	Comments Template on EIOPA-CP-15-004 **Consultation Paper on** **the Call for Advice from the European Commission on the identification and calibration of infrastructure investment risk categories**	**Deadline** **09.August.2015** **23:59 CET**
Company name:	The Investment Association	
Disclosure of comments:	EIOPA will make all comments available on its website, except where respondents specifically request that their comments remain confidential. Please indicate if your comments on this CP should be treated as confidential, by deleting the word Public in the column to the right and by inserting the word Confidential.	Public
	Please follow the instructions for filling in the template: ⇨ Do **not** change the numbering in column "Reference". ⇨ Please fill in your comment in the relevant row. If you have no comment on a paragraph, keep the row empty. ⇨ Our IT tool does not allow processing of comments which do not refer to the specific paragraph numbers below. o If your comment refers to multiple paragraphs, please insert your comment at the first relevant paragraph and mention in your comment to which other paragraphs this also applies. o If your comment refers to sub-bullets/sub-paragraphs, please indicate this in the comment itself. **Please send the completed template to CP-15-004@eiopa.europa.eu, in MSWord Format, (our IT tool does not allow processing of any other formats).** The paragraph numbers below correspond to Consultation Paper No. EIOPA-CP-15-004.	
Reference	**Comment**	
General comments	The Investment Association represents UK investment managers. We have over 200 members who	

manage more than £5 trillion for clients around the world. Our aim is to make investment better for clients so that they achieve their financial goals; better for companies so that they get the capital they need to grow; and better for the economy so that everyone prospers. Ultimately much of what they manage belongs to the man in the street through their savings, insurance products and pensions.

The Investment Association welcomes EIOPA's proposals on identifying and calibrating infrastructure investment, which take into account the specific characteristics, risk profiles, and long-term nature of infrastructure investment.

However, we have a number of concerns with the proposed scope and qualifying criteria as they currently stand.

- Taken as a whole, the criteria proposed by EIOPA are overly prescriptive, and may exclude all but a very few projects. To this extent they will act as a barrier to infrastructure investment.
- Whilst the definition of infrastructure proposed by EIOPA is reasonable, it deliberately excludes infrastructure corporates. This is despite the fact that the Moody's project loan study (cited in Annex 1) shows there is the same risk for corporates as for private finance, with the drivers of recovery being strong covenants and limited ownership of assets.
- By adopting this approach EIOPA:
  - seems to incentivise a private equity model of infrastructure financing versus a corporate model, which is unwelcome; and
  - excludes corporates, such as utility providers or network operators, therefore considerably constraining the pipeline of infrastructure projects that insurers can invest in.
- The definition of infrastructure project entity is drawn too narrowly. This appears to exclude

	two key areas of infrastructure financing: o Project assets that are operated by an operating company, such as a transmission grid where operating and asset servicing are operated on an insourced basis. o Pooled funds such as closed-ended funds with no or low levels of leverage such as ELTIFs or other similar AIFs which are designed to be bought on a buy-to-hold basis, and which provide portfolio diversification benefits. • The additional requirements proposed by EIOPA on predictability of revenues, strong sponsors, financial risk and political risks are either unnecessary or too granular. If left unchanged, there is a risk that they would exclude too many projects severely impacting the pipeline of projects that insurers can invest in. In our response we highlight key changes that would be required to ensure that the qualifying criteria are fit for purpose. In addition to these changes, we strongly recommend that EIOPA should make clear that projects are only required to fulfil the qualifying criteria at the time of investment, to avoid future cliff effects.	
Section 1.1.		
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Section 1.3.		
Section 1.4.		
Section 1.5.	EIOPA indicates in this section that it has a preference for calibrating using the spread risk model. However, the treatment of infrastructure debt under the spread-risk module assumes that insurers trade infrastructure investments, and are exposed to short-term volatility of market spreads and the impact this has on the market price of the infrastructure. However, investors will usually hold these illiquid investments over the long-term.	

