestion, but recommended reconsidering it as part of the wider review of the Solvency II standard formula in 2018. The suggested treatment has also not been adopted in the EU Commission's proposed rules.

(b) **Infrastructure Equities**: Where the asset takes the form of an equity investment in an infrastructure project entity, it will benefit from a more favourable capital charge than a listed equity, even where it is not itself listed.

Where the infrastructure project entity is not a related undertaking of the insurer, the equity will have a capital charge of 30%, subject to certain adjustments. By comparison, a listed equity generally has a capital charge of 39%, and an unlisted equity generally has a capital charge of 49%, in each case subject to adjustments.

It is notable that EIOPA had proposed a range of between 30% and 39% for the capital charge for qualifying infrastructure equities, and the EU Commission has opted for 30%, the percentage at the bottom of EIOPA's proposed range.

Where the infrastructure project entity is a related undertaking of the insurer, the capital charge is reduced to 22%, which is the same as for non-infrastructure equities in related undertakings.

The lower capital requirements will only apply where the relevant qualifying criteria are satisfied, which underlines the importance of ensuring that transactions are structured so as to satisfy them. This is particularly pronounced in the case of unlisted equity, where the capital charge will differ by 19% depending on whether the criteria are satisfied.

Provisions have been made so that insurers which will benefit from the Matching Adjustment in determining their technical provisions will not receive a duplicate benefit from the more favourable requirements. In particular:

(a) The lower capital requirements will not apply in relation to qualifying infrastructure investments in bonds and loans assigned to credit quality step 2 or better (equivalent to A or better) that are held as part of the Matching Adjustment portfolio.

(b) The lower capital requirements will apply in relation to other qualifying infrastructure investments in bonds and loans, but there will be a reduction in the level of the Matching Adjustment in respect of those assets.

QUALIFYING CRITERIA

In order for an asset to constitute a qualifying infrastructure investment, a number of criteria must be satisfied. These criteria include the following:

(a) **Core definitions**: The investment must be made directly in an "**infrastructure project entity**". This is defined as:

"*an entity which is not permitted to perform any other function than owning, financing, developing or operating infrastructure assets, where the primary source of payments to debt providers and equity investors is the income generated by the assets being financed*."

Some stakeholders had suggested a wider definition of "infrastructure corporates". However, EIOPA was not satisfied with the evidence that such entities would perform better than other corporates, so preferred the narrower definition, and this preference has been accepted by the EU Commission.

"**Infrastructure assets**" are defined as:

"*physical structures or facilities, systems and networks that provide or support essential public services*."

This leaves some doubt about what projects will constitute "essential public services". For example, is a public swimming pool an "essential" service ?

(b) **"Predictable" cash flows**: The cash flows that the infrastructure project entity generates for investors must be "predictable". This will be satisfied if:

(i) the revenues it receives are "***availability-based***" (meaning that the revenues will be paid to the project infrastructure entity irrespective of actual demand or level of usage), subject to a "***rate-of-return regulation***" (meaning that the revenues are set by law or regulation) or subject to a "***take-or-pay contract***" (meaning that the ultimate purchaser of the project must either accept and pay for the project or pay a penalty), or if the same objectives are otherwise satisfied; and

(ii) other than where the revenues are funded by payments from a large number of users, the ultimate purchaser of the project is rated at least BBB or is an EU institution or similar institution, or a central or regional government or local authority, or is replaceable without a significant change in the level and timing of revenues.

Following feedback received by EIOPA, it has been made clear that immaterial parts of the cash flows do not have to satisfy this criterion.

(c) **High degree of protection**: Investors must benefit from a contractual framework that provides a high degree of protection. This includes the following:

(i) There must be protection against losses arising from termination by the ultimate purchaser of the infrastructure project. However, this does not apply if the revenues are funded by revenues from a large number of users. It is not clear what will constitute "a large number" of users.

(ii) The infrastructure project entity must have sufficient reserve funds or other financial arrangements to cover the contingency funding and working capital requirements of the project. Other financial arrangements would include letters of credit and liquidity facilities.

(d) **Further requirements in the case of debt**: For qualifying infrastructure investments in bonds or loans, further requirements apply:

(i) The bonds or loans must be assigned, by external or internal rating, to at least credit quality step 3 (equivalent to BBB).

(ii) The insurer must be able to demonstrate to the regulator that it is able to hold the bonds or loans to maturity.

(iii) The investors must have security to the extent permitted by law or regulation in all assets and contracts necessary to operate the project.

(iv) Equity in the project entity must be pledged to the debt providers so that they can take control of the infrastructure project entity prior to default.

(v) There must be restrictions on the infrastructure project entity to prevent it:

(1) using cash flows other than for paying mandatory payment obligations and servicing debt obligations; or

(2) performing activities that may be detrimental to debt providers; or

(3) issuing new debt without the consent of the existing debt providers.

(e) **Further protections in the case of unrated bonds**: If the relevant bonds are unrated, they must be senior to all other claims against the infrastructure project entity other than statutory claims and claims from derivatives counterparties. This leaves some question over how the claims of security trustees, paying agents and liquidity providers will be treated.

(f) **Further requirements in the case of equities and unrated debt**: In the case of equities and unrated bonds or loans, further requirements apply. In particular:

(i) The infrastructure assets and the infrastructure project entity must be located in the EEA or the OECD.

(ii) The equity investors must have a history of successfully overseeing infrastructure projects and the relevant expertise, have a low risk of default, and be incentivised to protect the interests of investors. EIOPA had originally proposed that country-specific expertise would be required, but this proposal was dropped following industry feedback.

ADDITIONAL REQUIREMENTS

In addition to the above qualifying criteria, the insurer must conduct adequate due diligence prior to making the qualifying infrastructure investment, with suitable controls to avoid conflicts of interest. Verification of financial models is required, but this can be done by suitably independent internal personnel, and an external auditor is not required.

When holding the investment, the insurer must regularly monitor and perform stress tests on the cash flows and collateral values. The insurer must also set up its asset-liability management to ensure that it is able to hold the investment to maturity.

If you have any queries in relation to this note, please contact Steven McEwan (on 020 7296 2972 or at steven.mcewan@hoganlovells.com) or your usual Hogan Lovells contact.

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