insurance europe

Position Paper

Comments on the IAIS survey on infrastructure and strategic equity

Our reference:	ECO-IAR-20-045	Date:	9 December 2020
Referring to:	Public survey on infrastructure and strategic equity		
Contact person:	International Team	E-mail:	international@insuranceeurope.eu
Pages:	3	Transparency Register ID no.:	33213703459-54

Introduction

Insurance Europe is committed to the objective of a single, high-quality and robust insurance standard. The insurance capital standard (ICS) should promote a sound, global level playing field and it can only be considered global if all major jurisdictions commit to implementing it consistently.

Insurance Europe welcomes the IAIS work on a differentiated capital treatment of infrastructure and strategic equity investments within the ICS standard method.

The insurance industry is the largest institutional investor in Europe, with more than €10trn of assets under management. The significant investment capacity of the insurance industry allows it to play a key role in supporting economic growth through investment in a wide range of assets, including infrastructure and strategic equity.

For the insurance industry to contribute to economic growth to its full capacity, two key conditions need to be met:

- Suitable long-term assets need to be available. Insurers need to have access to a wide range of assets that provide portfolio returns and diversification, to the benefit of their policyholders.
- The prudential treatment of these assets needs to be appropriate and reflect the actual risk exposure. Indeed, a capital treatment of assets that is not risk-based, meaning non-reflective of the actual risk exposure that insurers face when investing, can become a barrier to investment.

Insurance Europe therefore supports work by the IAIS to allow for an appropriate and tailored treatment of infrastructure and strategic equity in the ICS.

Insurance Europe aisbl • rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 00
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

© Reproduction in whole or in part of the content of this document and the communication thereof are made with the consent of Insurance Europe, must be clearly attributed to Insurance Europe and must include the date of the Insurance Europe document.

insurance europe

Comments on infrastructure

It is currently assumed in the ICS standard method that infrastructure investments behave like any other exposures, such as to corporate bonds or general equity. This is despite the fact that infrastructure investments have shown higher recovery rates and lower instances of default than other investments[1], which justifies a more tailored approach to measuring the underlying risks and implicit capital requirements.

Infrastructure assets are attractive to insurers because they represent a good source of diversification and yield for insurers' portfolios. Infrastructure projects will only be financed if providers of both equity and debt-financing are found. Insurers are interested in and invest in both forms of investment, and preference for one type of instrument over another is company-specific and based on the nature of liabilities, while also depending on other factors, such as a company's areas of expertise, its risk appetite, the availability of the investments and expected yields.

Insurers typically hold infrastructure debt over the long-term, reflecting the long-term nature of their liabilities. They have the ability to avoid forced sales due to liquidity management combined with asset-liability management (ALM). They are, however, exposed to credit risk (ie default risk) and for this risk they must hold capital as part of the credit risk submodule.

Nevertheless, infrastructure debt investments are also in the scope of the non-default spread risk (NDSR) submodule which can create a capital requirement for potential adverse spread movements, depending on the insurer's risk profile and ALM.

In addition to capital treatment, other design features of the ICS will affect infrastructure investments, such as the treatment of assets that do not have a public credit rating. Here, Insurance Europe would encourage the IAIS to allow the use of internal ratings to mitigate the disconnect between observable spreads and the spreads currently allowed under the ICS for assets that do not have a public credit rating.

With respect to the IAIS strawman proposal, Insurance Europe:

- **Does not support requiring the IAIGs to demonstrate low volatility using quantitative evidence on a regular basis**.
    - There is no need to include such a requirement, given existing market studies and evidence proving this point. For example, JP Morgan's 2013 study[2] shows that credit spreads for infrastructure project finance debt are sustainable around 250 to 300bps and have exhibited much lower volatility than corporate credit, especially during the 2008-09 crisis, when they were less volatile than A-rated corporate bonds.
    - There is no liquid market for infrastructure and so market valuation is irregular. However, this is not generally a problem for insurers since the more relevant metric is the external or internal rating. Measuring volatility is therefore much less relevant. Regarding the behaviour of infrastructure assets vs other types of fixed income assets, it is worth noting that ratings for total infrastructure securities are generally more stable and were notably more stable than those for non-financial corporate issuers in the 2008-09 financial crisis and recession. As explained in a Moody's report published in September 2011, "infrastructure issuers tend to enjoy open and welcoming capital markets, and rarely experience trouble raising the necessary capital to meet their investment needs."[3]
- **Supports that the capital treatment for qualifying infrastructure debt be based only on credit (ie default) risk and removed from the scope of the NDSR submodule.**
    - This would reflect the commitment to hold the investment to maturity, as required by criteria 9 (d). As any infrastructure debt investment held to maturity will only be exposed to default risk, it should no longer be in the scope of the NDSR submodule.

