Comments

of the German Insurance Association

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on the legislative proposal by the European Commission for the European Fund for Strategic Investments (EFSI)

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Executive summary

The German Insurance Industry welcomes the initiative of the European Commission to strengthen growth and jobs in Europe by mobilising at least 315 billion Euro in additional investments in the real economy over the next three years. We also strongly support the overall objective pursued by the European Commission's legislative proposal for the European Fund for Strategic Investments (EFSI) to increase the level of infrastructure investments within the European Union by fostering additional projects and mobilising private capital. In order to set up the EFSI in the most efficient way we would like to highlight some key aspects for this proposal from an investor's perspective:

- In order to **avoid crowding-out of private investments** the **EFSI should focus on projects where financing is not available from private sources on reasonable terms.** As a general principle, priority should be given to fully private financing.
- The concept of **credit enhancements should be used** to establish attractive risk-return profiles and protect tax payers' money. A mechanism equivalent to the **PBCE should be introduced for equity investments.**
- Setting the **right governance** for the EFSI is key to create trust amongst institutional investors. Therefore an **independent advisory committee should be set up to** consult the Steering Board on the availability of financing from other sources. Moreover, an **independent third party should be mandated with the evaluation** of the EFSI.

Apart from specific comments on the EFSI proposal we would also like to share some more general remarks which we believe are important to make the European Commission's initiative to strengthen growth and jobs in Europe successful.

- **Ensuring a stable political framework, legal certainty and protection against ex-post adjustments to investments** is an important condition for a long-term engagement of institutional investors.
- **Ensuring that projects are reasonable from an economic point of view** in order to avoid misallocations of capital and protect tax payers' money.
- **Reflecting low risk of infrastructure investments in Solvency II by establishing a** new equity risk sub-module with a lower capital charge at 20 percent**.**

Introduction

The German insurance industry greatly appreciates the opportunity to contribute to the European Commission's plan on strengthening growth and jobs in Europe with a 315 billion Euro Investment Plan. With assets of about 1.4 trillion Euros under management, the German insurance industry is a major institutional investor at international capital markets and can play a vital role for the success of the Europe 2020 strategy.

Infrastructure investments are a main part of the proposed Investment Plan. Through its provision of savings, pensions and other products with long durations, insurers are typically long-term oriented. **Infrastructure investments are therefore of great interest for the insurance industry as they fit the focussed business model** of insurers very well. For a sustainable asset-liability-management investments with durations of 20 or 30 years are necessary. The projects identified by the Member State Working Group chaired by the European Commission and the European Investment Bank, may provide for such investment opportunities.

When making investment decisions, insurers carefully assess investment opportunities as well as possible threats and weaknesses of the respective asset. In this respect insurers also benefit from the experiences in providing insurance cover for such projects. Currently German insurers are only invested below 1 percent of total investments in infrastructure. In order to stimulate economically sustainable investments in infrastructure certain legal and regulatory restrictions need to be relieved or removed.

I. Comments on EFSI set-up

We strongly support the overall objective pursued by the European Commission's legislative proposal for the European Fund for Strategic Investments (EFSI), i. e. increasing the level of infrastructure investments within the European Union by fostering additional projects in the European Union. We welcome the Commission's intention to mobilize private capital. We understand that private investors can contribute via a) joining the EFSI agreement, b) co-financing so-called investment platforms and c) co-financing projects. In order to set up the EFSI in the most efficient way we would like to highlight some key aspects for this initiative from an investor's perspective

1. EFSI should focus on projects where financing is not available from private sources on reasonable terms.

To attract institutional investors the **EFSI should focus on projects that are difficult or not possible at all to be financed by private investors only.** Otherwise we see the risk that engagement from EFSI or EIB can result in a **crowding-out of private investors.** This concern of crowing-out of private investors is based on past experiences with the involvement of sovereign or supranational institutions and potential credit enhancement products. In the past projects have been considered unattractive by private investors when **expected return rates were too low** as a consequence of sovereigns' or supranational institutions' engagement. Moreover projects were considered unattractive when **investment volumes became too small** as a consequence of such engagement to be conducted in a cost efficient way.

