Amundi ASSET MANAGEMENT

Solvency 2

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

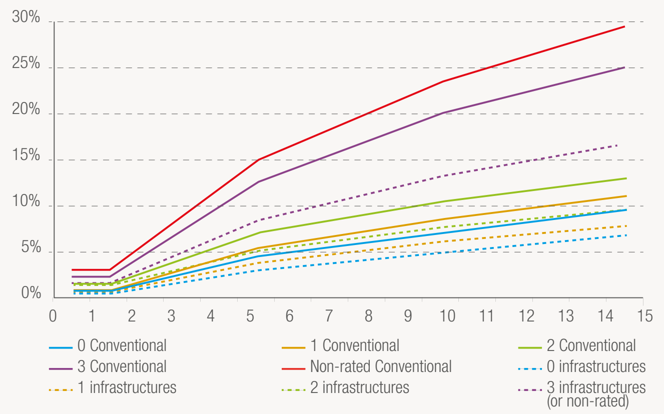
■ **Two types of financing have been identified in the amendment - equity and debt.** The amendment covers all criteria that insurer investments must meet, whether equity or debt, to be considered infrastructure investments.

■ **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).

Credit SCR for "conventional" bonds and bonds of entities meeting the criteria of infrastructure projects based on the credit quality step (CQS)



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 package[1] 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

❷ 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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