

## Industry's potential solutions to enable the calibration of a range of long-term assets under the draft Delegated Acts to support growth and long term investment

### INTRODUCTION

Reviving long-term financing remains one of the most pressing policy issues in Europe. In March 2014, the industry proposed a number of recalibrations to the Delegated Acts to support the political efforts to foster long term investment and investment in the real economy. The need for this revival has become even more critical now and remains a key topic on the G20 agenda.

Action on long term investments has also been identified as one of the key priorities for the new Commission and was the focus of discussion amongst policymakers, finance ministries and industry at the recent Eurofi Conference in Milan. Separately, actions by the ECB and publications by the ECB and Bank of England highlight the need for a functioning securitisation market that attracts long term investors.

Despite amendments to the Delegated Acts since March, the currently foreseen capital charges for a range of long-term assets, such as infrastructure, SMEs or securitisations do not correctly reflect the real risks that insurers are exposed to when holding these long-term assets and risk pushing insurers away from such investments.

The Level 2 Delegated Acts must support the efforts to foster long-term investment and investment in the real economy while maintaining policyholder protection. In order to achieve this, a number of changes are proposed to:

- better reflect the real risks triggered by a range of investments which have been recognised by recent European and global debates as extremely important for economic growth; and
- enable effective and deeper markets and data in these investments to develop.

These changes are needed now to remove barriers to long term investment and support the progress being made by the industry in addressing issues around data and transparency of the different types of investment. This cannot be delayed to 2018.

This paper looks at recalibrations<sup>1</sup> for the following investments:

- **Securitisations:** While we welcome recognition that high quality securitisations can and should be identified, the definition of the high quality "Type 1" is restrictive and the calibrations proposed are too high. This will restrict the ability of this asset class to be viable for insurance companies. For example, a AA 5-year securitisation will still have a capital charge of over 15%. This should be compared to a total actual accumulative default rate during the crisis (2007 to 2013) of only 0.14%.
- **Infrastructure:** There is evidence that **infrastructure investments** react less (or even not at all) to general financial market movements due to their long-term nature and underlying exposures. There is also evidence that the risks of default and/or recovery rates of infrastructure investments exhibit better performances than those of corporates. The calibration of capital charges for infrastructure investments have to allow for (i) the recognition of the specificities of infrastructure and implicit lower investment risk, as well as for (ii) the recognition of the low correlation between infrastructure risk and other asset risks. Such an approach would require a definition of infrastructure, along with simple approaches to improve the SCR calibration methodology.
- **SME investments** are key to funding economic growth in Europe. Insurers, via their long-term and illiquid liabilities, have the ability to hold such investments in their portfolios. The current calibrations do not appropriately take into account the long-term nature of such investments and the risk mitigation features including collateral that can reduce the risk.

The industry proposes the following as potential solutions to address some of the challenges mentioned above in the Delegated Acts. The paper is split into two sections – *section 1* which includes developed solutions proposed by the industry and *section 2* which contains potential avenues being explored to further recognise particular investments in infrastructure and SME equity for discussion.

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<sup>1</sup> This letter does not cover other SCR calibration issues that may have been raised such as transitional measures for equity risk.

**SECTION 1 - INFRASTRUCTURE AND SME DEBT AND SECURITISATION**

**SECURITISATIONS**

While a split between high and low quality **securitisations** is necessary and welcome, the approach and the new proposed capital charges remain punitive.

A number of challenges emerge from the currently foreseen treatment of securitisations:

**1. Proposed EIOPA capital charges do not reflect the inherent risk of high-quality securitised assets.**

The corresponding high capital charges are largely due to high volatility experienced during the last crisis and resulting from leveraged investment vehicles involvement in the market. However, regulatory and market initiatives mean that the global securitisation market has experienced significant changes since 2007/2008, among which:

- ECB initiative to begin ABS Purchase Program would have a beneficial effect on market making and liquidity reducing the volatility of this class of assets,
- the exit from the market of leveraged investment vehicles that were responsible for most of the volatility,
- the set-up of obligatory underlying risk retention and a collateral quality market-label that ensure interest alignment between originators and investors,
- transparency initiatives requiring loan-level data disclosure.

