Financial Stability Board Secretariat
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

8 Canada Square
Canary Wharf
London
E14 5HQ
United Kingdom

T. +44 207 991 9800
timothy.j.clausen@hsbc.com

www.hsbc.com

31 August 2018

Dear Madam/Sir,

Evaluation of the effects of the financial regulatory reforms on infrastructure finance

We welcome the opportunity to respond to the Financial Stability Board's consultation document[1] (the 'Consultation'), having participated in the earlier industry survey, and roundtable industry discussion on infrastructure finance ('IF'). We also provided feedback on the development of the FSB's *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms*[2] (the 'Framework') and have contributed to, and support the joint trade association submission from the Institute for International Finance, and the Global Financial Markets Association.

The G20's goal is to deliver radical IF growth

IF is important for productivity and growth in all economies, but also to support the transition to a low carbon economy, consistent with COP21. According to McKinsey, the 2015 Paris Agreement to limit temperature rises to 2 degrees will require at least an additional USD1 trillion of new infrastructure every year between now and 2030.

G20 Leaders have identified the need for rapid growth in the contribution of private financing, given the limited scale of national budgets and multi-lateral development resources. This agenda has inspired many initiatives, including the MDBs Joint Principles and Ambitions on Crowding-In Private Finance[3], and in 2018, the 'Roadmap to Infrastructure as an Asset Class'[4] ('Roadmap') which sets out a comprehensive agenda to systematically address barriers to private finance 'as a way of lifting growth, job creation, and productivity'.

We have said that crowding in private finance will require the commitment of development bank 'billions' to catalyse private sector 'trillions'[5] to meet G20 ambitions, and yet five years into the G20's co-ordinated work in this area, practitioners do not see radical change on the ground.

[1] FSB Evaluation of the effects of the financial regulatory reforms on infrastructure finance – consultative document: http://www.fsb.org/wp-content/uploads/P180718.pdf
[2] HSBC submission to the FSB during the development of the post-crisis impact evaluation framework: http://www.fsb.org/wp-content/uploads/HSBC-1.pdf
[3] For example, Joint MDB Statement of Ambitions for Crowding in Private Finance https://www.bundesfinanzministerium.de/Content/DE/Downloads/G20-Dokumente/Hamburg_Genannte_Berichte/Joint-MDB-Statement-of-Ambitions.pdf?__blob=publicationFile&v=1
[4] G20 Roadmap to Infrastructure as an Asset Class: https://www.g20.org/sites/default/files/documentos_producidos/roadmap_to_infrastructure_as_an_asset_class_argentina_presidency_1_0.pdf
[5] HSBC Sustainable Finance Newsletter 'Mind the gap' https://www.gbm.hsbc.com/solutions/sustainable-financing/edition6-newsletter-2017/mind-the-gap

The FSB Consultation is directly relevant to the G20 Roadmap, as one of its seven elements is to address ‘regulatory frameworks and capital markets’. Yet while the FSB’s Consultation is a necessary contribution to this agenda, it does not optimise the post-crisis financial regulation to crowd in private finance.

As the Consultation concludes in its executive summary ‘the feasibility of a different regulatory calibration for different sectors go beyond the scope of this evaluation’. Given that banks remain a key source of lending, yet their contribution has been flat for a number of years while the G20’s IF expectations have continued to grow, the G20 should launch a more ambitious agenda to address areas where the risk sensitivity of the prudential capital framework could be improved to enhance the potential of IF, consistent with the primary goal of ensuring financial stability.

Banks have become expert intermediaries as balance sheet allocation to IF has evolved

Like other G-SIBs that are active in IF, HSBC has increasingly sought to support clients by bringing together a range of market participants to better match the risk and return profile of different types of infrastructure across different sectors, procurement preferences and market structure, diversified corporates and single asset projects. Public sector involvement touches many of these and we have sought to work with the public sector to develop new ideas, including credit enhancement options. Since the financial crisis, we have also increasingly sought to optimise our balance sheet allocations, partly for regulatory reasons, but also to improve our flexibility to manage changing market conditions and meet our investors’ preferences. Using this strategy, we have been able to significantly grow our business with modest changes to our balance sheet exposures (‘do more with less’).

While IF is not specifically penalised, prudential treatment could be more risk sensitive to support G20 objectives and better secure financial stability

While our responses to the earlier FSB survey and roundtable did indicate that regulation was not the main barrier to the expansion of IF, there are aspects of the regulation that could be more supportive of IF without compromising, and potentially improving, financial stability.

