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AFME-ICMA Infrastructure Working Group 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

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Deadline
09.August.2015
23:59 CET

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<tr><td>Company name:</td><td colspan="2">AFME ICMA Infrastructure Working Group (“WG”)</td></tr>
<tr><td>Disclosure of comments:</td><td>

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The paragraph numbers below correspond to Consultation Paper No. EIOPA-CP-15-004.

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<tr><td>Reference</td><td colspan="2">Comment</td></tr>
<tr><td>General comments</td><td>The WG welcomes the call for advice from the European Commission and recognises that EIOPA has made a valuable contribution in its draft advice. The specific draft proposals are a step in the right direction. However, the proposed definition is too narrow and the capital charges still exaggerate the risk posed by investing in infrastructure. We believe that further work is required on definitions and capital charges in order to remove unnecessary barriers to investment.</td><td></td></tr>
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Although it is difficult to determine the exact risk parameters, there is sufficient evidence that a risk based calibration can be set at significantly lower levels for both infrastructure debt and equity. This should be reflected for individual debt and equity risks, but also looked at from a portfolio perspective in which correlation between infrastructure and other investments should be recognised as being zero or very close to zero. In addition, a number of concerns remain on the proposal for the identification of infrastructure risk categories and should be addressed in EIOPA's final advice to ensure that particular details in the identification requirements do not unnecessarily exclude good infrastructure projects.

The following adjustments should be made to the proposed definition:

The definition is too restrictive. It should be extended to corporates' operating infrastructure assets provided that the cash flows or assets pertaining to the infrastructure activities are ring-fenced. Notably, in Section 3.1 we provide examples of high quality transactions within the Investment Plan for Europe, that would be excluded from investment eligibility due to the overly restrictive definition proposed by EIOPA.

A number of adjustments should be made to the proposed criteria, including:

- There needs to be more flexibility as the current list of criteria has the potential to disqualify many high quality infrastructure transactions.

- The advice should consider internal ratings equivalent to ECAI rating as long as such internal ratings are assigned based upon an appropriate internal credit assessment, consistent with Solvency 2 prudent person principle.

Regarding the recalibration proposals, the WG notes the following:

	- If a recalibration of the risk charges for infrastructure in the spread risk module is chosen, then a combination of EIOPA's liquidity and credit risk approach should be considered. - A proposal for a calibration in the counterparty default risk module should be included in EIOPA's advice if, significantly, loans and securities receive the same calibration (in order to avoid EIOPA regulatory arbitrage between loan and bond format that currently exists in other asset classes such as securitisation), and also if the calibration takes into account at least some level of mark to market risk that assets included in the counterparty default risk module will still need to incur, even though the counterparty default risk module is intended to solely capture credit. An example for a calibration is included in WG's comments to section 5.1. The advice does not distinguish between listed and unlisted infrastructure equity. The advice should include the latter in a new market risk sub-module with a risk charge of 22% and very low, preferably zero, correlation with other sub-modules.	
Section 1.1.		
Section 1.2.		
Section 1.3.		
Section 1.4.		
Section 1.5.	The WG supports an adjustment of the spread risk charges based on a comparison of loss given default rates in order to more adequately reflect the risk characteristics of infrastructure debt instruments, especially lower default rates, higher recovery rates and regular cash flows. Current capital charges as well as the charges currently proposed in EIOPA's draft advice make infrastructure investment uneconomical. The proposed adjustment for the spread module consists in adjusting the capital charge by the ratio of the loss-given default for infrastructure debt to the loss-	

given default for corporate bonds.

This could be achieved through the following amendment to the Solvency II spread risk sub-module:

Article 176

(Add) 4 Notwithstanding paragraph 3, bonds or loans to infrastructure shall be assigned a reduced risk factor $stress_{reduced,i}$ as follows:

$$stress_{reduced,i} = stress_i \times \frac{LGD_{specific}}{LGD_{other}}$$

where:

(a) $stress_i$ denotes a function of the credit quality step i and/or of the modified duration of the bond or loan *i*, as set out in paragraph 3 depending on whether a credit assessment by a denominated ECAI is available or not;
(b) $LGD_{specific}$, denotes the loss-given default to the infrastructure bonds or loans;
(c) LGD_{other}, denotes the loss-given default for bonds.

For the purposes of this amendment proposal, the following could be used as an example of how to determine the LGD figures:

(1) [20%;35%] for the infrastructure bonds or loans $LGD_{specific}$ based on the Moody's study "Default rates and recovery rates for project finance bank loans 1983-2008" for the infrastructure and power industry sector;
(2) 60% for the LGD_{other} as it is the expected recovery rate for a BBB bond.