Most of the empirical analysis in the consultation paper is based on default/recovery studies, which indicate that it would be appropriate to use the counterparty default risk module.

Using the spread or counterparty default module affects not only the stand-alone basic SCR for infrastructure debts (different SCR formulae), but also the overall SCR because:

- Under the spread module, the infrastructure debt SCR will be added into the spread module under market risk SCR;
- Under the counterparty default module, the infrastructure debts SCR will be added into (presumably) type-2 exposure module under default risk SCR, which benefits from a 25% correlation with the market risk SCR; and
- So, even if the stand-alone capital treatment is the same under the spread module and the default module, the overall SCR will be lower under the latter because of the capital diversification.

The Investment Association considers that the counterparty default module should be used, so that the diversification benefits of holding infrastructure (debt and equity) are recognised.

- If a spread risk sub-module *is* used, it would be sensible to aggregate the liquidity and credit risk approaches within them to arrive at an appropriate level of capital charge relief. A combination of those approaches at present would lead to a maximum capital relief of 35%. Further relief will be needed, however, to reflect the diversification benefits of holding infrastructure. A capital charge relief in the region of 60% would be appropriate.

	• Further clarity is needed as to what constitutes a 'well-diversified portfolio', as referred to in paragraphs 1.19 and 1.20.	
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Section 3.3.		
Section 3.3.1.	We welcome EIOPA's work in developing a broad definition for infrastructure, in particular the	

	decision not to limit the scope of qualifying infrastructure to certain sectors. However, we have concerns regarding some aspects of the definition for infrastructure assets, infrastructure project entities, and special purpose entities. *Infrastructure assets* • The requirement that eligible infrastructure assets have "to provide or support essential public services" would seem to rule out investment in longer term infrastructure which are additive to existing structures and which contribute to long term growth and economic development. This narrow definition runs counter to the definition adopted in the EFSI Regulation (article 9) particularly in the area of development and deployment of information and communication technologies and environment and resource efficiency. The definition should be widened to refer to 'public services' or 'public benefit' and drop the reference to 'essential'. • It is not clear what is meant by networks, particularly in the transport sector. There seems to be a distinction between core and peripheral infrastructure, for example train track versus rolling stock. Greater clarity on what is meant by networks should be provided and should include peripheral infrastructure. • It will be difficult to define and verify what is meant by "limited competition". In any case, we are concerned as to whether a policy that encourages monopolies is the right one. • In addition to seeking further clarity on the proposed definition for infrastructure, we propose that the current definition should be restated as:	

"Infrastructure assets' means physical structures, systems and networks that provide or support ~~essential~~ public services. ~~and are subject to limited competition~~.

Infrastructure project entity

- EIOPA defines an infrastructure project entity as where:
  a) the contractual arrangement give lenders a substantial degree of control over the asset, and
  b) the primary source of repayment is the income generated by the asset.

- This definition of 'infrastructure project entity' assumes a SPV-style entity where many of the core operating functions are sub-contracted to third party service providers. This type of financing is more applicable to the financing or operation of a clearly definable asset such as a toll road. Other more complex, networked assets such as an electricity grid supply do not tend to be operated by an SPV but by a general operating company where the provision of services is insourced. For example in the UK electricity grids are run by Distribution Network Operators.

- The Investment Association strongly believes that infrastructure corporates (and not only projects) should be included in the definition. According to the Moody's project loan study cited in Annex 1, infrastructure rating and recovery data indicates that there is the same risk for corporates as for private finance, with the drivers of recovery being strong covenants and limited ownership of assets. Lenders to corporates have no direct control over the assets but they have control over debt, leverage, dividend distribution and disposal of asset through covenants. These covenants can enable some recovery of the assets, so corporates should not be excluded. Excluding corporates such as these would considerably reduce the pipeline of investable projects.

