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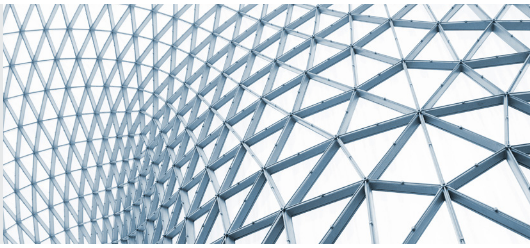

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The case for core infrastructure

Insurers benefit from long-horizon income, low volatility and reduced capital charge

Key Takeaways:

- Insurers must distinguish between two broad types of infrastructure assets: value-added infrastructure, in which performance is based on capital appreciation; and core infrastructure, which produces steady, consistent income streams.
- Core infrastructure provides yields which typically surpass those available on traditional fixed income securities. It is decorrelated from traditional asset classes and also offers substantial potential to mitigate climate change risks and harness sustainable strategies.
- Regulatory and accounting treatments further enhance the case for a core infrastructure allocation. Compared with private equity-like infrastructure assets, core infrastructure enjoys a more favorable treatment under Solvency II.

There are many reasons why infrastructure is sought for insurance portfolios. Perhaps the most persuasive of these are the predictable, foreseeable cashflows, with low probability of significant drawdown. In addition, infrastructure has low correlation with traditional asset classes. It also receives favourable treatment under regulations and accounting rules. And, not least, infrastructure offers a pathway for insurers to meet the coming challenge of climate change stress-testing.

Infrastructure covers a wide spectrum of investments and only part of this spectrum meets the particular requirements of insurance groups. Specifically, the part which helps insurers to generate income, reduce the probability of loss and lubricate regulatory friction is core infrastructure.

Core vs value-added infrastructure

It is possible to view infrastructure as a single homogenous asset class. That view ignores the wide range of assets and risk-return profiles that can be accessed through the asset class.

For any infrastructure investor, it is important to distinguish between two broad types. Core infrastructure is the steady, reliable end of the spectrum. It is an umbrella term for assets which are primarily income-producing. These assets include classic infrastructure projects such as toll roads, bridges and hospitals.

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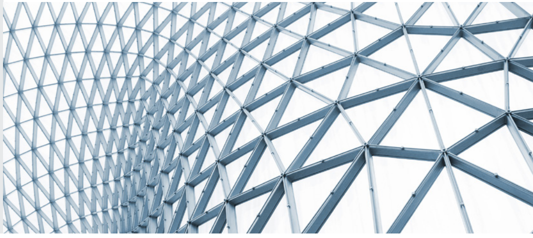
But the list of core infrastructure assets is fast-expanding. "Core infrastructure now includes technology-related projects such as mobile towers, cloud storage and even new types of heating systems for commercial and residential buildings," says Estelle Castres, Head of Key Insurance Clients Group at Natixis Investment Managers.

What these assets have in common is they are typically very long term and are held by investors for many years, even decades. "Performance is derived primarily from stable and regular cash-flow generation, rather than capital appreciation," says Castres. The regular cashflows provide resistance to potential reductions in asset value during phases of economic slowdown. A core infrastructure strategy is therefore compatible with a long-term income strategy such as asset-liability management (ALM).



Core infrastructure is distinct from value-added infrastructure, in which performance is partly predicated on capital appreciation realised on the sale of the asset. Value-added infrastructure requires stronger shareholder participation in project governance and is comparable with private equity in terms of risk vs return and how the asset is managed.

For core infrastructure, the holding period may be 20-25 years or even longer. This compares with, typically, a 10-year lifecycle for value-added infrastructure projects, which must be sold to realise their full value.

The ultra-long duration of core assets makes them particularly attractive to insurers which have liabilities that can stretch decades into the future and for whom matching assets are hard to come by.

The core benefits

So what does core infrastructure do for the typical insurance portfolio?

First and foremost, it provides yields which typically surpass that available on traditional fixed income securities.

Second, it is highly decorrelated from traditional asset classes such as stocks and bonds, thus offering diversification in periods of high market volatility.

Third, climate risk is particularly relevant to insurers, whose time horizons are naturally longer than those of most other investor types. As sustainability becomes a key component in the building of tangible assets, adequate infrastructure offers the potential to mitigate climate change risks and harness sustainable strategies.

Climate change represents a challenge for investments not only through the expected physical risks, but also through the regulatory measures taken to mitigate them – the transition risks.. The EU, the UN, the G7, IOSCO and the OECD are all integrating ESG guidance into their long-term strategy planning. In Europe,

Infrastructure Vs traditional asset classes[1]

	Infra Eur Pooled Ret	MCSI Daily Net TR Europe	JPM GBI EMU in Euro	Corporates Europe Euro
Annual Return	7.7%	3.8%	4.6%	4.0%
Annual Volatility	6.8%	17.6%	4.5%	4.6%
Return / Volatility	0.73	0.22	1.01	0.88
Desmoothed Volatility	10.6%	-	-	-
Correlation (Infra ; Liq)	-	0.58	-0.48	0.07

Sources: Cambridge Associates, MSCI Bloomberg, Natixis IM Solutions, from 30/09/2006 to 30/06/2020.

EIOPA has recently been consulting on the supervision of the use of climate change scenarios in the ORSA; across Europe, insurers are likely to face climate mitigation stress-testing during the course of 2021, in an exercise that was pioneered in the UK over the second half of 2019, and again next year. The French regulator, ACPR, has launched a Climate Stress Test for banks and insurers over the summer of 2020. This means a simple economic risk-return approach is no longer sufficient for insurance investment teams. They must position their portfolios to address ESG issues and make efforts to positively impact the environment while making sure climate risks (physical and transition) do not threaten their balance sheet.

