November 2, 2015

Infrastructure will be treated more favorably under Solvency II after all

http://docs.bepartners.pro/news/2015-09-30_amendment-to-the-delegated-act_en.pdf

On 30 September 2015, the European Commission adopted a draft amendment to the Level 2 Delegated Regulation for Directive 2009/138/EU. The draft amendment will establish infrastructure as a separate asset class. The capital requirements for investments financed through equity and debt are to be reduced.

In addition, investments in ELTIF will also have to provide less capital requirement in the future. Following the amendment, equities traded through multilateral trading platforms will be treated as listed equities. Finally, the transitional measures for listed equity investments will be extended to unlisted equity investments.

1. What is infrastructure?

Two new definitions were added in Article 1 of the Level 2 Delegated Regulation. The first definition describes 'infrastructure assets' as physical structures or facilities, systems and networks that provide or support essential public services. The second definition defines an 'infrastructure project entity' 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.

2. Which investments will have privileged treatment?

The Level 2 Delegated Regulation includes a new subsection for the new asset class: Article 164a sets forth the criteria and conditions that are to be satisfied by infrastructure investments in order to be 'qualifying infrastructure investments'.

3. The hurdles are high for the project

Qualifying infrastructure investments include an investment in an infrastructure project entity that meets the following criteria:

- The infrastructure project entity can meet its financial obligations under sustained stresses that are relevant for the risk of the project.
- The cash flows that the infrastructure project entity generates for debt providers and equity investors are predictable. The second section of the new Article 164a states when this criterion is met.
- The infrastructure assets and infrastructure project entity are governed by a contractual framework that provides debt providers and equity investors with a high degree of protection, including where the revenues of the infrastructure project entity are not funded by payments from a large number of users, the contractual framework includes provisions that effectively protect debt providers and equity investors against losses resulting from the termination of the project by the party which agrees to purchase the goods or services provided by the infrastructure project entity. Special conditions are imposed on the party that agrees to purchase the goods or services provided by the infrastructure project entity (Article 164a(2)(b)).
- 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.

Additional criteria apply if investments are made in bonds or loans. Additional criteria also apply to investments during the construction phase.

Special criteria are also imposed on investments that do not have an external credit assessment by a nominated external credit assessment institution. Moreover, mezzanine investments are prohibited, and the infrastructure asset as well as its project entity must be located in the EEA or the OECD.

The list of criteria and conditions is long; the Commission has thereby set the bar high for qualifying infrastructure investments. As a result, a thorough due diligence is necessary prior to such an investment.

4. Investors also have a duty

When investing in bonds or loans, the investing insurance and reinsurance undertakings must be able to demonstrate to the regulatory authority that they are in a position to hold the investment until maturity.

5. Capital requirement for equity investments

The capital requirement for equity investments in qualifying infrastructure investments is to be significantly decreased compared to the capital requirement of 49 % for Type 2 equities:

- 22 % for investments of a strategic nature
- for all other investments 30% plus 77 % of the symmetric adjustment factor.

Whether an investment is of a strategic nature will depend on Article 171 of the Delegated Regulation, i.e. on the rules applicable to all equity investments.

6. Capital requirement for debt investments

The capital requirement for the spread risk for loans and bonds, which meet the criteria for qualifying investments pursuant to Article 164 a, can be determined pursuant to the new sections 11, 12 and 13 of Article 180 of the Delegated Regulation. The stress is calculated similar to that for normal bonds and loans pursuant to Article 176 subject to the credit assessment and modified duration.

However, only the credit quality steps 0 to 3 are available for the spread risk in debt investments in infrastructure, i.e. the decreased capital requirement does not apply to investments in the credit quality steps 4, 5 and 6. The spread risk of such investments is to be calculated pursuant to Article 176 applicable to normal bonds and loans, and not pursuant to Article 180(11) to (13).

If Article 180(11) is applicable, significantly reduced multiplicators are applied for assessing the credit quality steps in the calculation. In the chart below we have included the difference to the figures applicable to normal bonds and loans in the rows marked in green.

Credit quality step		0		1		2		3	
Duration (dur)	$stress_i$	a_i	b_i	a_i	b_i	a_i	b_i	a_i	b_i
up to 5	$b_i * dur_i$	–	0,64 %	–	0,78 %	–	1,0 %	–	1,67 %
Difference		–	-0,26	–	-0,32	–	-0,4	–	-0,83
More than 5 and up to 10	$a_i + b_i * (dur_i – 5)$	3,2 %	0,36 %	3,9 %	0,43 %	5,0 %	0,5 %	8,35 %	1,0 %
Difference		-1,3	-0,14	-1,6	-0,17	-2,0	-0,2	-4,15	-0,5
More than 10 and up to 15	$a_i + b_i * (dur_i – 10)$	5,0 %	0,36 %	6,05 %	0,36 %	7,5 %	0,36 %	13,35 %	0,67 %
Difference		-2,0	-0,14	-2,35	-0,14	-3,0	-0,14	-6,65	-0,33
More than 15 and up to 20	$a_i + b_i * (dur_i – 15)$	6,8 %	0,36 %	7,85 %	0,36 %	9,3 %	0,36 %	16,7 %	0,67 %
Difference		-2,7	-0,14	-3,05	-0,14	-3,7	-0,14	-8,3	-0,33
More than 20	$\min [a_i + b_i * (dur_i – 20)]; 1]$	8,6 %	0,36 %	9,65 %	0,36 %	11,1 %	0,36 %	20,05 %	0,36 %
Difference		-3,4	-0,14	-3,75	-0,14	-4,4	-0,14	-9,95	-0,14

be in touch: If you have any questions, please do not hesitate to contact us!

Dr. Carsten Bödecker
Partner . Steuerberater . Rechtsanwalt

Tel. +49 211 946847-51
Fax +49 211 946847-01

carsten.boedecker@bepartners.pro

Carsten Ernst
Partner . Steuerberater

Tel. +49 211 946847-52
Fax +49 211 946847-01

carsten.ernst@bepartners.pro

Harald Kuhn
Partner . Rechtsanwalt

Tel. +49 211 946847-54
Fax +49 211 946847-01

harald.kuhn@bepartners.pro

Nathalie Grenewitz
US-Attorney at Law

Tel. +49 211 946847-57
Fax +49 211 946847-01

nathalie.grenewitz@bepartners.pro