Alternatively, the WG believes that the liquidity and credit risk approaches can be combined into a single approach accounting for these two risks. According to paragraph 1.21 EIOPA is still considering whether the two methods should be combined under the spread risk module. Furthermore, under a

	combined approach, the spreads should reduce by approximately the sum of the respective reductions for the credit risk approach and liquidity approach. The WG supports EIOPA's proposal that infrastructure debt investments without an ECAI rating may still qualify for a tailored standard formula treatment. This issue is important since infrastructure debt investments are often unrated. The WG supports EIOPA's proposal of treating qualifying unrated infrastructure debt investments equivalent to rated infrastructure debt with credit quality step 3. Moreover, both internal ratings and ECAI ratings should be allowed. The WG also supports EIOPA's aim to change the calibration for infrastructure equity investments. For listed equity the WG supports the reduced risk charge of 30 - 39%. However, a separate proposal for *unlisted* infrastructure equity is needed. The proposal should take into account the low correlation between unlisted infrastructure equity and other asset classes which the EIOPA proposal unfortunately lacks. The WG acknowledges the difficulties of finding a valid data base for unlisted equity. But it also believes that listed equities should not be used as a proxy to calibrate the risk capital charge for unlisted infrastructure equity. The WG is concerned about the additional requirements for risk management, including the requirement on stress testing. With regard to the prudent person principle, these requirements do not seem necessary, but only cause additional efforts and costs. This is contradictory to the political objective facilitating the long term financing of infrastructure development. Therefore the impact of new requirements and whether they are really necessary should be carefully considered.	
Section 2.1.		
Section 2.2.		
Section 2.3.		
Section 2.3.1.		
Section 2.3.2.		

	AFME-ICMA Infrastructure Working Group 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
Section 2.3.3.		
Section 2.4.		
Section 2.4.1.		
Section 2.4.2.		
Section 2.5.		
Section 2.5.1.		
Section 2.5.2.		
Section 2.5.3.		
Section 3.1.	Para 1.52 The WG strongly believes that the risk profile of "infrastructure corporates", i.e. businesses which operate infrastructure assets, but are long dated or perpetual (i.e. not limited-life) businesses, should be included within the scope. Infrastructure project finance is only a subset of infrastructure finance and therefore of available infrastructure debt and equity. Most of such corporates are limited either by licensing or permitting restrictions or by contractual covenants in their financing from engaging in activities outside the scope of operating the infrastructure assets in question and ancillary services. Investors view the risk profile of such corporates as similar to (if not better than) the risk profile of project finance. In many respect these are mature businesses representing what were once large capital projects that now have an established track record during operations. It seems counter-intuitive to exclude infrastructure assets merely because they are a long-way into operations and not necessarily of time limited duration or fully amortising. Typically these business have the predictable long-dated and stable cash-flows that project finance models are seeking to replicate. Further, for a given asset and cash flows, it is often possible to structure an investment either as a corporate financing or as a project financing, in each case with a similar level of covenants, security and risk profile. Differing regulatory treatment should arise from different risks rather than form over substance.	

By way of illustration, investments into the following sectors and transactions would fall outside of the proposed definition but are considered by the market to be core infrastructure and could be expected to feature in a diversified infrastructure portfolio:

1. UK water sector

2. UK ports

3. European airports such as Heathrow, Gatwick, Brussels and Copenhagen

4. Utility transactions outside the UK such as Redexis Gas, Elenia, Net4Gas. For instance, the project "Redexis Gas Transmission and Distribution" (link) pre-financed by the EIB which will receive the backing of the EFSI guarantee in the context of the Investment Plan for Europe, would fall outside the proposed definition.

The WG also believes that the definitions should accommodate infrastructure debt issued by a corporate that owns a portfolio of infrastructure assets (e.g. solar or wind plants or accommodation assets or other smaller bundled projects/assets) where the portfolio of assets has characteristics that are consistent with project finance (whether in construction or operation) or infrastructure corporates.

It should be noted that consequential changes, not specifically highlighted in these comments, will be necessary as a result of the WG's comments on paragraph 1.52.

It is also worth noting that recital 50 (Articles 243(5) and 244(5), CRR; PRA SS9/13, paragraph 2.2.)

	of the CRR, should be considered by EIOPA to be added to the definition of eligible infrastructure investments, to make it clear that all forms of infrastructure investment should be eligible based on assets, rather than their corporate form or relative seniority. In principle, the final language on "eligible infrastructure investments" should be wide enough to reflect the need to help promote the financing of the real economy, where the financing is infrastructure in nature and particularly where the credit is viewed as investment grade.	
Section 3.2.		
Section 3.2.1.		
Section 3.2.2.		
Section 3.2.3.	The restriction of the application of credit approach to CQS2 and 3 is not indicative of the actual credit risk of infrastructure for the other CQS categories. The infrastructure debt instruments with high credit quality, i.e. CQS 0 and 1, should also be considered for better treatment than corporate bonds with the same CQS. Infrastructure debt investments are in many cases not rated by ECAI. Therefore, internal ratings in the classification of these investments should be allowed as well. Especially small and medium size projects usually have no rating although they contain low risk. The use of non-ECAI ratings should therefore be allowed.	
Section 3.3.		
Section 3.3.1.	"Infrastructure Assets" definition: the WG considers that the definition needs further clarification: - **Equipment and facilities** should be considered as infrastructure assets. Otherwise the approach may result in investment in projects such as schools and hospitals not qualifying, as these may not be covered by the reference to "structures". - More clarity should be provided on what would qualify as an "essential service" or "public service". Infrastructure assets also provide or support public services that are **desirable** but not necessarily essential to the public such as sporting, recreational or social facilities,	

government accommodation or FTTH (Fiber to the Home) infrastructures.