In a similar way as the draft EFSI Regulation the current EIB's statutes foresee that the EIB should take initiative only if financing is not available from other sources on reasonable terms (Art. 16 EIB statute). However, the EIB is providing 50 percent of the debt on a number of investible projects where the capital market appetite has been well above the available investment after netting-off the amounts financed by the EIB. In addition, although the Project Bond Credit Enhancement (PBCE) has been an extremely useful investment facilitator, we have also seen the PBCE applied in instances where it was not required by investors. Another example is the Maguerite Fund which has funding from the EIB and sovereign development banks to act as a "catalyst" for infrastructure investment but is now also competing with a number of existing private infrastructure equity funds who were otherwise prepared to provide direct equity investments.

- In order to reduce the risk of crowding-out we welcome the condition in Recital 15, that the "EFSI should only be used where financing is not available from other sources on reasonable terms". In order to underline this condition a sentence should be introduced to **Recital 15**, that **as a general principle, priority should be given to fully private financing.**

- We welcome the condition in **Recital 22**, that "infrastructure and project investments supported under EFSI should be consistent with State aid rules". Given the ever changing market conditions we are however skeptical that setting up "core principles for purposes of State aid assessments" will be an appropriate and sufficient tool to ensure additionality of projects. To provide for sound and sensible **principles stakeholder consultation should be mandatory prior to adaption.**

The Commission should also provide further guidance on the set of core principles with a view to **ensuring the avoidance of distortions in competitions with fully private sources of financing.**

2. The PBCE Concept should be used to establish attractive risk-return profiles and protect tax payers' money

Finding the right balance between risk and return is key to attract institutional investors. Institutional investors such as insurers are looking for relatively secure investments with stable cash flows. Full state guarantees on the other side are not desirable for potential investors, since they result in returns that are par with government bonds which in turn is not attractive in the current low interest rate environment. Moreover, full state guarantees increase risks from complex infrastructure projects for tax payers and the general public. In order to improve the overall investment environment as part of the 3rd element of the investment plan announced in November 2014, the European Commission should investigate **how to design individual infrastructure projects** in a way that the risk borne by private investors is commensurate to the expected return of the infrastructure project.

To find the right balance partially guaranteed investments should be considered. In this respect we **encourage the EFSI to expand the Project Bonds Credit Enhancement (PBCE) mechanism** tested in the Europe 2020 Project Bonds Initiative to projects under the new funds. The provision of "first loss pieces" covered by the EFSI / the EIB can improve the credit quality of a project to an investable level while not diminishing returns to the level of government bonds.

- A **mechanism equivalent to the PBCE should also be introduced for equity investments** in projects that as such are unable to attract equity investments because their risk-return profile is not sufficiently attractive. For instance, the yields assigned to private equity investors could be disproportionately high.

- In order to provide for greater attractiveness for investors and lower aggregated risks it is important that there will be **no country-specific or sectorial project allocation.**

- Additionally, the attractiveness of EFSI supported infrastructure projects could be enhanced by **easy and lean handling without complex regulatory requirements.**

3. Setting the right governance for the EFSI is key to create trust amongst institutional investors

We believe that there is still considerable need for clarification of EFSI's governance. The announcement that EFSI "will support strategic investments of European significance in infrastructure" could result in a rather political selection of projects. Notwithstanding the ambitious timeline, **legislative diligence and the need for democratic legitimacy** require that the co-legislators provide for a **clearly defined and appropriate governance** of EFSI.

- In order to ensure that EFSI gains trust and acceptance from the very beginning we recommend that under **Article 2** a **strategic advisory committee** is set up comprised of long-term investment experts from insurance companies, pension funds, asset managers specialized in infrastructure and banks. The strategic advisory committee should be involved in the selection of suitable projects for the EFSI and consult the Steering Board on the availability of financing from other private sources.