1. It would be helpful to explore further options that would allow better recognition of the risks and the way they are mitigated through the different phases and structure of projects, particularly where the financing is outside normal corporate lending.

    - Where elements of infrastructure financing are structured as part of corporate lending, rather than through special purpose vehicles/project finance (i.e. credit risk is captured as part of the overall assessment of the counterparty rather than the specific project – for example a diversified power generation company as opposed to a single power station), the capital requirements under IRB are more reflective of the default risk and ultimate potential loss if a default takes place. It should therefore be of little surprise that this is the way the largest volume of non-government funded infrastructure is financed.

    - Financing arrangements for project finance are necessarily bespoke by nature, complex, and typically commercially sensitive, and therefore do not lend themselves to modelling that would meet data-heavy regulatory requirements. In the regulatory capital framework for credit risk, for a bank to use the Internal Models Based (‘IRB’) approaches for its capital charge, the modelled parameters must be derived from statistically meaningful data on past default events. In the case of infrastructure projects which are captured within the Specialised Lending asset class for credit risk regulatory capital requirements, there is relatively little data to build the models on, even for large global institutions such as HSBC.

    - The limited ability of banks to use models has to an extent been recognised through the slotting approach, which allows the use of IRB for specialised lending even if the probability of default of the counterparty cannot be modelled. However, the slotting

approach is itself a blunt measure and does not allow full recognition of risk mitigants (such as the value of collateral and security provided) typically associated with IF. This lack of risk sensitivity reduces the power of public resources being deployed to catalyse private finance, with no offsetting additional financial stability benefit.

- Basel III is introducing a specialised lending asset class for the Standardised Approach, but with a link to an external issue-specific rating, which severely limits application of the more risk sensitive risk weights on exposures to IF (for example, guarantees and cash collateral of export credit agencies (ECAs) and some multi-lateral development bank's (MDB) are not fully recognised).
- Where innovative credit enhancement and risk sharing models are developed (such as political risk coverage or FX pooling by MDBs) to promote the growth of IF, there should be an ongoing role for the Basel Committee to ensure that appropriate transfers of risk are being reflected in the risk weights and capital implications for banks. Where risks are being transferred, global standards for banks should not impede innovation in the role of ECAs and MDBs in meeting wider G20 objectives. We have attached an HSBC case study of the well-known Elazig Hospital project in Turkey as an example of the bespoke nature of projects, and the types of risk-sharing innovations that are being deployed.
- The Consultation report in the Annexes also notes a number of other areas where risk sensitivity is not as powerful as it could be. For example, it notes[6] that the leverage ratio does not allow risk mitigants (such as ECAs, MDBs and highly rated sovereign guarantees) to reduce the leverage exposure measure, potentially reducing the attractiveness of guarantees when making lending decisions.

2. There is a proposal to include an IF supporting factor that reduces capital requirements for qualifying exposures in Europe's Capital Requirement Regulations (CRR2) provided these benefit from appropriate risk mitigation features. This is a field where multinational development organisations and banks play a significant role in provision of finance. The FSB could highlight this for evaluation by the Basel Committee in its final report. Given the scale of IF growth required, bespoke solutions around the world can be expected to emerge and serious consideration by the standard setters is therefore to be encouraged to drive consistency and a level playing field. These proposals should be grounded in risk sensitivity rather than blanket exemptions or tolerances and a proactive agenda from the FSB and the standard setters could promote such an approach to ensure the core financial stability objective is not compromised.

   - The process of using MDB and government resources to catalyse the maximum private finance is still in its early stages. It is still all too often the case that banks find themselves in direct competition with cheap public money for risks that private investors are very willing to take. Given the scale of the problem the G20 is trying to solve, and slow progress being observed, it is all the more important that innovative risk sharing achieves risk-sensitive regulatory treatment.

Opportunity for the G20 to seek a forward agenda from the FSB and standard setters to drive a proactive risk-sensitive agenda for IF

The Consultation is a rigorous implementation of the Framework, yet for the industry there is a sense that work remains to be done by the FSB and the standard setters to contribute to the crowding in of private finance agenda.

There is an obvious extension to the Consultation. The next step would be for the FSB and the standard setters to consider how the regulatory environment for IF can be more supportive of IF through enhanced risk sensitivity – without compromising financial stability.