- It is not clear why the definition should be restricted to those with "limited competition", or how "limited competition" would be assessed. In the toll road example given in paragraph 1.72, this flaw would be reflected in the level of predicted income.

In the definition of "Infrastructure Project Entity":

- Paragraph (a) should only apply where there are debt providers (i.e. the project is not 100% equity funded) and where the investment being assessed for regulatory treatment purposes is a debt investment. No equivalent is needed for equity investments. In relation to the proposal to replace "lenders" with "investors" in the definition of infrastructure project entity (as suggested in paragraph 1.74), please clarify whether the intention is to refer to debt and equity investors, or rather to capture bank lenders and bondholders/private placement note holders, for example? Consider changing the term "lenders" to"debt providers" or similar.

- Similarly, paragraph (b) should refer to "debt providers (if any) and equity investors" instead of "lenders and equity investors".

Further, it should be clarified, that infrastructure financing does not require the physical ownership of the mentioned structures, systems and networks, but also for example the concession to operate them.

In the definition of "Special Purpose Entity", consider deleting the final sentence "and the structure of which is intended to isolate the special purpose entity from the credit risk of an originator or seller of exposures", or replacing "an originator or seller of exposures" with "other parties" as the current language is a securitisation-style definition.

As described in the WG's 15-003 DP response, the WG considers that the following list of the relevant

	sectors should be part of the definition: (a) water, electricity, gas, sewage, waste or other related assets, facilities or services; (b) energy or renewable equipment, assets or facilities; (c) roads (including bridges and tunnels), railways (including rolling stock) and railway facilities, ports, airports or other transportation assets, facilities or services; (d) health or medical equipment and facilities; (e) education, employment or training facilities; (f) courts, prisons or custodial facilities; (g) defence equipment, assets, services or facilities; (h) sporting, recreational or social facilities; (i) governmental assets or facilities; (j) flood defences; (k) housing; (l) telecommunications and broadcast assets or facilities; (m) physical distribution networks including pipelines and network connections and/or (n) fibre to home and other information technology assets. The WG disagrees with the exclusion of e.g. a power plant providing electricity to a single factory from the scope of the infrastructure definition (as suggested in para 1.71). As noted, the risk profile may be similar (depending on the strength of the off-taker in each case) and the criteria should be based on risk rather than whether or not a corporate has "funding problems".	
Section 3.3.2.	While from a high-level perspective the objectives behind general provisions relating to stress analysis, predictability of cash flows and contractual frameworks are understandable, their translation into requirements is overly prescriptive and operationally burdensome and there is a need for greater flexibility.	
Section 3.3.2.1.	Where a construction company or operating company is a strong credit, is it intended that there still a requirement to test the ability to meet its obligations in the event of an insolvency of such entity? If there are limited companies which can replace the contractor, it may be that a project will not qualify on this test, which seems inappropriate if this risk of contractor failure is assessed as low risk.	
Section 3.3.2.2.	The predictability of revenues and costs is implicitly included in the predictability of cash flows (which are made up by revenues and costs) so the consideration in paragraph 1.89 appears to be unnecessary.	

The requirement in the advice on predictability of cash flows, 2.a.iv that *"the level of output shall be…sufficiently stable"* should focus on predictability rather than stability. Provided the cash flows are predictable, they can be modelled and any risks relating to any instability can be properly assessed. Predictable unstable cash flows that meet all obligations to creditors and, in respect of equity investments, generate returns for equity investors should not be disqualified. The WG believes this requirement should be replaced by another requirement to have, for example, a minimum predictable cash-flow.

Regarding greenfield projects, some projects might not be initially in line with the projections, not only on the downside case but also some projects might perform better than expected. As a consequence, EIOPA should not penalise projects that have shown a better performance than expected. EIOPA's proposal does not reflect the fact that some projects might have experienced important changes during the construction or operation phase (e.g. modifications required by the procurement entity, new investments, service enhancement etc.) – which does not imply that these projects are not performing well or that the cash-flows are not predictable. These circumstances should be taken into account when assessing the predictability of cash-flows for greenfield projects.

The reference to credit rating requirements (see 2.b.iii of the advice on the predictability of cash flows) should include both an ECAI rating and an internal rating, and the requirement should only apply at the time when the investment is made.

- An internal credit assessment should also be encouraged given the aim to reduce overreliance on external ratings (as specified by rating regulation CRA III, Regulation 462/2013). An internal rating can be understood either as an internal rating of a partner company e.g. from a credit institution with an approved internal rating system of the internal rating or an internal rating from the investor.
- A requirement of a minimum rating should only apply at the time when the investment is

