GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

07 December 2020

Response to IAIS survey on infrastructure and strategic equity

Infrastructure investments

Q1: Are there any supporting materials, academic research reports, institutional or professional studies / publications that you think would help in the assessment of suitability of a differentiated treatment for infrastructure investments?

Item name	Description and rationale
The World Bank – Risk and Capital Requirements for Infrastructure Investment in Emerging Market and Developing Economies	The World Bank report on risk and capital requirements for infrastructure notes that infrastructure projects tend to yield long-term, predictable cash flows, with low correlation to other assets and a relatively high recovery value in cases of repayment arrears, and that this match is so significant that some regulators provide special treatment for insurers that hold them to maturity. It also points to analysis of infrastructure debt in EMDEs as having credit performance that is not substantially different from that of comparable debt in advanced economies, and that applying this shows sufficient scope for reducing the capital charge for investments in infrastructure debt in the ICS.
Credit Risk Dynamics of Infrastructure Investment: Considerations for Financial Regulators, Andreas Jobst, International Monetary Fund	This report stresses that "infrastructure projects are asset-intensive and generate predictable and stable cash flows over the long term, with low correlation to other assets; hence they provide a natural match for insurers' liabilities-driven investment strategies." Highlights that while fully operational infrastructure provides a lower risk profile to more risk-averse investors, such projects are in short supply compared to non-operational projects.
Mobilising Insurance Investment in Sustainable Infrastructure, United Nations Development Programme	This report by the United Nations Development Programme highlights the unique role that insurers can play in providing long-term financing to sustainable infrastructure. It estimates a $16trn financing gap for sustainable infrastructure over the next 20 years, while noting insurers' global assets under management of $33trn.
S and P Default, Transition, and Recovery: Annual Infrastructure Default And Rating Transition Study	Annual publication by S&P on rating movements and default statistics on infrastructure exposures.
Fitch Ratings Global Infrastructure and Project Finance 2019 Transition and Default Study	Annual publication by Fitch Ratings on rating movements and default statistics on infrastructure exposures.
Mexico's Infrastructure Plan	The Mexican government has committed to boosting private sector investment in national infrastructure. The Mexican insurance industry has engaged its government and regulator to highlight where the current

Global Federation of Insurance Associations (GFIA)
Secretariat: rue Montoyer 51, 1000 Brussels, Belgium
Tel: +32 2 894 30 81 E-mail: grant@GFIAinsurance.org
www.GFIAinsurance.org

Item name	Description and rationale
	prudential regime requires inappropriate capital charges for infrastructure investments: • In the SCR standard model, infrastructure investments risks are treated similarly to equity risk. • The standard model does not consider infrastructure investments as debt assets or loans. • The standard model does not distinguish strategic equity.
CONSAR CKD public definitions and recommendations	Mexican insurers use development capital certificates (CKDs) to finance the sector activities and projects with long-term yields, for example: infrastructure, mining, telecoms, etc. The SCR model for these investments maps out to the primary investment (risk factor) “Price-quote index” of Mexico and generates profits and losses scenarios with a lognormal model.
J.P. Morgan Asset Management, Global Real Assets (2013): A case for Core Infra-structure.	This study 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 where they were less volatile than A-rated corporate bonds.
Moody’s Study: The Great Credit Shift – Infrastructure Finance Post Crisis, published in September 2011	This report explains that “infrastructure issuers tend to enjoy open and welcoming capital markets, and rarely experience trouble raising the necessary capital to meet their investment needs.”

Q2: Are there any data which you think would be suitable to be used for the purpose of calibrating a differentiated treatment for infrastructure investments? Please provide a description of the type of data, whether they are publicly available, the time period for which they are available and the frequency of the data updates.

Data sources	Description of the type of data and rationale	Publicly available	Time period available	Data update frequency
Infrastructure Trusts	UK Traded investment Trusts, self-created value weighted index	Yes	2006	Daily
EDHEC private infrastructure indices	Various type, broad, unlisted, corporate, project GBP & EUR	Yes	2006	Monthly
Broad infrastructure & Utility indices	Various indices but including corporates adds dilution. DJ BROOKFIELD (USD) FTSE DEVELOPED CORE (USD) FTSE EMERGING MARKETS CORE (USD) FTSE GLOBAL CORE (USD) MSCI EUROPE (EUR) MSCI_WORLD (USD)	Yes	2000	Daily

	S&P GLOBAL (USD) FTSE UTILITIES (GBP) STOXX600 UTILITIES (EUR)			

Strategic equity investments

Q3: Are there any supporting materials, academic research reports, institutional or professional studies / publications that you think would help in the assessment of suitability of a differentiated treatment for strategic equity investments?

