

Lower capital charges for infrastructure investments?

The European Commission proposes to lower the capital charge in infrastructure investments in the draft amendment to the Solvency 2 Delegated Regulation

The Commission’s draft, which was released in late September, introduces new rules for calculating the capital charge for qualifying long-term investments for insurance companies that apply the Solvency 2’s “standard formula”¹.

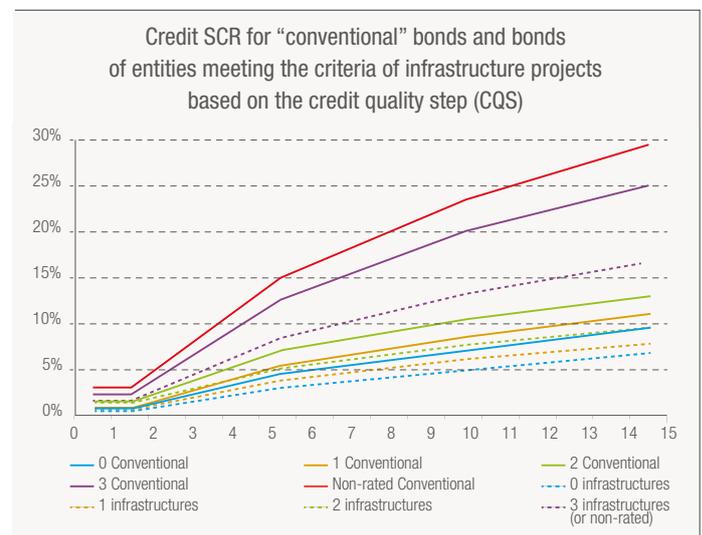
1 The main innovation involves the treatment of infrastructure project financing

■ **Two types of financing have been identified in the amendment - equity and debt.** The amendment covers all criteria that insurer investments must meet, whether equity or debt, to be considered infrastructure investments.

■ **Equities classified as infrastructure investments** carry a lower capital charge than equities listed in an EU or OECD country (Type 1 equities). Indeed, “infrastructure equities” are a new category of equities for which the capital charge is 30% (compared to 39% for Type 1 equities).

- The symmetric adjustment, often called the Dampener effect, applies in part to infrastructure. Its purpose is to modulate the capital charge around the core parameter (within + or - 10%), depending on the market level.
- Moreover, investments in infrastructure equities have a diversifying impact on insurers who mainly hold listed European equities, as infrastructure equities SCR is only 75% correlated to the Type 1 equities SCR.

■ **Infrastructure financing through loans or bond subscriptions** is also under a regime that is more favourable than loans to “conventional” companies. At an equivalent rating, the SCR spread is about one third lower (see chart below).



Source: Delegated Regulation (EU) 2015/35 of the Commission of 10 October 2014 and Draft Amendment, Amundi, October 2015.

The low-interest environment has led insurers to seek out investments that offer higher returns than government bonds and investment grade corporate bonds but that also offer a steady source of income.

Infrastructure project financing aiming to generate almost certain income is an integral part of this approach.

¹ The Solvency 2 directive defines a standard formula for calculating the Solvency Capital Requirement to reflect the risk profile of most insurance and reinsurance companies. This formula has a modular structure, i.e., the exposure to each risk category is assessed separately, then all exposures are aggregated.

The eligibility criteria for an investment to be “qualifying” cover both the income-generating prospects of the infrastructure project and the security of the financing package¹ for investors, as well as the insurer’s ability to assess the risks of its investments.

■ Main criteria for “qualifying” infrastructure projects

- The project must be able to bear sustained stress (the level of which has not been defined)
- Cash flows must be predictable and the project must have sufficient reserves and working capital
- If cash flows depend on a single buyer, the documents must provide for an indemnity in the event that the buyer backs out
- Income must be ensured either via contract or because demand outstrips supply
- If there are few buyers, they must be either a national government, an EU local government, or a BBB-rated entity or be able to be replaced without a significant impact on cash flows

■ Additional criteria for investments in bonds or loans

- Creditors must hold collateral on the project assets as well as on the equities so they can take control before bankruptcy. No new debt may be issued without their consent
- The insurance company must be able to demonstrate that it is able to carry the securities until maturity

■ There are additional restrictions if the investment is not rated by a ratings agency

- Two requirements, for example, are that the debt must be senior in rank and the assets must be located in an EU or OECD country

1. The investment carries a risk of loss of capital

2 Other assets are assigned a more favourable level of risk

■ The amendment aligns the treatment of European Long-Term Investment Funds with that of European Venture Capital Funds and European Social Entrepreneurship Funds. The equities held by such funds are considered Type 1 Equities and funds where full look-through is not possible. The overall investment in this fund is treated like an investment in Type 1 equities.

■ Equities traded on a multilateral trading facility are also treated like equities listed on a regulated market in an EEA or OECD member-country.

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