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Financial Services Risk and Regulation

Hot topic

Solvency II - lower capital charges for infrastructure investments and more transitional relief for equities

Highlights

The European Commission has published key updates to the standard formula and transitional measures, which it expects to be implemented before 1 January 2016:

- *A new investment category with lower capital charges will be created for infrastructure investments in debt and equity.*
- *The transitional measure on equities will be extended to all equities, and can be applied to equities held in collective investment schemes where full look-through is not possible.*
- *Investments in ELTIFs and those traded on MTFs will be treated as type 1 equities.*

On 30 September 2015 the European Commission published a new delegated regulation amending the Solvency II Delegated Acts. The new regulation:

- Introduces significantly lower capital charges under the standard formula for qualifying infrastructure debt and equity investments (around 70% of the charges applicable to other debt and equities). This is intended to facilitate investment by insurers in European public infrastructure projects.
- Sets out requirements for documented and validated due diligence and ongoing risk management by insurers to qualify for the lower charges.
- Extends the transitional measure on equity investments to all equities (including equities held in collective investment schemes where full look-through is not possible). Under the transitional measure the impact of the move to Solvency II's standard formula capital charges on equities held at the time of implementation of Solvency II is spread over a period of up to seven years.
- Allows investments in European Long-Term Investment Funds ("ELTIFs") and equities traded through Multilateral Trading Facilities ("MTFs") to be treated as type 1 equities, qualifying for a lower standard formula charge.
- Corrects a number of drafting errors.

The introduction of a new class of asset for infrastructure so close to implementation reflects the political will created by the Investment Plan for Europe announced in November 2014. The Investment Plan aims to mobilise at least €315 billion of investment over three years, with institutional investment by insurers identified as a key under-utilised source of investment. The amendments are therefore intended to remove obstacles to investment in infrastructure created by Solvency II. The European Parliament and Council have three months to review the changes (with the option to extend review for a further three months).

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Qualifying infrastructure investments

The new delegated regulation introduces a new asset category for the standard formula, 'qualifying infrastructure investments'. In order to qualify, the investment must be issued by an 'infrastructure project entity' defined as "an entity which is not permitted to perform any other function than owning, financing, developing or operating infrastructure assets, where the primary source of payments to debt providers and equity investors is the income generated by the assets being financed." 'Infrastructure assets' are defined as "physical structures or facilities, systems and networks that provide or support essential public services."

A qualifying investment must meet a number of criteria providing for a high degree of protection and security for investors and predicable cash flows, requiring documented and validated due diligence and ongoing risk management on the part of the insurer. For investments in bonds or loans, the insurer must also demonstrate that it is able to hold the investment to maturity. It is not necessary for an investment to be externally rated, but where not rated (or if the investment is in equities) additional criteria must be met. Rated infrastructure debt investments must be investment grade to receive a reduced capital charge.

Capital charges for qualifying infrastructure investments

Qualifying infrastructure investments are subject to lower capital charges under the standard formula than other equities, bonds or loans:

Equity risk: 30% capital charge (compared to 39% or 49% for other equities)

Spread risk: Capital charges are based on the credit quality and modified duration of the investment, and are generally around 70% of the charges applicable to other bonds and loans (the reduction is higher for unrated debt). For example, a qualifying infrastructure investment bond of up to 5 years duration in credit quality step 2 receives a 1.0% risk factor per year compared to 1.4% for regular bonds and loans.

These amendments make qualifying infrastructure debt and equity investments significantly more attractive for insurers under standard formula than they would have otherwise been - the onus being on the insurer to establish and document that their investments qualify.

Infrastructure debt is therefore potentially more attractive for insurers under the standard formula than other fixed income investments, although other considerations such as diversification clearly play a part.

Whether standard formula insurers are prepared to invest in infrastructure equity will depend not only on capital charges, but also on considerations such as liquidity - where an investment in listed equities has clear potential advantages, as well as being amenable to hedging strategies. Another consideration is that investments in infrastructure equity, despite being long term, are not eligible for the Matching Adjustment (since underlying cashflows are not fixed).

The criteria are intended to capture suitable secure projects without being unnecessarily restrictive, and the European Commission accordingly broadened slightly the criteria set out in EIOPA's technical advice published on 29 September in order to avoid unintentionally excluding suitable projects.

Transitional measure for equity risk

The transitional measure for standard equity risk is extended to all equity investments. The regulation also provides for the transitional measure to be applied to equities held within investment funds where full look-through is not possible, by reference to the target asset allocation of the fund as at 1 January 2016, reduced annually in proportion to the asset turnover ratio of the fund.

The transitional measure was previously only available for type 1 equities, and the extension to all equities is intended to avoid a sell-off by insurers of type 2 equities in the run-up to Solvency II.

Under the transitional measure the impact of the move to Solvency II's standard formula capital charges on equities held at the time of implementation of Solvency II is spread over a period of up to seven years.

Other updates and clarifications

The new delegated regulation also makes a number of clarifications and updates to the Solvency II Delegated Acts, including the following:

- Equities traded on Multilateral Trading Facilities (MTFs) based in the EU are treated as type 1 equities.
- Equities held within European Long-Term Investment Funds (ELTIFs) are treated as type 1 equities where full look-through is possible, or the units or shares in the ELITF itself are treated as type 1 where full look-through is not possible.
- The exemption from deducting from own funds strategic participations in financial and credit institutions consolidated using method 1 may be applied by insurance groups as well as by financial conglomerates.
- The deadline for submission of transitional (day one) information for groups is corrected to 26 weeks.

All holdings in undertakings excluded from the scope of group supervision under article 214(2) of the Directive should be valued at nil.

What next?

The European Parliament and the Council have up to three months to exercise their right of objection to the proposed amendments, with the possibility to extend this for another period of three months at their initiative. Therefore, provided Parliament and Council neither object nor extend their period of consideration, these changes should come into force in time for Solvency II going live.

Affected insurers should therefore be ready to implement the new requirements from 1 January 2016.

What do I need to do?

The updates contained in the new delegated regulations contain significant changes to the standard formula for those insurers with investments that may qualify for the new asset class. The updates also change the business case for insurers to invest in infrastructure in the coming years.

All insurers calculating their SCR under the standard formula should therefore review the new requirements, both to ensure that appropriate due diligence is carried out, documented and validated to a standard that could be reviewed for any current investments that may qualify for the new capital charges, and so that the strategic case for infrastructure investment is considered going forwards.

The new requirements also significantly broaden the application of the equity transitional, impacting investment strategy in advance of Solvency II and changing the capital charges that will apply in the years immediately following implementation. Reviewing and reflecting the requirements in standard formula calculations in advance of implementation will allow insurers to make the most of the extension to the transitional measure.

The new delegated regulations remain subject to a political process, and approval may not take place until close to Solvency II implementation. Insurers should monitor the new requirements to ensure compliance with the Solvency II Delegated Acts as amended (or not) on day one.

Contacts

Bas van de Pas

T: 088 - 792 6989

E: bas.van.de.pas@nl.pwc.com

Mohamed Lechkar

T: 088 - 792 1625

E: mohamed.lechkar@nl.pwc.com

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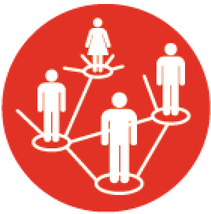
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