---

[1] See J.P. Morgan Asset Management, Global Real Assets (2013): A case for Core Infrastructure; Moody's Annual Default Study: Corporate Default and Recovery Rates, 1920-2013, published in February 2014; and Moody's report: Default and Recovery Rates for Project Finance Bank Loans, 1983-2013, published in February 2015

[2] See J.P. Morgan Asset Management, Global Real Assets (2013): A case for Core Infrastructure

[3] See Moody's Study: The Great Credit Shift – Infrastructure Finance Post Crisis, published in September 2011; and Moody's Infrastructure Finance Default Study, published in March 2015

insurance europe

Comments on strategic equity

Insurance Europe supports a tailored capital treatment for strategic equity in the ICS standard method.

Insurers invest in equities for their long-term performance arising from the combination of dividends and capital gains. While equities can exhibit significant short-term price volatility, the actual risk faced by insurers that can avoid being forced sellers of their equity holdings is one of long-term underperformance of the asset and not an instantaneous fall in value. It is the long-term liabilities and the stable resources (including future premiums on a going-concern basis and own funds), combined with flexibility in terms of management actions that allow insurers to avoid being forced sellers. In fact, insurers manage equity investments as part of diversified portfolios of assets that include fixed income, property, etc., which back liabilities. These assets are bought and managed based on insurers' ALM strategies and in line with their risk appetite and internally set investment limits.

The current ICS proposal requires a number of improvements to make it useful. If the criteria are not appropriate, then there will be little use of this sub-category in practice. Insurance Europe believes the following changes should be made:

- **The low volatility criterion should be removed.** Requiring quantitative data on the volatility of the value of such investments does not take into account that what makes these investments strategic is not the investee's business performance, but the purpose of the IAIGs' participation through long-term ownership. An insurer deliberately decides that it will not give up the participation in case of stress, which justifies departing from the one-year holding period. Hence, quantitative methods will not help to shed light on this issue. Rather, the IAIS approach must ensure that the identification of an investment as strategic means a commitment from the participating investor, which needs to be based on the investor's ability to have a significant influence over the management of the investees. In addition, qualitative evidence could be provided, demonstrating the level of integration in the investor's business, eg the implementation of the group-wide governance system in a strategic participation.
- **The dividends criterion should be removed** as, in itself, it does not reflect the long-term commitment strategy of the insurer. It should also be noted that dividends will, by nature, not mirror the value of long-term commitments.
- **The 6-year minimum holding threshold should be removed.** While the ability to continue holding is ultimately linked to the strategic nature of the investment and the commitment of the investor, imposing an arbitrary six-year minimum threshold is not appropriate.

What needs to be assessed is an investor's ability to exercise a significant influence over the management of an investee. Insurance Europe therefore suggests **replacing the low volatility, dividends and minimum holding period criteria with a criterion of minimum ownership of 10% in the voting rights or capital of an investee.**

Comments on other long-term equity

Insurance Europe encourages the IAIS to consider the inclusion of another category of long-term investment in equity, namely long-term equity.

The core consideration underpinning such an asset class is, as discussed with regard to strategic equity, that the actual risk that insurers face is the risk of long-term underperformance of the asset and not an instantaneous fall in value. In general, given their long-term and predictable liabilities, insurers take a long-term approach to investment on the basis of robust ALM strategies and practices.

Long-term equity portfolios should be treated in the same way as strategic equity, where insurers commit to maintaining the investment for the long-term.