- In addtion, we note that in condition (a) as stated above, it is not clear what is meant by “lender” and if this would include equity investors. Not all infrastructure is financed with debt. A narrow definition would limit investments infrastructure projects that are fully equity financed. If the same definition of “infrastructure” applies to debt and equity infrastructure investments then condition (a) should be amended.

- In order to incorporate corporate entities which engage in infrastructure activities, and address the concerns above, we propose that EIOPA should allow for investment in “infrastructure project entity” or ‘infrastructure operating entity’. We propose the following wording:

  “**An entity which finances or operates infrastructure assets**, **where the following conditions are met:**

  a) There is a comprehensive security package;

  b) The primary source of payments to investors is the income generated by the assets being financed or operated.”

Special purpose entity

- The Investment Association is not supportive of limiting the definition of infrastructure to exclude infrastructure corporates. See ‘*Infrastructure operating entity*’ above.
- There is a concern that the current proposals are seeking to incentivise a private equity model of infrastructure financing versus a corporate model. This is unwelcome.

	Overall, the current proposals would also exclude pooled funds such as closed-ended funds with no or low levels of leverage such as ELTIFs or other similar AIFs which are designed to be bought on a buy-to-hold basis and which provide portfolio diversification benefits. Further consideration should be given to ensure that pool funds are including in the qualifying criteria.	
Section 3.3.2.		
Section 3.3.2.1.	We welcome EIOPA's approach, which allows insurers to apply the scenarios only where relevant. This takes into account that the stress scenarios set out in the advice go above and beyond what would be required by rating agency methodology for stress testing infrastructure investments, and a requirement to apply them in all scenarios would be overly prescriptive and restrictive.	
Section 3.3.2.2.	The predictability of cash flow requirement is overly prescriptive, and does not take into account that a project's revenues may predominantly but not fully meet the requirements. In addition, other factors can impact the predictability of a project's cash flow, such as tax and changes to tax rules. We recommend that this requirement be amended so that it refers **to predictability of net cash flows available to investors.** In addition we have certain concerns regarding several of the requirement's conditions. • Condition a) ii): It is not clear if the "rate of return regulation" referred to would capture certain elements of government policy that would have impact an infrastructure projects cash flow eg. feed in tariffs. This requirement should be amended so that it states:	

	"The revenues are subject to ~~a rate-of-return~~ **regulated return**". • Condition a) iv) a): Requirements for cash flows to be "sufficiently stable" could have unintended consequences for transactions with some economic/volume risk, such as essential infrastructure involving toll roads and airports, as well as renewables. For example, while projects in some jurisdictions (e.g.) France are supported by fixed price agreements, therefore removing price volatility, projects in other jurisdictions (e.g. UK) are supported by renewable certificates where there is implicitly more exposure to market prices. This requirement should be deleted. • Condition b) iii): The Investment Association does not consider this requirement to be necessary particularly where the offtaker is readily replaceable (eg. renewable companies need to sell power through a utility, but can replace the utility). There is also concern that if an off-taker with a CQS of at least 3 is downgraded, this could lead to significant cliff effects. This requirement should be deleted • EIOPA should clarify that these and all other criteria will only apply at the point of investment to mitigate these effects.	
Section 3.3.2.3.	The Investment Association believes it is important that infrastructure finance is governed by a strong contractual framework. However, the contractual framework proposed by EIOPA is overly prescriptive, is inconsistent with market practice and does not recognise that insurer abiding by the Prudent Person Principle will be managing these risks as part of their investment. We therefore propose the following amendments to ensure that the conditions are fit for purpose.	

