Client Update
European Commission Proposes Introducing New Infrastructure Asset Class Under Solvency II After EIOPA Advice

LONDON

James C. Scoville
jcscoville@debevoise.com

Edite Ligere
eligere@debevoise.com

Benjamin J. Lyon
blyon@debevois.com

BACKGROUND

On 30 September 2015, the European Commission (the "Commission") made amendments to the Solvency II Commission Delegated Regulation (EU) 2015/35, which included introducing a new asset category: "qualifying infrastructure investments". The amendments adopt with very little modification the technical advice provided to the Commission by EIOPA on 29 September 2015.

The new asset class will constitute a more tailored treatment of investments in infrastructure projects, identified as a priority in the "Omnibus II" Directive, in order to encourage long-term investment in a broad range of infrastructure projects, including innovative projects, systems and networks. It seeks to do this by creating an appropriate risk calibration for infrastructure investments, removing unjustified prudential obstacles and creating better incentives for insurers to invest in infrastructure projects by reducing the amount of capital they must hold against the debt and equity of qualifying infrastructure projects.

Capital charges applying to infrastructure investments under Solvency II will be reduced according to a modified credit risk approach. Infrastructure equity investments will now have a risk calibration of, broadly, 30% of their value, compared to 49% for unlisted equities, into which category most infrastructure project equities fall under the current regime.

The amendments also affect investment in European long-term investment funds and equities traded on multilateral trading facilities, giving the former lower capital charges and the latter the same capital charge as equities traded on regulated markets (39%). Capital charges relating to qualifying infrastructure investments structured as bonds or loans have also been significantly reduced for various maturities and credit quality steps.

Other amendments introduced include extending the benefit of the transitional measures under Solvency II, which currently only cover equities traded on regulated markets, to all equities in order to avoid an undesirable disinvestment from equities. The transitional measures will phase out previous capital charges and phase in new charges, over a period of seven years, for equities purchased before the end of 2015.

QUALIFYING INFRASTRUCTURE INVESTMENTS

Which infrastructure investments qualify for the new asset class will be decided on a broad range of criteria rather than a list of qualifying industries in order to ensure that innovative projects are not unfairly excluded. Eligible infrastructure investments must exhibit a better risk profile than other equity or debt investments. The criteria will include provisions requiring that infrastructure projects are able to generate predictable cash flow and withstand stressed conditions and have a contractual framework that offers a high level of protection to investors. Qualifying infrastructure assets should also be owned, financed, developed or operated by an infrastructure project entity that does not perform any other function.

More robust risk management requirements are to be applied to qualifying infrastructure investments, building on the Solvency II requirements. Provisions are added requiring high-level due diligence and active performance monitoring. It is not thought that these requirements will present a significant hurdle for most firms, as they are likely to already have such systems in place. The due diligence requirements will be particularly pertinent for more innovative projects.

NEXT STEPS

The European Parliament and the Council have up to three months to exercise their right of objection, with the possibility of extending that period for another three months if they so wish. Either institution could also reject the amendments. If neither institution objects to or rejects the amendments, they will be published in the Official Journal of the European Union and will enter into force the day after publication.

The Solvency II standard formula is expected to be reviewed in 2018, which will include a review of the provisions dealing with qualifying infrastructure investments.

Currently, the new asset class excludes corporate investment in infrastructure companies, but the Commission and EIOPA will review whether qualifying criteria can be established for corporate structures that perform similar functions to infrastructure project entities and which have a similar risk profile.

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Please do not hesitate to contact us with any questions.