Item name	Description and rationale
Insurance Europe proposal for an alternative treatment of equity under Solvency II	The European insurance industry made a number of proposals in relation to the treatment of strategic equity under the Solvency II Directive. This includes that: minimum ownership should be reduced from 20% to 10%; demonstration of lower volatility in the 12 months after acquisition should be removed, given irrelevance to longer-term horizon of insurance liabilities; a criterion aimed at testing the commitment of the insurer to the activity of the investee should be added.
Mexican "Green Finance Advisory Board"	The Mexican Green Finance Advisory Board is equivalent to the "Green Finance Initiative" in the UK. This advisory board provides guidelines and studies on which ESG criteria are formally requested to issuers as well any analysis and reporting demanded from intermediaries. One of the relevant elements of these investments is the fact that they are less volatile than regular investments, being considered sustainable projects (in line with the Paris Agreement). Mexico issued the first green sovereign bond in Latin America. AMIS (the Mexican Association of Insurance Companies) is a member of this board.

Q4: Are there any data which you think would be suitable to be used for the purpose of calibrating a differentiated treatment for strategic equity investments?

N/A

General feedback

Q5: Please provide feedback on the IAIS strawman proposal on definitions and criteria for infrastructure and strategic equity (cf. Annex 1).

- **Infrastructure**

GFIA is committed to the objective of a high-quality and robust insurance capital standard that promotes a sound, global level playing field.

GFIA welcomes the proposal for a differentiated and more appropriate capital treatment of infrastructure investments. It welcomes the overall approach taken by the IAIS in its strawman proposal and broadly agrees with the initial list of risk mitigation factors shown. Infrastructure investments have shown higher recovery rates and lower instances of default than other investments, which justifies a more tailored approach to measuring underlying risks and implicit capital requirements. Despite this, it is currently assumed in the ICS standard method that infrastructure investments behave like any other exposures, eg corporate bonds or general equity.

Infrastructure assets are attractive for 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.

Risk types

For many small and medium-sized insurers, already operational or brownfield construction projects are the only option from a risk perspective, but this is not true for large firms with significant and sophisticated risk management, research and operational resources.

From a risk perspective, it is often beneficial that investors take on an element of construction risk so they have "skin in the game" when the project becomes operational. Construction risks can regularly bleed into the operational phase of a project, so in the interests of delivering a project on time, as well as good risk management over the long term, it is helpful that a single investor is invested in both project phases.

Large investments from insurers could significantly improve long-term liquidity in the market and help fill the funding gap for infrastructure globally. There is very limited supply of already operational or brownfield infrastructure projects globally, especially for green energy infrastructure. Allowing insurers to provide financing to the construction phase through more appropriate capital risk charges, where the risks can be adequately evidenced, could significantly increase the number of infrastructure projects deemed financially viable, enabling insurers to drive supply higher rather than waiting for supply to materialise from other sources of financing.

Sustainable finance

Prudential regulation and capital requirements often reflect additional risks posed by investment in green energy infrastructure (eg construction risk), but a wealth of recent research strongly indicates that investments with ESG factors will provide higher returns over the long term. GFIA would therefore suggest that climate change risk is explicitly factored into the differentiated treatment of infrastructure under the ICS, given the reduced political risk and redundancy risk of, for example, a wind farm compared to a coal-fired power station (noting this can vary to some extent by jurisdiction).

Proposed changes to strawman proposal

In order to improve the IAIS's approach to infrastructure assets under the ICS in order to more appropriately reflect the risks posed to insurers, GFIA proposes the following:

- Group-wide supervisors should leverage existing evidence, which already demonstrates infrastructure assets' lower volatility, as much as possible and thereby reduce the burden on IAIGs to provide quantitative evidence on a regular basis:

    - GFIA suggests that the IAIS also reviews the evidence provided by the respondents to this questionnaire and first and foremost applies this evidence when calibrating firms' required level of capital.
    - The JP Morgan 2013 study referenced above 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 200809 crisis, when they were less volatile than A-rated corporate bonds.
    - 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 200809 financial crisis and recession. As explained in the Moody's report referenced above, 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."
- GFIA supports that the capital treatment for qualifying infrastructure debt be based only on credit (ie default) risk and removed from the scope of the Non Default Spread Risk (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.