	• It is not clear what is meant by "lenders", and if this would include equity investors. • Requirements d) and e) surrounding covenant packages are overly prescriptive and inconsistent with current market practice. • Requirement d) should be amended so that states: "The covenant package to restrict activities of the project company is strong including ~~the provision that the project shall not issue new debt~~ **investor control over the issuance of new debt.**" • Requirement e) should be amended so that it states: "~~All reserve funds have a longer than average coverage~~ period **All reserve funds have a coverage period that is consistent with market practice** and are fully funded in cash or letters of credit from a ~~bank~~ **counterparty** of high credit standing." These amendments would provide insurers with the ability to adequately manage the risk in investing in an infrastructure project in a manner that is consistent with the Prudent Person Principle.	
Section 3.3.3.	Sub-investment grade products should not be excluded from the framework. The Moody's project finance study cited by EIOPA in Annex 1 demonstrates that the recovery benefit applies across the project finance spectrum and applies to projects which were generally not externally rated and may often have been rated as non-investment grade through internal models. Limiting qualifying projects	

	to investment grade products only seems therefore to be unnecessarily restrictive.	
Section 3.3.4.		
Section 3.3.4.1.	The political risk criteria are highly subjective. We are concerned that, should insurers be required to consider recent changes made in countries where assets of the project are located, this could exclude infrastructure investments in countries, such as: • The UK, which made recent changes to the tax regime to the oil and gas sector and announced that it would discontinue the Climate Change Levy that would significantly impact the renewable energy sector. • Norway, which announced it would cut the natural gas pipeline tariffs despite the country previously being considered as one of the most politically stable for infrastructure investment • Spain, which retroactively cut feed in tariffs for solar. We propose that the political risk criteria be deleted in its entirety.	
Section 3.3.4.2.	The structural requirements criteria are at present unnecessarily prescriptive and do not take into account more complex infrastructure projects, such as an electricity grid supply, that do not tend to be operated by an SPV but by a general operating company where the provision of services is insourced. • Condition 3): The requirement to have a strong sponsor – we do not agree that there needs to be a requirement for a “strong sponsor”. As the assets are non-recourse to the sponsor, there is no need for this requirement. Infrastructure debt providers are protected in a number of	

ways including through a strong security package over the projects assets and strong financial covenants that include step in rights to manage the projects if necessary. To the extent that there is a dependency on the sponsor to inject more money into the project, it should be sufficient that this specific risk is mitigated – for example by a letter of credit.

This condition should be deleted.

- Condition 4) a): This criteria may limit the ability for sponsors or operators to venture into new markets. We also note that defining sector will be difficult. For investors in infrastructure projecs, it is more important that sufficient alternatives exist in the event an operator or sponsor needs to be replaced.

  Conditon 4) a) should therefore be amended so that it states:

  “The sponsor **or operator** has a very strong track record and relevant ~~country and sector~~ experience.”

- Condition 4) b): It is unclear what the condition “high financial standing” actually implies and if it is at all applicable to infrastructure project sponsors. Sponsors do not always have much in the way of funding. In addition, most financings are non-recourse and so even if the sponsor had a large balance sheet, it may not necessarily choose to support a project in times of trouble. Equally, very few contractors are rated. These shortcomings are overcome by strong security packages that include the ability for the investors to replace the sponsor or operator.

	This condition should be deleted or at the very least Condition 4) b) should be amended so that it states: "The sponsor **or operator** has high financial standing." • In addition, if conditions 4 a) and b) are met, we do not believe meeting condition 4) c) should be required, as its inclusion would be overly prescriptive. We recommend that condition 4) c) be deleted.	
Section 3.3.4.3.	The Investment Association has some concerns regarding the financial risk requirements. • Condition 6): Some infrastructure projects would do super-senior swaps (for risk mitigation purposes). It would therefore not be possible to ensure that the instrument possesses the highest level of seniority at all times. We therefore propose that condition 6) be deleted. • In addition, we note that EIOPA has not yet decided whether to propose restricting qualifying infrastructure projects to those with amortising debt. We are strongly against any criteria that would limit qualifying infrastructure to those with amortising debt. Not only would it be difficult to define what is meant by "amortising debt" but a large number of infrastructure projects have bullet maturities (such as perpetual assets) or are partially amortising (some assets with a finite life). Such an approach would significantly limit the assets available for investment by insurers.	

