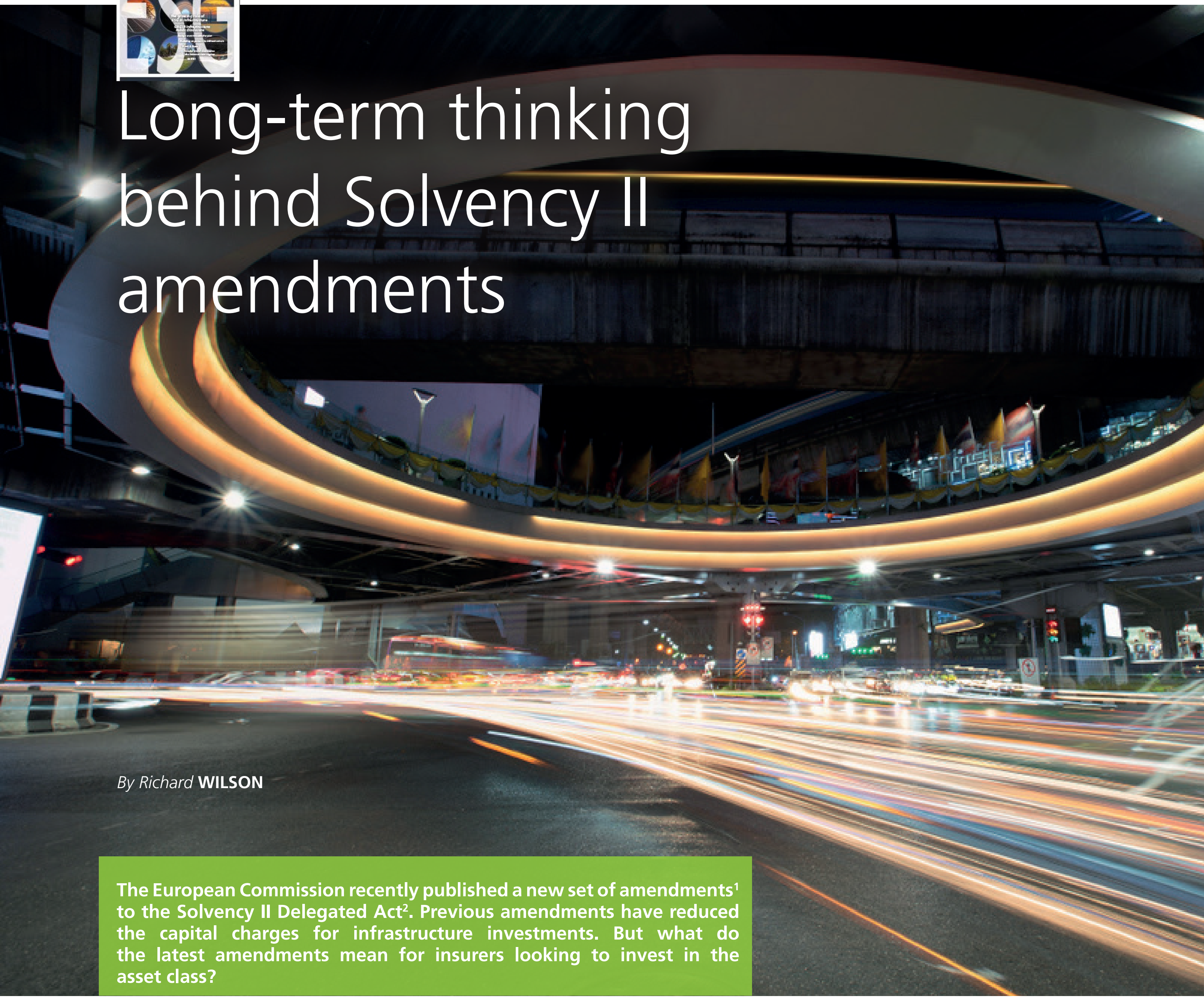
Click image for full magazine



Long-term thinking behind Solvency II amendments

By *Richard* **WILSON**

The European Commission recently published a new set of amendments[1] to the Solvency II Delegated Act[2]. Previous amendments have reduced the capital charges for infrastructure investments. But what do the latest amendments mean for insurers looking to invest in the asset class?