The proposed calibration does not give credit to these significant changes in the securitisation market since 2007.

We recommend adjusting the calibration for the exceptional volatility experienced in 2007 and recognising that the spread performance experienced by the securitisation market in the past years is very similar to that of corporate bonds.

Calibration should be similar to corporate bonds: Article 178

Credit rating	Capital charge (per year of duration) for Type A securitisations
AAA	0.9-1.1%
AA	1.1-1.4%
A	1.4-2.5%
BBB	2.5-4.5%

Amendments proposal

Article 178 [...]

1. The capital requirement for spread risk on type 1 securitisation positions shall be equal to the loss in the basic own funds that would result from an instantaneous relative decrease of stress<sub>i</sub> in the value of each type 1 securitisation position i. The risk factor stress<sub>i</sub> shall be equal to the following:

$$stress_i = \min(b_i \cdot dur_i; 1)$$

where:

- (a) dur<sub>i</sub> denotes the modified duration of securitisation position i denominated in years;
- (b) b<sub>i</sub> shall be assigned depending on the credit quality step of securitisation position i according to the following table:

Credit quality step	0	1	2	3
$b_i$	0.9 %	1.1 %	1.4 %	2.5 %

**2. The current proposal includes a large number of criteria to define high quality securitisations. We believe that this list of criteria should be simplified.** A high quality securitisation should be mainly defined based on the quality of the underlying pool.

This is the purpose of the criteria: asset class eligibility and related collateral characteristics.

Criteria related to claw back, servicing or information disclosure, etc are important but not fully necessary in a regulation. We believe that regulators should favour flexible mechanisms to define and control the criteria, and set up a Prime Collateralised Securities (PCS) type label.

Furthermore we believe it is critical that regulation for banks and insurers are aligned in this respect. The European Banking Authority is to issue end of September / beginning of October this year a consultation on the definition of high quality securitisation (HQS). The European Central Bank jointly with the Bank of England initiated also discussion around the definition of HQS. Should the deadline for the Delegated Acts issuance be too tight as regards those initiatives from EBA and ECB, an insert in the Solvency II Regulation should be made so that rules can be applied consistently across sectors. We would suggest the possibility of having a dedicated European solution that would be used across various regulatory streams (for example LCR in bank regulation, capital charge differentiation in insurance regulation) be further explored.

Criteria should not be enshrined in the regulation to avoid freezing the evolution of the market.

Article 178

As senior securitisation tranches benefit from protection against underlying collateral risk, we would recommend capping senior securitisation charges to the capital charges that apply to the underlying collateral.

**Amendment proposal:**

Article 178

(Add) 1bis. Notwithstanding paragraph 1, the capital requirement for spread risk on type 1 securitisations shall not exceed the capital requirement for assets underlying the securitisation.

**3. Junior tranches of category 1 securitisations are included in category 2 only because of their junior status. We recommend excluding High Quality Non Senior securitisation from Type 2 since High Quality Non Senior securitisation have been showing much better performance than non-High Quality Securitisation both from a credit and spread perspective since the financial crisis.** Switching from type 2 to type 1 the high quality ABS mezzanine would make sense as there is less and less evidence of significant deviation of spread volatility performance between high quality ABS mezzanine tranches and high quality ABS senior tranches.

As pointed out in the joint discussion paper on the functioning of the securitisation market in the EU<sup>2</sup> from the European Central Bank and the Bank of England: *The aim of designating securitisations that conform to certain principles is to identify securitisations where their simplicity, structural robustness and transparency enable investors to model risk with confidence. Such a designation is not intended to provide an opinion on credit or other risks, but make the assessment of these risks more straightforward. The designation would apply to all tranches of the securitisation.*

<sup>2</sup> The case for a better functioning securitisation market in the European Union – May 2014 (ECB, BoE)

## Definition of infrastructure

A definition of infrastructure is needed to enable the benefits and characteristics associated with infrastructure to be appropriately captured, to incentivise the development of opportunities for infrastructure investment and to allow further discussion on this topic, particularly as solutions are developed. The following definition is proposed. In addition to this definition, a recital is proposed to provide further context.