Section 3.3.4.4.	The construction risk requirements imposes conditions that may be unnecessarily restrictive and go further than the criteria applied by rating agency methodologies. This will make the criteria for unrated debt more prescriptive than for rated debt. This is unwelcome. We propose the following amendments to these requirements: • Condition 2) b) should be amended so that it states: "The contract includes the payment of ~~substantial~~ liquidated damages which are supported by financial substance or there is a strong completion guarantee from sponsors with ~~excellent financial standing~~ ~~or~~ **reference to other forms of liquidity.**" • Condition 2) c): construction companies typically operate volatile business models. This volatility is typically mitigated by the security package over the contractor's obligations. Therefore we do not believe that financial strength should be a consideration. Condition 2) c) should therefore be amended so that it states: "The construction company has the necessary expertise and capabilities, ~~is financially strong~~, and has a strong track record in constructing similar projects." • Condition 2) d): The Investment Association believes this condition should be deleted entirely, as we do not believe that it is appropriate for the criteria to set out the way in which insurers	

	should undertake their investment analysis. This is contrary to the Prudent Person Principle under Solvency II.	
Section 3.3.4.5.	These criteria assume that following construction all the risk is passed on from the construction company to the operating company. However, it is common for the cost risk associated with major maintenance to be retained by the project company (with appropriate reserving mechanics), rather than passed down to a subcontractor. Therefore, the criteria should be amended. • Condition 2) c): Infrastructure debt providers are protected in a number of ways including through a security package over the contractor's obligations. It is therefore not necessary to require that the operator be financially strong. It is more important there are sufficient alternatives to allow the operator to be easily replaced. We therefore believe condition 2) c) should be amended so that it states: "The operating company has a very strong track record in operating similar projects, the necessary expertise and capabilities ~~and is financially strong."~~ • We consider that condition 2) f) should be deleted entirely, as this requirement would contravene the Prudent Person Principle under Solvency II.	
Section 3.3.4.6.	There is a risk that this design and technology risk criteria could limit investment and innovation both in new and existing technologies. For example, it is not clear whether a variation on an existing	

	design would be meet the “fully proven technology and design” requirement. We propose deleting this requirement as this would allow insurers to adopt a risk based approach to their investment in infrastructure assets.	
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Section 4.3.1.		

Section 4.3.2.		
Section 5.1.		
Section 5.2.		
Section 5.3.		
Section 6.1.		
Section 6.2.	To achieve the most accurate equity calibration, a full-look through approach is better suited for infrastructure equities (or alternatively, a percentage value stress for the underlying infrastructure assets), for the following reasons: • It is in line with the look-through principle in Article 84, particularly when the investment is structured as fund. • The three proxies considered by EIOPA do not recognise that leverage plays an important role when comparing equity performance or VaRs. For example, the degree of leverage of the PFI portfolio could be materially different to that of the wider FTSE All Index. • Applying a 30-39% risk charge to all infrastructure equities would penalise equity investment in unleveraged infrastructures. We consider that a risk assessment of 22% for equity is more appropriate, as this is the capital charge applied to ‘strategic equity’, with which infrastructure shares many characteristics. For example, infrastructure equity is generally held until maturity, and has a lower volatility than listed equity.	
Section 6.2.1.		
Section 6.2.2.		

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Section 6.2.3.		
Section 6.3.		
Section 7.1.		
Section 7.2.		
Section 7.3.	Overall, we do not believe that there is any justification for EIOPA prescribing elements of risk management. This approach seems to run counter to the prudent person principle that is currently the mandated approach under Solvency II.	
Section 8.	Guarantees provided by RGLA should be treated, at a minimum, in the same way as a direct exposure to a RGLA. An explicit guarantee ensures repayment by the RGLA in the event of a default. The lower credit risk should therefore be recognised in prudential regulation.	
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