Insurance companies with long-dated liabilities see infrastructure investments as an attractive proposition, owing to the asset and liability matching opportunities, its long-term nature and strong risk-adjusted returns. The European Commission (EC) has further enhanced the attractiveness of the asset class by reducing the capital charge which investors must hold under the Solvency II Standard Formula for infrastructure investments which meet certain eligibility criteria. These came in two amendments to the Solvency II Delegated Act:

- The 2016 amendment[3] introduced infrastructure as a separate asset class with reductions in the capital charge for equity and debt issued by infrastructure projects benefiting from a Special Purpose Vehicle (SPV) structure. In this regard this was mainly aimed at the unlisted sector.
- The 2017 amendment[4] introduced a reduction to the capital charge for infrastructure corporates which broadly aligned to any debt or equity issued by listed infrastructure companies.

The EC released a further set of amendments on 8 March 2019 which at the time of writing are going through a three-month scrutiny period by the European Parliament and Council. Although there is no explicit mention of listed infrastructure investment in the latest amendments, the amendments could affect the relative merit of this asset class for insurers.

Further insight into the latest changes to the Solvency II Delegated Act

While many amendments have been made to the Delegated Act, those >

Listed infrastructure equities are likely to be prime candidates for the new long-term equity category if insurers can navigate the restrictions around this new asset class.

most likely to affect listed infrastructure investment are as follows:

- **Long-term equity investment** – The European Commission (EC) has created a new class of "long-term equity investment" which allows an insurer to apply a 22% equity risk capital charge, as opposed to the standard 39% (plus symmetric adjustment) equity risk capital charge for Type 1 (i.e. listed) equities. The insurers must demonstrate that these equities are adequately segregated from the rest of their investment portfolio and the average holding period of the long-term equity portfolio must exceed five years.
- **Unrated debt** – Previously the capital charges for unrated debt were relatively high. The commission has allowed some unrated debt to be given a lower capital charge if certain qualifying criteria are met. The documentation explicitly does not allow this lower charge to be applied to investments in infrastructure.
- **Regional Governments and Local Authorities** – The amendments to the Solvency II Delegated Act define a prescribed list of regional and local authorities. If debt is guaranteed by one of these authorities then the debt will receive a 0% spread risk capital charge, whilst if the authority is not on the list then the debt could be eligible for a lower capital charge depending on credit quality. As infrastructure debt is often backed by governments, it may be a good candidate to receive these lower charges.

What is the effect of these changes on listed infrastructure?

While the previous amendments directly targeted infrastructure, the EC have stated the intention of these amendments is to encourage more investment into the small and medium enterprise sector. There will however be both indirect and direct effects on the relative attractiveness of listed infrastructure given these changes. The changes will affect both listed infrastructure debt and equity.

Long-term equity investment

The new long-term equity asset class allows insurers who can demonstratively hold a portfolio of equities for a substantial amount of time to benefit from a reduction to their equity risk capital under the Solvency II Standard Formula. This new class can be applied to both private and listed equities and does not exclude equities that conform with the infrastructure project and corporate criteria.

The rules appear to be geared towards insurers buying and holding the equities themselves rather than using funds structures. Given the long-term nature of infrastructure, listed infrastructure investments could be a prime candidate to form part of the long-term equity portfolio alongside other equity investments linked to real assets such as real estate.

The rules regarding qualifying for the reduced long-term equity investment capital charge are stringent and, as insurers often hold equities as risk assets, it is not yet clear whether this new category will lead to an increase in equity investment by insurers operating under Solvency II.

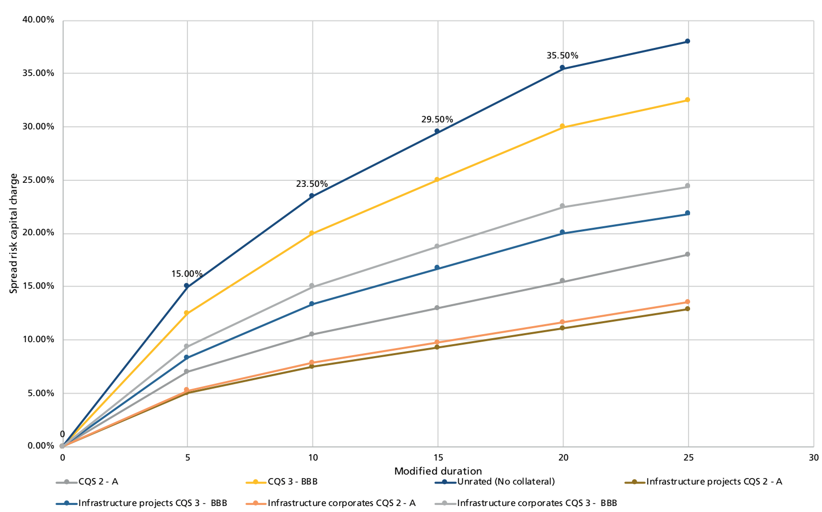
Unrated debt

The new lower charge on unrated debt is explicitly not applicable to infrastructure investments and like infrastructure debt, private debt carries a substantial illiquidity premium. Given the new lower charge, insurers may look to unlisted debt as an alternative to listed infrastructure debt, believing it provides greater diversification from liquid assets. This could particularly be the case if the demand for infrastructure continues and leads to higher prices in the sector.

