Infrastructure Debt to Become Insurers' Darling?

Scope expects demand for infrastructure debt investments to rise significantly among insurance companies. Rated qualifying infrastructure debt with a credit quality in line with a 'Credit Quality Step' (CQS) 2 will become particulary sought after. This follows the European Commission's recent draft amendment to Solvency II from 30 September 2015[1] (the 'amendment'), which lays down favourable regulatory treatment of such infrastructure debt. This amendment also creates stronger demand for instruments from the European Fund for Strategic Investment ('EFSI' or 'Juncker Plan'), since these instruments aim to increase the robustness of senior infrastructure debt to make such an investment more attractive to insurance companies.

Rated infrastructure debt can benefit on several levels

The amendment introduces a new category of specific exposures to Article 180 of Solvency II: bonds and loans that meet the requirements of qualifying infrastructure investments[2]. In the case an Eligible Credit Assessment Institution (ECAI) rates infrastructure debt, it does not have to comply with additional requirements in Article 164a (f) (the "164a (f) criteria") to qualify. While rated qualifying infrastructure debt can benefit from the lower capital charges corresponding to CQSs as high as CQS 0, unrated infrastructure debt will at best enjoy a capital charge reduction corresponding to CQS 3. If the amendment is approved in its present form, this should prompt the following effects:

1. Qualifying infrastructure debt will (in general) benefit from a significantly lower capital charge than bonds and loans that depend on the duration and credit quality of the respective investment. This is a function of the spread risk of the investment, which the regulator deems to be lower for infrastructure investments versus other asset classes.
2. Insurance investors will have incentives to seek a public rating from an ECAI on their infrastructure debt investments, as the investment would not have to comply with 164a criteria to be categorised as qualifying infrastructure debt.
3. Infrastructure debt investments with an ECAI rating in line with CQS 2 will benefit from a significant reduction in capital charge compared to investments with a CQS 3 credit quality. The step down in capital charges between these two CQSs is very significant, and the savings in capital charges from CQS 2 to CQS 1, and CQS 1 to CQS 0, respectively, are rather minor.
4. This is why Scope expects issuers and investors to move towards rated structures, with infrastructure debt enhanced towards a credit quality of about CQS 2. For most established ECAI, including Scope, CQS 2 should equate to a rating in the 'A' category.

The effects above are illustrated by the risk factors $stress_i$ in the spread risk table:

Table 1: Risk factor $stress_i$ for bonds and loans vs. qualifying infrastructure debt[3]

	CQS 0	CQS 1	CQS 2	CQS 3
Bonds/Loans (duration: 10 yrs)	7.00%	8.50%	10.50%	20.00%
Qualifying infrastructure investments (duration:10 yrs)	5.00%	6.05%	7.50%	13.35%
Bonds/Loans (duration: 20 yrs)	12.00%	13.50%	15.50%	30.00%
Qualifying infrastructure investments (duration: 20 yrs)	8.60%	9.65%	11.10%	20.05%

[1] Commission Delegated Regulation (EU) amending Commission Delegated Regulation (EU) 2015/35
[2] See Art. 164a of the amendment
[3] Extract from Article 176, paragraph 3, and Article 180, paragraph 11, Solvency II (as amended)

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EFSI instruments to play a vital role

The EFSI – launched jointly by the EIB Group and the European Commission – plays well in tandem with the proposed regulatory changes. EFSI can provide debt instruments, guarantees, equity, quasi-equity instruments, credit enhancement tools or venture capital. Scope expects EFSI instruments to become a major source of credit enhancement for qualifying infrastructure investments, and these instruments are also well matched to provide the credit support investors seek at the senior level to achieve a rating in line with a CQS 2. It also provides potential investors extra protection against downward rating migrations, making the asset class eligible for new investors, and potentially reducing yield requirements of existing ones.

Other advantages of ECAI ratings for infrastructure debt

The amendment treats ECAI-rated debt favourably because unrated infrastructure debt has to fulfil the additional 164a (f) criteria to become a qualifying infrastructure investment. Infrastructure debt investments therefore benefit from an external rating for a number of reasons:

Certainty

An external rating for an infrastructure debt investment relieves the insurance or reinsurance undertaking from proving it meets 164a (f) criteria for their investment. Given the complexity of infrastructure investments, this provides significant relief to an investor. Beyond that, most of these requirements are expressed in highly subjective terms. It may be difficult for the investor to assess if, among other things, equity investors have a "low risk of default"; "refinancing risk of the infrastructure project entity is low"; and the SPV "uses tested technology and design".

Flexibility

Unlike Credit Rating Agencies, the investor or arranger has to stick to the EC's 'one size fits all' approach set out in 164a (f) criteria. Contrary to the analysis of a rating agency when applying the 164a (f) criteria, there is no credit that can be given to other mitigants that has the same or even better risk-reducing effect than these criteria.

Recognition of credit enhancement

When assessing the credit risk of infrastructure debt investments, a credit rating can consider credit enhancement. The requirements set out by the European Commission look at infrastructure-inherent risk factors, and do not take into account the risk-mitigating effects of credit enhancement features, which are common in structured finance, such as mezzanine or junior debt. Obviously this also applies to credit enhancement provided by the EFSI, as discussed above.

Geographical range and subordinated debt

Lastly, such infrastructure investments qualify for the reduced spread charges vis-à-vis the 'bonds and loans' category when infrastructure assets and the infrastructure project entity are located in the European Economic Area or an OECD member state, unless an ECAI rating is available. The same applies to investment instruments in the form of bonds not senior to all other claims other than statutory claims and claims from derivative counterparties. This could jeopardise the reduction of capital charges, for example, when the claims of service providers are or cannot be subordinated. It further denies the benefit of a capital charge reduction to subordinated infrastructure bonds, which could be rated at a CQS 3 level.

Conclusion

The significant difference between unrated debt and (especially) spread risk charges between infrastructure debt with a CQS 2 vis-à-vis CQS 3 gives a strong incentive for insurers to invest in infrastructure debt in line with a credit quality commensurate with CQS 2, and for arrangers to involve EFSI credit enhancement. The reduction in capital charges for qualifying infrastructure debt at CQS 2 will make such investments much more attractive to insurance companies, and will ultimately help the Juncker Plan's aim – to foster institutional investment in infrastructure.

SOURCES

(Draft) Commission Delegated Regulation (EU) amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings, European Commission, 30 September 2015[4]

Final Report on Consultation Paper no. 15/004 on the Call for Advice from the European Commission on the identification and calibration of infrastructure investment risk categories, EIOPA, 29 September 2015

Consultation Paper No. CP-15-004 on the Call for Advice from the European Commission on the identification and calibration of infrastructure investment risk categories, EIOPA, 2 July 2015

[4] The draft amendment should enter into force at the beginning of 2016 following publication in the Official Journal of the European Union at the end of this year. By then the period within which either the European Parliament or the Council have the right to reject this amendment should expire. This period should not exceed three month starting from the date of the draft amendment, unless it is extended for another three month at the initiative of the European Parliament. The European Council has confirmed already that it does not have any objections to the amendment.

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