- Under Annex 1, Group-wide supervisors (GWS) are allowed to consider certain infrastructure investments to be less risky based on a set of criteria based on quantitative evidence. In the spirit of comparability, the calibration of capital requirements should be applied consistently based on the common criteria.

The IAIS should consider the different ways in which insurers invest in infrastructure in different jurisdictions. For example, it will be important that exposure to infrastructure via structured products and securities is taken into account and still benefits from any relevant differentiation of capital requirements as part of firms' look-through requirements.

- **Strategic equity**

GFIA welcomes the proposal for a differentiated treatment of strategic equity under the ICS.

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 (asset liability management) strategies, and in line with their risk appetite and internally set investment limits.

The IAIS strawman proposal states that: "The reduced volatility of the equity investment's value is linked to the influence exercised over the investment, and that this link will persist for at least the following 12 months".

This line is unclear and could suggest that firms must demonstrate lower volatility over a 12-month period and not just ensure that influence is exercised over the investment during this period. A 12-month period would be an insufficient timeframe to demonstrate lower volatility considering insurers' much longer investment horizon in strategic equity to match long-term liabilities. 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.

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.

GFIA asks that the IAIS clarify that while firms must demonstrate influence exercised over the investment for at least 12 months, firms are able to demonstrate reduced volatility over a significantly longer timeframe, eg five years.

It is also unclear what is meant by the line that "dividends, if any, should be continuous in value." This suggests that some companies may refrain from paying dividends, but for those that do pay dividends, every payment to shareholders must be the same. GFIA suggests that the IAIS aligns its requirement for dividend payments with the approach taken to the volatility of the investment as a whole, ie the insurer should demonstrate that dividend payments are less volatile than other investment types, but this should not require that dividends are necessarily continuous in value. GFIA therefore suggests 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, by nature, will not mirror the value of long-term commitments.

Currently there is no minimum ownership requirement outlined in order to meet the differentiation requirement for strategic equity. GFIA suggests that 10% would be an appropriate minimum requirement because a 10% holding of voting rights allows an investor to exercise a significant degree of influence over the management of the holding. This could then be appropriately decreased in order to reflect other factors listed by the strawman proposal, ie joint products or distribution lines, cross-selling, the creation of joint ventures.

The 6-year minimum holding threshold should also 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.

In many jurisdictions, structured products may also be considered strategic, under the definition provided in this document, since their volatility is expected to be less than that of other equity investments.

Q6: Please share any other information you consider relevant, such as lessons learned from your own experience, regarding the treatment and calibration of risks attached to investments in infrastructure and strategic equity. That information may include considerations on investment practices, governance and risk management, internal credit assessments for unrated exposures, internal valuation assessments for private exposures, financing/funding structures, regional differences, etc.

- **Infrastructure**

Aside from capital charges, other design features of the ICS will affect infrastructure investments, particularly the treatment of assets without an external/public credit rating. Ensuring that firms are able to use internal ratings under the ICS will be essential across multiple jurisdictions.

The Three Buckets Approach under the ICS will also be an essential element of the regime that will determine the extent to which insurers with long-term liabilities can invest in infrastructure assets. The experience of holding infrastructure within comparable portfolios in other prudential regimes, eg the Matching Adjustment in Europe or Singapore, has shown that eligibility criteria have often been overly rigid and encouraged complex asset restructuring that discourages some insurers from investing in infrastructure. GFIA would also note that concentration risk is not a material risk for insurers in the context of infrastructure investment. In aggregate globally, insurers have only 2.5% of their assets invested in infrastructure. Even if this allocation were doubled or tripled over time, GFIA does not believe this would constitute a material concentration of risk, given the risk profile of infrastructure assets.

- **Strategic equity**

Aside from strategic equity, GFIA suggests that the IAIS scrutinises the capital calibration of non-strategic equity investments, given the ability of insurers to ride out short-term volatility by matching equity with long-term liabilities.

Considering historic performance, long-term buy and hold equity investment strategies have tended to outperform fixed income. Equity also represents one of the few opportunities insurers have to diversify investment risk in the context of the current ultra-low interest rates environment.

GFIA contact

Charlotte Clark, Chair of the GFIA Capital working group (Charlotte.Clark@abi.org.uk)
James Padgett, GFIA secretariat (secretariat@gfiainsurance.org)

About the GFIA

Through its 41 member associations and 1 observer association, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 64 countries. These companies account for around 89% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.