	made; otherwise it is not clear what would happen in case an off-taker is downgraded. The risk of cliff effects should be avoided. The requirement of CQS 3 for the off-taker seems too restrictive. EIOPA should consider to change the requirement to CQS 4. - The credit rating requirement should read as follows (additions are underlined) "*…ii.i an entity with an ECAI or <u>internal rating</u> with a CQS of at least 3 <u>at time of the investment</u>.*	
Section 3.3.2.3.	Point 2.d in the advice on "contractual framework" needs to be further improved to better reflect current market practices and good project management. The requirements that *"the project shall not issue new debt"* should be replaced with *"limitations on leverage and the issuance of new debt*". • While it is generally true that the project entity does not issue new debt, regulated assets that are remunerated on a regulatory asset base (RAB) or are similarly operating under a licensing tariff or other governmental system or support framework in a situation of limited competition should be allowed to raise more debt as long as it increases their RAB and thus their remuneration. • An improvement in this requirement is also needed to allow for financings structured to require a refinancing; for instance, in the case of the Australian PPP market tenors are typically up to 10 years compared to a much longer project life. • In light of the above, the requirement could be redrafted as follows (additions are underlined): *"…d) the covenant package to restrict activities of the project company is strong including ~~the provision that the project shall not issue~~ <u>limitations on leverage and issuance of new debt</u>"* Requirement 2(a) and (b) appear to cover the same point. In relation to 2(b), it is worth noting that market practice in some jurisdictions will mean first perfected security interests over all assets are not taken - for example, it is market practice in Spain to take promissory mortgages, rather than full perfected mortgages, due to stamp duty liabilities which arise on the grant of certain mortgages, and therefore on the current criteria project finance in Spain in accordance with current practices would	

	be excluded. It does not make sense that in Requirement 2.e regarding the contractual framework that reserve funds have a "longer than average coverage period". It is more appropriate to have a coverage period consistent with market practice. The WG would therefore suggest the following amendment (additions underlined): "*All reserve funds ~~have a longer than average~~ coverage period* <u>*in line with market practice*</u> *and are fully funded in cash or letter of credit from a ~~bank~~ counterparty of high credit standing*".	
Section 3.3.3.	See 3.2.3 above	
Section 3.3.4..		
Section 3.3.4.1.	The WG supports the suggested advice on political risk. However, many post-closing changes in rules are in the form of local regulation in addition to laws. Therefore point b) may be redrafted: "*there is a low risk of specific changes in law and* <u>*regulations*</u>..." Non-EEA and non-OECD jurisdictions should be allowed as long as political risk is mitigated. Point 2.a or the advice on political risk could be redrafted to read: "*the assets of the infrastructure project entity are located in a member state of the EEA or OECD* <u>*or the risk is sufficiently mitigated (eg guarantee by an international organisation such as the World Bank or the project is insured via credit insurance).*</u>" It be challenging to prove that there be a low risk of specific changes to law, regulatory actions or the imposition of exceptional taxes. Requirements 2.b and 2.c should be removed: - The WG believes that the requirement that there be a low risk of specific changes to law,	

| | regulatory actions or the imposition of exceptional taxes may be challenging to prove in practice. In any case, companies are always assessing via their risk management and pillar 2, the valuation of their assets based on their allocation, their investment policies and their strategies.

- There is a concern that points 2.b and 2.c of the advice on political risk may potentially exclude Italy, Spain, Czech Republic or Norway from the scope of the identification of infrastructure jurisdictions.

- Excluding these countries from the scope of investment into countries is contrary to the wider political objective, that EU countries that would benefit the most from infrastructure investment are able to do so.

- Projects should always be assessed on a case-by-case basis. | |
| Section 3.3.4.2. | The WG believes that the advice on structural requirements needs further improvement to recognise that some project finance transactions use another entity as issuer/finance vehicle. The present definition appears to imply that infrastructure debt can only be issued out of the operating entity.

Regarding the strength of the sponsor (point 4 in advice box in paragraph 1.98.): the WG suggests the following rewording:
"*The project or operating entity has a strong sponsor (for instance a highly reputed and experienced developer, or for operational entities experienced shareholder(s) or a long and diversified list of shareholders (for listed entities)).*"

Paragraph 2 should include "financing" of the infrastructure asset. Consider also overlap of paragraph 2 with definition of "Special Purpose Entity" (see 3.3.1 above). | |

	Requirement 4.a in the advice of structural requirements causes concern as it would be hard to support a sponsor's new ventures into a new market. At a minimum the following changes should be made to the wording: *"~~very~~ strong track record ~~and relevant country and sector~~"* Requirement 4.b on the "*high financial standing*" of the sponsor is restrictive. Where this refers to sponsors as shareholders, to the extent all funds expected as part of the capital structure have been provided, the financial standing of such shareholders is of limited relevance (and many such sponsors may be financial institutions or infrastructure funds, for that the "financial standing" concept is not very relevant. For infrastructure in construction, building contractor sponsors are often unrated, but these entities can be accommodated by commensurately stronger security packages / structuring. Their ability and incentive for them to work through difficulties should also be considered. The definition and identity of the "sponsor", which is derived from the Basel II approach, which is also unclear, should be refined as well. The WG believes paragraph 4(c) is inappropriate. This paragraph effectively seeks to evaluate factors which may result in a sponsor providing more financial support to a project than it is contractually obliged to. This is not consistent with a limited recourse, project finance structure (the contractual obligations of which should be considered on their own merits).	
Section 3.3.4.3.	The requirement on amortizing debt should not be part of the framework, as considered in paragraph 1.104. There are some projects where there is a component of non-amortizing debt, where a bullet repayment may be guaranteed or adequately covered and controlled before the payment date. It is not clear how 2(b) assists in assuring the ability of the entity to repay debt, nor why 4 or 6 should be strict requirements. In particular on point 6, it is worth noting that in many transactions the "senior debt" may in fact be	