### Proposed amendment

#### Article 1

xx. 'Infrastructure' means assets including networks, facilities, utilities and installations that support the current or future functioning of a community or society, whether at local, regional, national, EU/EEA or international level, and exhibit specific economic and financial features relating to credit risk, demand and competition as result of the function provided and restrictions on ownership and/or use of the assets.

#### Recital [xxx]:

The definition of infrastructure should capture the broad range of assets such as public institutional buildings (including corrective institutions and prisons, defence accommodation and training facilities, fire stations, schools, student accommodation, universities and other public buildings), social or retirement housing, car parking structures, combined heat and power plants and district heating systems, desalination plants, energy generation and power transmission, distribution and metering (including gas, hydro, nuclear, wind & solar power installations, waste to energy conversion plants, interconnectors, pipelines), environmental facilities (parks, flood or tidal protection including dredging), health care (including long-term care centres, mental health facilities, primary care and health care centres – including hospitals), information technology and communication systems (including broadband and cable, broadcast infrastructure including broadcast towers, telecom towers), large-scale civil engineering projects, renewable energies, storage facilities, street lighting, transportation and associated technologies (including airports, bridges, ports, roads, rail including high-speed lines, rolling stock and locomotives), waste, research and development activities, water including waste water. Often, a significant part of the revenues from such assets are subject to regulation or contractual clauses with a State authority. These characteristics result in common financial features that are predictable, steady and long-term cash flows.

### Treatment of infrastructure and SME bonds/loans

The treatment of infrastructure and SME bonds/loans should allow the reflection of empirical evidence showing higher recover rates (compared to investments in corporate bonds), as well as the importance of risk mitigation tools such as collateral and/or guarantees.

Moody's study<sup>3</sup> shows that

- The average historical recovery rate is significantly higher on infrastructure debt (in the range of 65-80%) than on traditional corporate bonds,
- For infrastructure, the recovery rate is independent of the average default rate, whereas for bonds the ultimate recovery rates fall as default rates rise.

Overall, this can justify that for equivalent residual duration, the risk charge on infrastructure bonds might be lower than the charge applied to traditional corporate bonds. Furthermore, any credit enhancement from, for example, the EIB in its project bond initiative, should be adequately captured in the charge on infrastructure debt instruments.

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<sup>3</sup> Moody's Investors Service (2013): Default and Recovery Rates for Project Finance Bank Loans, 1983-2011

In the same way, EIOPA ignores the higher recovery rate for infrastructure loans in general and SMEs in particular compared to bonds, while structurally and historically there is some evidence that the default recovery rates are higher due to the existence of guarantees and/or senior level in the capital structure.

The following amendment proposal – namely (a) - would reflect such higher performances within the spread risk module and constitute a workable and easy solution. Alternatives are proposed under (b) and

(c) in order to take into account how the long-term nature of such investments and risk-mitigating features can reduce the actual risk that insurers are exposed to when investing in these assets.

**Amendment proposals for infrastructure and SME debt :**

**a. Article 176**

(Add) 4 Notwithstanding paragraph 3, bonds or loans to infrastructure or to small and medium-sized enterprises 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 for the bond or loan belonging to one of the following categories:
  - i. Infrastructure bonds or loans;
  - ii. Loans to small and medium-sized enterprises.
- (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  $LGD_{specific}$  as it is posted in the EIOPA technical report on the standard formula for certain long term investments and 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) [35%;40%] for the SME loans  $LGD_{specific}$  with respect to the Moody's paper "Moody's global approach to rating SME Balance Sheet Securitisations"
- (3) 60% for the  $LGD_{other}$  based on a BBB bond in the QIS5 exercise

## **SECTION 2 - INFRASTRUCTURE AND SME EQUITY INVESTMENTS**

In addition to the proposals set out in section 1 to make changes to the Delegated Acts to enable appropriate recognition of infrastructure and SME loans and bonds as well as high quality securitisations, the following possibilities are also being explored as potential avenues for an appropriate recognition of infrastructure and SME equity investments.