Adapting portfolios to meet climate change objectives is not simple.
But doing so has benefits beyond the reduction of investment and regulatory risks, in a context where the Regulator's intervention is for now through climate stress tests, increasing disclosure obligations through the TCFD framework, and not reduced "green" capital charges. By helping to finance the real economy, through the building of tangible assets, insurers can enhance their reputation and brands.

Sticking to the rules

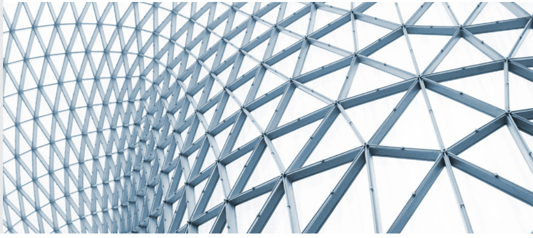
The impact of regulatory and accounting standards further enhances the case for a core infrastructure allocation.

Under Solvency II, which came into force in Europe in 2016, the capital charge for holding some types of investments can be unpalatably high for insurers. "Concerning infrastructure investments, the regulator has taken a number of steps to reduce it, directly attached to the asset class; this is especially true for investments in unrated qualifying infrastructure assets. The detention horizon could also be relevant for equity investments", says Oliver Trecco, portfolio manager at Natixis Investment Managers Solutions.

Detention horizon incentives

In the latter category, the matching adjustment (MA) provisions under Solvency II help insurers to the capital charge on long duration assets more palatable. "The MA provisions allows insurers first to increase the discount rate used to calculate the Best Estimate Liabilities in the MA portfolio, and second potentially to decrease the spread risk SCR, in return for holding long-term assets which match the cashflows of a

1. Methodological Note. Data of the reference indeces on illiquid assets cannot be used without adjustment - as published by traditional index providers - especially for the purpose of estimating the volatility of these indices and their correlation with liquid asset indices. Indeed, the quarterly valuation of illiquid underlyings, which is also based on estimates, can lead to an autocorrelation of returns, resulting in an underestimation of the "real" volatilities and correlations of these illiquid indices. This phenomenon can be increased by behavioral biases such as the principle of prudence, which leads fund managers to depreciate assets more aggressively during declines than to appreciate them during increases. In order to capture the "real" statistics of illiquid indices, it is necessary to perform a process of profitability delamination. This process aims at adjusting the series of returns to take into account their autocorrelation. The application of our data-splitting process leads to an upward adjustment of the level of volatility and correlation levels while keeping the level of the mean returns unchanged.



particular portfolio of eligible liabilities”, says Trecco. “Such portfolios have essentially been reported in the UK and Spain”. The MA is designed to encourage the use of illiquid fixed-income type of assets, including core infrastructure, which offer fixed cash flows that cannot be changed by the issuer. For infrastructure debt, prepayment can potentially be an issue, as the MA portfolio might only benefit from cash-flow recognition up to the first call date, but it can be mitigated through the use of an appropriate Spens clause.

Equity investments in core infrastructure (as well is in other sectors of course) might benefit from the latest revision (July 2019) by the European Commission related to the new treatment of Long Term Equity Investments. Listed & unlisted equity investment portfolios with an average holding period over 5 years and head offices in the EEA would benefit from a much reduced capital charge (22% vs 39% or even 49%), but would have to be managed separately, with potentially adverse consequences on diversification gains.

Asset Class incentives

The European Commission has since the entry into force of Solvency II published a series of ad hoc regulations aimed at creating incentives to invest in qualifying infrastructure projects and corporates, both for equity and bonds. Eligibility requirements are numerous but prominent amongst them is the predictability and resilience of cash-flows, which favours core infrastructure.

SCR reductions will be greater for qualifying projects than for corporates compared with the standard treatment. For bonds, the gain is particularly marked for unrated instruments, with capital charge gains around -40%. For equity, the gain is of a similar order for unlisted instruments, which will additionally benefit from a reduction of the exposure to the Equity Dampener.

“All in all, compared with non-infrastructure unrated bonds, core infrastructure enjoys a friendlier treatment under Solvency II”, says Trecco.

Meanwhile, IFRS 9 which comes into force for insurers from 2023, is likely to require insurance companies to value an increasing number of financial assets at full fair value. This will have a negative impact on volatile assets and encourage greater use of illiquid and less volatile assets such as infrastructure. Because core infrastructure is income-driven, it tends to have a particularly low volatility profile. Note that core infrastructure fixed income assets could also potentially pass the SPPI test and therefore be accounted at amortised cost or at fair value through Other Comprehensive Income, thereby reducing P&L volatility.

Allocations growing steadily

Infrastructure is one of the fastest-growing components of insurers’ investment portfolios. “Our own data based on working with insurers shows infrastructure allocations are on average 2-3% of overall allocations,” says Castres. “We expect allocations to rise towards 5% next year.” That compares with allocations to infrastructure that were negligible as recently as 2011.

Only few insurers invest directly in infrastructure, she says. “You need a big in-house resource and plenty of experience. Most importantly, you need to be able to access deal pipeline. Few insurers can do all of this.”

Many insurers instead invest indirectly through closed-ended infrastructure funds, where assets are pooled with those of other institutional investors. There is also an accelerating trend towards co-investment whereby insurers have greater discretion about the deals they participate in. “This allows them to do their own due diligence and match the project to a specific set of liabilities or return expectations,” says Castres.

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ADDITIONAL NOTES

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