	subordinate to a superior-senior class of debt (such as liquidity facilities or some hedging), and thus may not meet the criteria that it is the "highest level of seniority at all times", whilst still being considered senior debt. - Further, depending on the structure, it does not necessarily follow that subordinated debt is not a credit-worthy investment. Indeed, such debt could be investment grade.	
Section 3.3.4.4.	The WG notes that the criteria on construction risk seem to go further than those of rating agencies' methodologies and, in addition, the criteria for non-rated debt are significantly more restrictive than for rated debt. Point 2 (a) of the advice on construction risk (paragraph 1.111) should be removed as an absolute requirement. - In various sectors, one contractor does not "wrap" all construction work in this way (e.g. this is often the case in off-shore wind transactions). - There are other contractual arrangements with construction companies than fixed-price/date, certain turn-key contracts that adequately transfer risk and create incentives for the construction company to deliver a project on time and within the applicable specifications. - There are also more differentiated penalty/incentive schemes (cf. NEC3 contracts) that incentivise the right behaviour, while simultaneously avoiding excessive interface problems as in the case of a fixed-price, fixed-date contract, meant to incentivise risk transfer to subcontractors. - If point a) is not removed then it should be supplemented in the following way (additions underlined): "the infrastructure project entity enters into a fixed-price date-certain turnkey construction engineering and procurement contract with a realistic time horizon and estimate of costs <u>or an incentive and risk-sharing mechanism which is based on a detailed bottom-up</u>	

| | cost analysis and has adequate risk contingencies."

Regarding paragraph 1.111 2.b) the requirement of "substantial liquidated damages" is unclear and too restrictive.
It should read as "*liquidated damages in line with market practices*" (additions underlined).

The WG recommends to modify the requirement in paragraph 1.111 point 2.c) in order to ensure that innovative European projects can also be included in the scope of qualifying infrastructure: "*The construction company has the necessary expertise and capabilities, is financially strong~~, and has a strong track record in constructing similar projects;"~~*

In point 2.d of the advice on construction risk, the monitoring and management of risks have to be done by the investors and cannot be outsourced to a third party. Investors can have support with technical advice from a third party for example.
The requirement in 2(d) could be redrafted to read: "*when assessing whether the conditions in points a) to c) are met insurance and reinsurance undertakings shall use independent ~~thirdparty~~ technical and legal expertise.*" | |
| Section 3.3.4.5. | The requirement for material risks related to the operation of infrastructure assets to be transferred to an operating company should be removed.

- It is frequently the case that operation and management contracts are shorter than the life of the concession, and thereafter, the project company conducts the operation and management of the infrastructure assets or enters into another similar contract.

- It is common practice for the project company to retain the risk budget for lifecycle works – and reserve appropriately rather than have a fixed price contract with a lifecycle contractor. | |

	- There are various examples where project companies, such as airports, do not sub-contract the operation. These project companies have gained a lot of experience with the operation and should be allowed to continue doing so. The condition for the operator to have a *"very strong track record"*, as proposed in 2.c of the advice on operating risk is too restrictive and should be dropped in order to allow for innovative projects.	
Section 3.3.4.6.	The requirement to document *"fully proven technology and design"* would be difficult and exclude innovative projects. This could limit investment and innovation relating to both new and existing technologies. For example, it is not clear whether a variation on an existing design would still meet the "fully proven technology and design" requirement.	
Section 4.1.	1.117. The discussion about whether to apply or not to the spread risk module should not be triggered by the lack of empirical spread data but rather by the appropriateness to consider spread risk coming from a prudent risk identification process. Not the availability of data but the relevance of the risk factor should be dominant. 1.118. The WG does not agree with EIOPA's argument for treating infrastructure projects in the spread risk module. Price quotation is a common practice amongst banks as bank loans bear mainly floating rate interest rates referenced to a short term money market index, e.g. LIBOR. This pricing practice does not express the existence of spread risk volatility of an infrastructure project. In comparison as we have seen in the financial crisis the index, e.g. LIBOR reflect the banks' default risk which is empirically proven by the different Interest Rate Swap rates depending on the floating leg index, .i.e. EIONA, 3-M-EURIBOR etc. (please refer to the risk-free interest rate discussion). 1.119. Infrastructure debt will be most often categorized as level 3 assets. This is why there are most similarities of its balance sheet value with other level 3 assets rather than with corporate bonds	

	which are more of level 1 or level 2 types. This is why the conclusion would support the counterparty default risk approach. A drop of value even without default does not need to be the consequence of spread movements but of impairment which is driven by default risk and does not express a different risk aversion as a spread change. 1.120. The economic loss only materialises with default or "forced-sale". Most insurers tend to place infrastructure investments into portfolios matched by stable liabilities due to the relative illiquidity of the investment. The likelihood of a forced fire sale of this asset class is very low. This is why a possible deterioration in credit quality does not cause a loss per se (when a loss becomes really predictable the debt needs to be impaired anyhow). The argument that the risk is much higher for a sufficiently highly rated diversified pool of long-term debt is again just the repetition of the assumption that there is spread risk when focussing on the one-year horizon. The response to that argument is not to assume a trading motive and therefore consider default risk via cumulative default rates while ignoring the one-year spread risk. 1.121. If the existing approach is not appropriate for that type of risk - which is obviously the case - it is the duty of a prudent regulation to come up with alternative methodology especially when they are already applied for comparable risks. The risk here is rather to overestimate the risk and eliminate reasonable and prudent investments.	
Section 4.2.	It is worth noting that spread risk, unlike default risk, is not an integral part of a financial instrument but a consequence of the specific and individual asset-liability position of each insurer.	
Section 4.2.1.	If EIOPA decides to leave infrastructure calibration within the credit spread module, the WG supports EIOPA's view that as a result of lower credit risks of the infrastructure asset class, there is a justification for reducing the spread risk charges. The WG would favour the adjustment of the charge based upon the Loss Given Default in comparison to corporates (as seen on response to Section 1.5).	