[6] At page 49.

As the FSB rightly notes, this is a matter for the G20 to consider in terms of its priorities for the future in driving IF as an asset class.

We are very grateful once again for the opportunities we have had to engage with the FSB Secretariat throughout this review.

Yours sincerely

Stewart James
Managing Director
Head of Group Public Affairs, Asia Pacific

HSBC

Attachment: Elazig Hospital PPP case study

Elazig Hospital PPP in Turkey

EUR288m Project Bond enhanced with LS-PRI

December 2016

European Social Infrastructure Deal of the Year

Southern Europe Deal of the Year

Turkish Deal of the Year

Healthcare Deal of the Year

HSBC | ELZ SAĞLIK YATIRIM A.Ş.

Elazig Hospital PPP in Turkey

EUR288m Project Bond enhanced with LS-PRI

HSBC was Sole Arranger, Global Coordinator, Bookrunner and Financial Adviser for a groundbreaking project bond, issued to finance the Elazig Hospital PPP in Turkey in December 2016

The Sponsors are Meridiam, Ronesans, Sam, Sila and TTT

HSBC devised the innovative Liquidity Supported Political Risk Insurance ("LS-PRI") credit enhancement

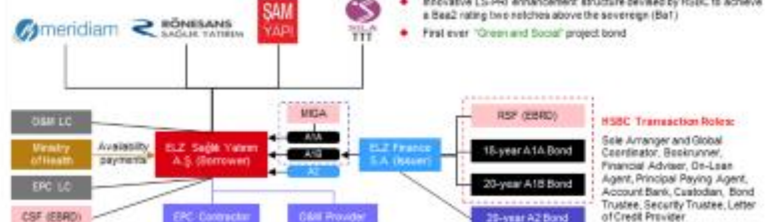
LS-PRI combines PRI from MIGA with subordinated liquidity from the EBRD. The bond was rated Baa2, 2 notches above the sovereign (Ba1)

This landmark structure addresses the aims of DFIs to look to new and capital efficient ways of supporting debt financing in lower rated countries by providing credit enhancement not substitution

Vigeo EIRIS classified the bonds as "Green and Social" based on the Issuer and Borrower's overall commitments to good governance, environmental and social sustainability and robust reporting and project management

Key Terms

Issuer	ELZ Finance S.A. (Luxembourg)		
Borrower	ELZ Sağlık Yatırım A.Ş. (Turkey)		
Listing/Restrictions	Unlisted/Reg S		
Amount/Gearing	EUR288,464,000/80% debt, 20% equity		
DSCR (min/ave)	1.478x/1.797x		
Tranche	A1A	A1B	A2
LS-PRI	Yes	Yes	No
Rating	Baa2	Baa2	Unrated
Amount(EUR m)	83.128m	125.336m	80.000m
Maturity	13 Dec 2034	12 Dec 2036	12 Dec 2036
Tenor/WAL (years)	18.0/11.0	20.0/12.12	20.0/12.12
Coupon	4.192%	4.460%	5.210%
Pricing/Settlement	6 Dec 2016/13 Dec 2016 (T+5BD)		



Transaction Overview

- The EUR380m Elazığ Integrated Health Campus PPP consists of the design, build, finance and maintenance of a large integrated health campus located in Eastern Turkey for a concession period of 28 years. The Project has a total capacity of 1,038 beds, consisting of two hospitals and one clinic
- HSBC devised an innovative Liquidity Supported Political Risk Insurance ("LS-PRI") credit enhancement which achieved a Baa2 credit rating two notches above the sovereign (Ba1)
- HSBC's credit enhancement structure combined traditional political risk insurance from MIGA with subordinated liquidity from the EBRD to mitigate non-payment risk by the Ministry of Health, expropriation, currency transfer and convertibility restrictions at any time of political stress in Turkey
- The bonds also have a deferred draw feature to mitigate the cost of carry and funds are drawn periodically from investors
- HSBC managed the credit rating process, bond placement across multiple jurisdictions and financial advisory for the Sponsors

This ground breaking project features a number of "**firsts**"

- First ever greenfield project bond in Turkey
- First ever project financing to achieve 20-year maturity in Turkey
- Innovative LS-PRI enhancement structure devised by HSBC to achieve a Baa2 rating two notches above the sovereign (Ba1)
- First ever "Green and Social" project bond

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