The capital charge that can be applied to the unrated debt will depend on the spread of the individual debt asset. Upon qualification, the spread risk capital charge may be reduced to the equivalent of either that applied to a corporate bond or loan of credit quality step (CQS) 2 (A-rated) or CQS 3 (BBB-rated) depending on the spread. Chart 1. below shows that as a result the spread risk capital charge for private debt would move towards the spread risk capital charge for debt investments in infrastructure corporates.

At current spreads, it seems unlikely that many loans will qualify for the A-rating capital charge[5], whilst the reduction is less severe for those qualifying for the BBB rating. Capital requirements are therefore unlikely to be a primary driver in a movement from listed infrastructure to private debt with availability, diversification benefit and performance likely to continue to hold significant importance with investors.

Chart 1: Spread risk according to Solvency II standard formula



Listed infrastructure equities are likely to be prime candidates for the new long-term equity category if insurers can navigate the restrictions around this new asset class.

Regional Governments and Local Authorities

The revised list of regional government authorities, whose guarantee certifies a loan receives no capital charge could affect some infrastructure debt. This is however more likely to affect unlisted infrastructure (under Solvency II named "infrastructure projects") as company debt (listed infrastructure) is less likely to come with these guarantees.

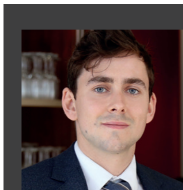
The examples listed by the UK Guarantees Scheme[6] show infrastructure projects guaranteed by a national government. Debt issued by these projects may be allowed to receive a 0% capital charge if the guarantee meets the requirements such as the guarantee applying to the debt payments rather than the project's income. The new regulation will allow infrastructure projects with qualifying guarantees by regional or municipal governments to also receive lower capital charges which could lead to insurers looking upon municipal infrastructure debt more favorably.

The new regulation will allow infrastructure projects with qualifying guarantees by regional or municipal governments to also receive lower capital charges which could lead to insurers looking upon municipal infrastructure debt more favorably.

Conclusion

With a number of explicit changes to the treatment of infrastructure preceding this latest set of amendments to the Solvency II Delegated Act, the expectation is that these latest amendments may not have the same impact on the listed infrastructure asset class. However, listed infrastructure equities are likely to be prime candidates for the new long-term equity category if insurers can navigate the restrictions around this new asset class. Additionally, any debt guaranteed by regional governments is likely to be very appealing to insurers given the zero-capital charge.

As a result of the call for information ahead of the 2020 Solvency II review[7] published by European Insurance and Occupational Pensions Authority (EIOPA) in December 2018, there may still be further changes ahead for the treatment of infrastructure assets as this asset class continues to evolve under a regulatory journey.



Richard **WILSON**

Richard Wilson is a Senior Consultant in the EY Investment Advisory team specialising in market risk capital requirements for insurers. He has helped a number of asset managers navigate the implications that changes to the Solvency II regulation will have on their offerings to insurers.
RWilson4@uk.ey.com

---

1. *Latest amendment of Solvency II Delegated Acts: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2015:012:FULL&from=EN*
2. *Original Solvency II Delegated Acts https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0467&from=EN*
3. *Amendment introducing the infrastructure projects asset class to the Delegated Acts: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0467&from=EN*
4. *Amendment introducing the infrastructure corporates asset class to the Delegated Acts: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1542&from=EN*
5. *The capital charge applied to unrated debt will depend on the following rules regarding the spread as well as a number of other criteria.*
   A CQS of 2 can be used for an unrated bond or loan if the yield does not exceed the greater of
   - *0.5% + the average of the yield on an index for bonds of CQS 2*
   - *the average of the yields on bond indices with a CQS of 2 and 4*
   - *A CQS of 3 can be used for an unrated bond or loan if the yield does not exceed the greater of*
   - *0.5% + the average of the yield on an index for bonds of CQS 3*
   - *the average of the yields of on bond indices with a CQS of 3 and 4*
6. *UK Guarantees Scheme: https://www.gov.uk/guidance/uk-guarantees-scheme*
7. *https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190211-request-eiopa-technical-advice-review-solvency-2.pdf*