	In connection with paragraph 1.24, th WG confirms that insurers tend to have matching long-term liabilities and therefore the probability of a force sale should be very limited. Infrastructure investments are ideal from an ALM-perspective and stabilise the solvency of insurers. Matching liabilities with appropriate assets is a key requirement for a prudent investor.	
Section 4.2.2.	1.128 Advantages - bullet points: (one) is not an advantage but only a description of a fact. Cumulative default rates do also capture implicitly the risk by its marginal default rates. (two) is a complete wrong anchoring of infrastructure investments to the world of corporate bonds. There is no statistical evidence of any coherence with regard to spread risk. (three) is an argument which is not justified by any statistical analysis. This is natural as one needs to compare short-term investments with a potential risk of forced-selling with investments that are held with a trading motive and that are therefore not endangered to be sold as the 1 in 200 market price. (four) is questionable as the current proposal can heavily overestimate own funds volatility which is also not in line with the prudent person principle. Disadvantages - bullet points: (one) this is correct and the problem of the approach. (two) this is correct as a BIS study from 2004 has clearly shown – there are no similarities between infrastructure and corporate debt. (three) correct and moreover the so called liquidity risk is derived from a wrongly chosen set of corporate bonds.	
Section 4.2.3.	1.131 The description of the facts are correct. But the relevant data sets for deriving conclusions should not be identical for corporate bonds and infrastructure investment. 1.132 The element of judgment is heavily coming from existing data sets on infrastructure. The so called pragmatic approach which is considered to be backed by studies is suffering from the unjustified assumption of coherence between corporate bonds and infrastructure investments. There is no study on infrastructure which could back the pragmatic approach of EIOPA.	

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Section 4.2.4.	For the liquidity approach, a probability of sale of 10% is assumed. The WG would argue that this probability should be set at a number closer to 0% given that insurers are usually able to avoid forced sales, ie especially when it is not possible to receive an appropriate price in the market. Based on the known illiquidity of this asset class, insurers typically only include infrastructure assets into portfolios which match liabilities with very low lapse risk. Also, insurers typically purchase a mix of assets to be matched against a portfolio of liabilities. Infrastructure assets, typically being amongst the lowest of secondary market liquidity, will be the "stickiest" asset class e.g. the last asset class to be chosen to be sold due to the long time required to sell the asset to another buyer due to the complexity of the documentation.	
Section 4.2.4.1.	1.133 This might be right but is not of relevance where assets are not held with a trading motive as for most infrastructure investments.	
Section 4.2.4.2.	1.134 This is correct and there is a difference between long-term holding and holding-to-maturity. 1.135 It is not about a reduction of spread risk but about the inappropriateness to consider spread risk at all for an asset class that is not held for the longer term. 1.136 The rationale applies for all illiquid assets that are held for the long term. Changes in the asset-liability position can be managed properly when considering both sides simultaneously.	
Section 4.2.4.3.	1.146 Correct - but only for a one-year horizon given the logic of the decomposition of the overall interest rate. Instead one needs to consider either the cumulative default rates or the marginal default rates over the maturity of the asset. 1.147 This approach is welcome and a first but not final step to achieve more independence from Rating Agencies.	

	1.148 It is not practical to have a sliding scale of probability of forced sales as it is very hard to calibrate.	
Section 4.2.4.4.	1.149 Even under the matching adjustment the risk perception is not correct and on should focus on pure default risk. 1.150 When focusing on default risk only this is a logical consequence.	
Section 4.2.4.5.	1.151 See the arguments in above comments with respect to the logic of risk when dealing with matched position or positions with a zero probability of forced sales.	
Section 4.2.5.		
Section 4.2.5.1.	The limitation of the credit approach to CQS2 and 3 is restrictive, and is not reflective of the actual credit risk for these CQS categories. For example, when looking at Moody's "Infrastructure Default and Recovery Rates, 1983-2014" study shows that there is a lower Probability of Default and Loss Given Default and lower rating volatility for all these asset classes. Furthermore, the same study shows that, at the end of 2014, more than 30% of infrastructure projects were rated Aa or higher: a correct prudentiall treatment of projects with a CQS of 0 or 1 is therefore important. 1.152 Reduction of spread risk charge is not an objective per se but a consequence of the appropriate risk identification of the asset-liability position of an insurer. Changing default rates shall be considered by (i) applying marginal default rates over the maturity of the asset and (ii) a permanent evaluation of the applicable marginal default rate term structure. 1.153 This is an assumption and cannot be commented with respect to capital charge calibration but is meaningful from a prudent portfolio management perspective. 1.154 If the decomposition of the overall spreads is properly done why should there be a reduction factor? The correct credit risk component is already a result of that decomposition?	