### **INFRASTRUCTURE EQUITY INVESTMENTS**

Unlisted equity investments in infrastructure are not subject to short-term trading and have to be valued based on their future net returns. Under Solvency II, however, equity investments in infrastructure are still assigned to the same high-risk factor as hedge funds or commodities of up to 59% for equity risk type 2. Unlisted equity infrastructure should be subject to a new sub-module “unlisted equity infrastructure risk” with a risk factor set at a prudent level of 22%.

A distinction between listed and unlisted equity infrastructure investment is crucial. While listed equity infrastructure’s characteristics are similar to global equity, the returns of unlisted equity infrastructure exhibit much lower volatility and are uncorrelated with both listed equity infrastructure and global equity. Therefore, the current treatment is not appropriate. Unlisted equity infrastructure should be subject to a new sub-module “unlisted equity infrastructure risk” with a risk factor set at a prudent level of 22%<sup>4</sup> (in line with the treatment applied to equity investments of a strategic nature).

**Amendment proposal:**

Article 164 [...]

2. The capital requirement for market risk referred to in Article 105(5) of Directive 2009/138/EC shall include a component for infrastructure risk and be equal to the following:

where:

- (a) the sum covers all possible combinations  $i, j$  of sub-modules of the market risk module;
- (b)  $\text{Corr}(i, j)$  denotes the correlation parameter for market risk for sub-modules  $i$  and  $j$ ;
- (c)  $\text{SCR}_i$  and  $\text{SCR}_j$  denote the capital requirements for sub-modules  $i$  and  $j$  respectively.

3. The correlation parameter  $\text{Corr}(i, j)$  referred to in paragraph 2 shall be equal to the item set out in row  $i$  and in column  $j$  of the following correlation matrix:

$j \backslash i$	Interest rate	Equity	Property	Spread	Concentration	Currency	<b>Unlisted infrastructure equity</b>
Interest rate	1	A	A	A	0	0.25	<b>0</b>
Equity	A	1	0.75	0.75	0	0.25	<b>0</b>
Property	A	0.75	1	0.5	0	0.25	<b>0</b>
Spread	A	0.75	0.5	1	0	0.25	<b>0</b>
Concentration	0	0	0	0	1	0	<b>0</b>
Currency	0.25	0.25	0.25	0.25	0	1	<b>0</b>
<b>Unlisted infrastructure equity</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1</b>

SUBSECTION X

UNLISTED INFRASTRUCTURE EQUITY RISK SUB-MODULE

New Article XXX

The capital requirement for unlisted infrastructure equity risk shall be equal to the loss in the basic own funds that would result from an instantaneous decrease of 22% in the value of the assets.

## **SME EQUITY INVESTMENTS**

SME equity investments are currently given a treatment similar to that of hedge funds, which significantly disincentivises insurers' investments in this asset class.

Equity investments in unlisted SMEs are illiquid and generally long-term. The currently foreseen capital charge for such investments is 49% (similar to investments in hedge funds). The long-term and illiquid nature of such investments should be recognised by an appropriate treatment of such assets. The capital charge for unlisted SME equity should be set at 22% (similar to the charge applied to investments of a strategic nature).

### **Amendment proposal:**

#### Article 168

The equity risk sub-module referred to in point (b) of the second paragraph of Article 105(5) of Directive 2009/138/EC shall include a risk sub-module for type 3 equities, which includes equity investments in SMEs and ELTIF.

#### Article 169

The capital requirement for type 3 equities referred to in Article ER1 shall be equal to the loss in the basic own funds that would result from an instantaneous decrease equal to 22 % in the value of type 3 equity investments.