  Alternatively, under **Article 3** EFSI's Investment Committee should include experts from the private sector, at least 50 %**.**

- In **Article 12** a provision should be introduced that in order to ensure trust in the governance of EFSI an **independent third party should be mandated with the evaluation** of the EFSI after a reasonable time. The evaluation should also include **possible effects on competition with fully private sources of financing.**

II. General Comments on the long-term investment Initiative

Apart from specific comments on the legislative proposal by the European Commission for the European Fund for Strategic Investments (EFSI) we would also like to share some general comments that we believe are crucial for the success of the initiative by the European Commission to strengthen growth and jobs in Europe. A sustainable and comprehensive framework needs to be established to overcome investment burdens. A first step in this direction has been taken by the measures highlighted in step 3 of the European Commission communication on the Investment Plan. However, in our view further steps are indispensable.

1. Stable political frameworks and legal certainty against ex-post adjustments

The most important conditions for long-term investors are a stable regulatory framework as well as regulatory stability and reliability. Against the background of investments with maturities of 20or 30 years, it is essential, that investors are confident with regard to **persistence and legal certainty of political and regulatory decisions.** This implies that changes to regulatory regimes should have **no retroactive effects on the existing investment portfolios** of investors. Negative experiences, like the subsequent taxation of photovoltaic systems in Italy and Spain, hinder the availability of investments significantly.

Given the state of government finances globally, uncertainty with respect to stable regulatory frameworks has the potential of becoming the largest impediment to grow investments in infrastructure. Depending on the characteristics of the investor, this uncertainty either inflates the cost of financing (which from a policy perspective should be considered an avoidable cost) or makes investing in this sector almost impossible for certain participants. Due to their focus on stability and predictability of returns, insurers should be considered to be of the latter type. As a consequence, it appears decisive to **stipulate and/or enforce a set of underlying principles, providing sufficient trust to investors regarding the reliability of the regulatory framework** for the tenure of their investment.

The ability of governments to readjust their policy and maintain flexibility increases financial sustainability. It is, however, vital to find a way forward which distinguishes between future projects for which capital has not yet been committed, and existing investments. We believe that it is crucial for Member States to reinforce the trust formerly present, and strengthen the commitment to and enforceability of such principles going forward. This could represent a **competitive advantage for Europe**, helping to embark on a relatively higher growth path. Building up investor confidence a portfolio protection clause for infrastructure investments should be implemented.

2. Economic reasonability of infrastructure projects

In order to **avoid misallocations of capital and protect tax payers' money** investments in infrastructure should always be scrutinized, whether they make sense from an economic point of view. The economic sensibility of an investment is also an important aspect for institutional investors since **reasonable projects tend to be less vulnerable to political risks in the course of the project lifetime.**

One way of achieving this is **setting an infrastructure agenda and careful planning of respective projects.** There should be a long-term and coordinated approach to the development of infrastructure in the European Union rather than short-term oriented country-specific projects that lack economic sustainability. Moreover it would be helpful for institutional investors that plan their investment activities long ahead to have a reliable project pipeline for infrastructure investments in upcoming years. The work of the Task-Force led by the European Commission and the European Investment Bank might have found the basis for such an agenda. However, it is important to transpose the list of identified projects into a clearly defined agenda for investments in European infrastructures.

Another way of reflecting economic sustainability when investing in infrastructure is the **introduction of market efficient user fee concepts that provide for stable cash flows.** User fees are, normally, a very reliable source of funding that is independent from budgetary constraints that can occur over the lifetime of infrastructure projects. Also, there is a direct link between usage of the infrastructure, payment and respective use of the proceeds. Moreover, only recipients pay for the infrastructure, non-consumers are not charged.