	1.155 Is this assumption based on the scepticism that the proposed idea might be not applicable at the edges of the credit risk spectrum due to the non evident reference to corporate risk?	
Section 4.2.5.2.		
Section 4.2.5.3.	1.159 It is about to find a proper calibration of infrastructure itself and not to compare it with corporate risk. 1.160 This is an arbitrary assumption with no disclosed statistical evidence. The spread risk charge attributable to credit risk for qualifying infrastructure project debt should be 50% lower consistent with EIOPA's comments that the ultimate loss-given default for qualifying infrastructure is roughly half the value for senior unsecured corporate bonds (paragraph 1.38), rather than the proposed reduction of 40% under the credit risk approach.	
Section 4.2.5.4.		
Section 4.3.		
Section 4.3.1.		
Section 4.3.2.	1.164 The main disadvantage is that due to the individual characteristics of each infrastructure project one cannot assume that secondary values will overtime vary with primary value of future projects. This is why that approach is not valid for calibrating spread risk - as already concluded by BIS in its study from 2004.	
Section 5.1.	The WG recommends that infrastructure debt should be treated under the counterparty default module to reflect the real risk to which companies are exposed. This is based on the more stable loss history of the asset class and its higher historical recovery rates compared to other asset classes, particularly since infrastructure assets are almost always senior in terms of security, as compared to other corporate bonds which are not always senior and therefore have a more volatile and lower recovery rate. It is also important that EIOPA treats both loan and bond/securities infrastructure	

exposures in the same way, so to avoid regulatory arbitrage created by EIOPA with residential mortgages.

The WG notes that EIOPA have not made a proposal for a review of infrastructure debt under the counterparty default risk module, despite that this approach was requested in the Call for Advice from the European Commission, and the political interest in this solution based on the regulation for the European Fund for Strategic Investments (2015/017). Recital 41 of the regulation references lower default and recovery statistics (i.e. the counterparty default module): *"In light of the general aim of ensuring a regulatory environment conducive to investments, and in light of the fact that infrastructure assets have a strong default and recovery record and that infrastructure project finance can be seen as a means of diversifying institutional investors' asset portfolios, the treatment of infrastructure investments, as currently provided for in relevant Union prudential legislation, should be re-examined."*

The WG would like to propose the following approach to calibrate infrastructure debt under the counterparty default risk module, where risk charges are distinct for infrastructure debt investments depending on their rating and the following duration buckets:

- 1st bucket: duration up to 5 years
- 2nd bucket: duration of more than 5 years and up to 10 years
- 3rd bucket: duration of more than 10 years
- Total loss due to defaults is calculated based on the combination of probability of default (PD) and recovery rates (RR).
- The capital requirement for infrastructure is calculated with the formula:

  〖SCR〗_infrastructure=PDx(1-RR)xExposure
- A recovery rate (RR) of 50% is assumed. This recovery rate is conservative, given that based

on CRA default and recovery data recovery rates for infrastructure range between 60% and 80% and the most common recovery rate is 100%.

- The following 1 in 200 default rates are derived:

Duration bucket / Credit quality step	0	1	2	3	4	5 and 6
Up to 5 years	3.4%	3.4%	3.4%	8.8%	31.8%	50.5%
More than 5 years and up to 10 years	3.9%	3.9%	7.3%	13.3%	43.0%	62.3%
More than 10 years	5.9%	8.1%	11.7%	18.4%	61.5%	90.6%

- The following capital charges are derived:

Duration bucket / rating	AAA	AA	A	BBB	BB	B
Up to 5 years	1.7%	1.7%	1.7%	4.4%	15.9%	25.3%
More than 5 years and up to 10 years	2.0%	2.0%	3.7%	6.7%	21.5%	31.2%
More than 10 years	3.0%	4.1%	5.9%	9.2%	30.8%	45.3%

The above figures assume a zero probability of sale of the assets matching a pool of liabilities. Although the Working Group believes that the probably of sale is very low, realistically it is not zero. The WG would recommend a very slight increasing of the above capital charges to reflect a probability of sale of between 0 to 5%. The WG does not have data to support this assumption. However, given the prudence required by undertakings in the purchase of long term illiquid but stable assets to match long term liability portfolios with very low lapse risk, it is highly unlikely that insurers