3. Reduced capital requirements for infrastructure investments in Solvency II

Investments in infrastructure and renewable energies constitute a new asset class generating predictable and stable revenues. Due to their predictable long-term liabilities, insurers are able to invest in these illiquid assets in order to diversify and to match their corresponding obligations. Long-term investments in infrastructure and renewable energy projects are not at all or only very moderately correlated with other financial risks at capital markets. However, with **capital requirements of up to 59 % investments in low risk infrastructure projects are treated similar to private equity or hedge funds** under the new prudential rules of Solvency II. This calibration is inappropriate as investments in private equity and hedge funds bear higher risks. The currently foreseen high capital requirement limits the scale of insurers' investments in infrastructure projects.

A separate risk class with significantly lower capital requirements is therefore needed. In this context the distinction between listed and unlisted infrastructures is crucial. While listed infrastructure's characteristics are similar to global equity, the returns of unlisted infrastructure exhibit much lower volatility and are nearly uncorrelated with both listed infrastructure and global equity. Unlisted infrastructure has rather bond-like characteristics. It generates a cash-flow that is mainly subject to technical-physical risks which are independent from the common market risks. Therefore, these assets should be subject to a new sub-module "infrastructure risk". Due to the wide range of possible investments, its risk factor should be set at a prudent level of 20 %. **A delegated act introducing such a module should be proposed as soon as possible.**

4. More flexible unbundling requirements for energy investments

The "unbundling" between energy production and transport prohibits investments along the entire value chain of the energy market. The required impact test for proving that an investment is not strategic causes great efforts as criteria and processes on which the decision is taken are not transparent. These requirements need to be adjusted to encourage private investments.

Insurers are interested in increasing investments in renewable energies as they often provide attractive risk return patterns regularly associated with very modest risks. Institutional investors are **hindered from investing in long-term energy projects** along the whole value chain due to the restrictive application of the current unbundling regime in directives 2009/72/EC and 2009/73/EC. **A review of the according provisions is necessary in order to allow for more flexibility** for financial investors.

Different to traditional energy companies, institutional investors such as insurers are not interested in exercising market power or abusing shareholder rights because energy projects are not part of their core business. Acknowledging that a review of the according directives will have a negative impact on the timeline of the Investment Plan, a **simplified "impact test" for institutional investors** could be a sensible solution in the meantime. The currently applied process is very complex, time consuming and comes along with legal uncertainties for investors. The criteria and conditions for the impact test should be transparent. Moreover, information should be publicly available and concrete enough to allow institutional investors to realistically assess the prospects of success for receiving permission for a specific energy project.

5. Appropriate accounting requirements

Investing in infrastructure projects is part of the long-term asset-liability-management strategy of an insurer. The impact of accounting standards on the behavior of market participants is often underestimated in the public debate. In our view, the **financial crises demonstrated clearly, that the full fair value concept** (i.e. fair value measurement through profit and loss) **can have serious undesirable consequences**. The market oriented valuation is **pushing the concentration of market participants towards short-term results**, which is not suitable in the case of the long-term oriented business model of insurers and not in line with the overall aims of the Investment Plan. When short-term market volatility is recognised in the income statement of insurers it does not truly reflect the business model with long-term horizon. The **high volatility of periodical net income** as a result would unavoidably lead to increased cost of capital, which does not seem to be a desirable outcome. The short-term **volatility of the entity's capital** is a serious problem for insurers, likewise. Therefore, any accounting principles for financing of infrastructural projects should be aligned with the ongoing IASB-project "Insurance Contracts" that is of crucial importance for insurers. Any misalignment with that project might significantly disadvantage long-term debt or equity financing of such projects.

The ongoing discussions around IFRS and Solvency II should be used to **reassess the interaction of the respective regimes with regard to content and timing**. Necessary changes to IFRS standards are not only relevant for insurers that have currently to report consolidated accounts in accordance with IFRS. Changes are relevant for insurers of all sizes and legal forms due to the interconnectedness with Solvency II. Despite the pretension to provide an own reporting framework for Solvency II a close alignment with IFRS is envisioned.

Berlin, 10 March 2015