	who do prudent matching will need to sell infrastructure assets until their maturity, irrespective of the levels of interest rates. Stated another way, if EIOPA proceeds with using a credit spread risk approach, the WG strongly supports using a combination of the two approaches stated in consultation sections 1.19 and 1.20, which will result in capital charges lower than in Table 2, but slightly higher than in the table immediately above. The WG recommends using a probability of sale assumption less than 10% based on the prudential person principal that will govern the decision making process of undertakings.	
Section 5.2.	1.171 This argument is not valid when valuing the positions properly in the accounts.	
Section 5.3.		
Section 6.1.		
Section 6.2.	EIOPA's advice to charge infrastructure-related equity risk between 30 and 39% is based on a PFI portfolio of 5 listed companies which invest mainly in social infrastructure. EIOPA concludes that infrastructure investments have higher returns than the market with much lower drawdowns, lower volatility, lower tail risks as wel as little or no correlation with the market. The WG believes that EIOPA's proposal is acceptable for listed equities. In relation to non-listed equities, the WG believes that it is essential that unlisted infrastructure equity are not treated as the listed equities would be. The returns of such unlisted infrastructure exhibit much lower volatility with correlation with both listed infrastructure equity and other assets close to zero. The WG believes that prices for listed equities should not be used as a proxy to calibrate the risk charge for unlisted infrastructure projects. A low correlation factor (for instance, zero), with other market risk sub-modules should be considered. The leverage ratio of the underlying project entity is relevant. Listed indices are usually composed of entities with a rather high leverage ratio resulting in higher volatility of these indices. A leveraged	

	infrastructure equity index therefore usually overestimates the risk of moderately or even unleveraged infrastructure equity investments. As a conclusion, the current treatment of unlisted infrastructure equity under Solvency II and in EIOPA's proposal are not appropriate.	
Section 6.2.1.	1.183 The conclusion is heavily influenced by the definition of proxies. As proxies seem to be operating companies also the outcome is not surprising. But the WG believes this is not relevant for project type equity.	
Section 6.2.2.		
Section 6.2.3.	1.192 Another limitation of the interpretation is whether returns of equity of an operating company investing into equity of project SPV are suitable proxies when having run through a risk inventory exercise of the proxies.	
Section 6.3.	There should be a clear distinction between listed and unlisted equity infrastructure. The returns of unlisted equity infrastructure investments are less volatile and uncorrelated with other asset classes. Unlisted equity should therefore be included in a new sub-module with a 22% charge. The WG believes that the zero correlation between unlisted infrastructure equity and other equity should be recognised in the definition of an unlisted infrastructure equity risk sub-module. 1.195 The WG supports this as project SPVs especially do not bear strategic management risk as corporates (operating companies) do. A consequence of it is that equities of operating companies do normally trade above the pure NAV in contrast to equity of project SPVs. 1.197 This assumption is not evident from statistical analysis. 1.198 To which losses EIOPA refers here - marked-to-market losses or realized losses?	
Section 7.1.		
Section 7.2.	1.202 The advice should properly take into account the existing requirements under pillar 2 for investments. 1.203 The stipulation of steps and procedures in relation to infrastructure investments should be in	

	accordance with the prudent person principle. 1.204 See comment 1.203. Costs should be capped to those which are needed to set up an appropriate risk management framework for infrastructure investments within the existing Solvency II system - a main focus here is to avoid cost for external ratings and/or for plausibility checks of external ratings.	
Section 7.3.	There is no justification for setting elements of risk management, as the Prudent Person Principle is presently the best practice. Legislating for best practice prevent future improvements. 1.207 Those specifications are welcome as they are in line with the prudent person principle and with all other asset classes. 1.208 Referencing infrastructure investments to the Guideline on non-routine investment activities seem only appropriate as long as those investments are non-routine for an undertaking. Once they are routine investments they shall be treated like all other routine investments. 1.212 There are alternatives to requiring an external audit, e.g. stressing the financial model. 1.215 Work-out strategies are in principle superior to forced sale strategies. Therefore it is prudent to incentivise work-outs and disincentives forced sales. The WG believes insurance companies should be able to validate themselves whether a project satisfies the qualifying criteria because the investor itself is best placed to make this assessment (rather than having an independent validation confirm it). Otherwise, this would impose higher requirements on insurance companies than those that the pillar 2 of Solvency II already calls for (where an insurance company needs to conduct its own assessment whether an investment satisfies the prudent person principle).	

<table>
<tr><th colspan="2">AFME-ICMA Infrastructure Working Group 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</th><th>Deadline
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23:59 CET</th></tr>
<tr><td>Section 8.</td><td>In the asset class for qualifying infrastructure, guarantees by regional governments and local authorities (RGLA) should be treated as central government exposures, given their lower risk.

- Guarantees provided by the central government are assigned a risk factor of 0% for SCR spread risk, concentration risk and counterparty default risk under the Solvency II Delegated Acts. From a risk perspective, there should be no difference between a guarantee provided by a central government or RGLA. In some member states regional governments possess more fiscal powers compared to the central government.

- In the event of a default a clear guarantee ensures repayment by the RGLA, thereby exposing Insurance companies directly to the creditworthiness of the RGLA. The lower credit risk of the RGLA should therefore be recognised in prudential regulation.

- For the counterparty default module, article 199 point 11 of the Delegated Acts ensures that RGLA guarantees are treated as central government exposures. Not recognising RGLA guarantees within qualifying infrastructure would lead to an inconsistent treatment in comparison to the counterparty default module.

Therefore the WG proposes to add the following paragraph within the asset class of qualifying infrastructure:

<u>“Exposures which are fully, unconditionally and irrevocably guaranteed by counterparties listed in the implementing act adopted pursuant to point (a) of Article 109a(2) of Directive 2009/138/EC shall be treated as exposures to the central government.”</u></td><td></td></tr>
<tr><td>Annex I</td><td></td><td></td></tr>
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<tr><td>Annex III Sections:</td><td></td><td></td></tr>
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