August 22, 2018

Comments on the Consultative Document *Evaluation of the effects of financial regulatory reforms on infrastructure finance* issued by the Financial Stability Board

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultative document *Evaluation of the effects of financial regulatory reforms on infrastructure finance* issued on July 18, 2018 by the Financial Stability Board ("FSB").

Japanese banks are in a position to lead the infrastructure finance ("IF") market and have a platform as well as an intention to continue contributing to a further development of the IF market. We understand that this is FSB's first report on its effort to evaluate the effects of financial regulatory reforms, and respectfully expect that the following comments will contribute to enhancing the effectiveness of FSB's series of evaluation exercises.

[Executive Summary]

<u>Support the evaluation of effects of financial regulatory reforms</u>

We express our respect for national authorities' continuous work to develop new global regulatory frameworks in the aftermath of the financial crisis to ensure financial stability and to avoid or mitigate the occurrence of next crisis. We also strongly support the evaluation of effects of financial regulatory reforms and the dynamic implementation of regulations which are set as prioritized agendas by the FSB, and ongoing initiatives for ensuring the relevance of regulations' objectives and actual regulatory treatment through these exercises.

As recognized by the FSB, if regulations deviate from their intended objectives or the level of resilience expected for the financial system, there are risks that economic growth, economic/social innovation and stability of the financial system will fail to balance appropriately, and that the real economy and intended beneficiaries of its growth would suffer a serious disadvantage.

We believe that an effective evaluation of regulations and, where necessary, decisive adjustments of regulations will enable full functioning of global financial markets and contribute to achieving sustainable growth in advanced and emerging/developing economies.

Effects of regulations which are not included in the scope of this survey on banks' behaviour

In this survey, effects of Basel III which was finalised in December 2017 are not included in the scope of analysis as it is difficult to quantitatively measure the degree of effects of regulations yet to be implemented.

In practice, however, it has been observed that conservative actions are taken in developing a policy and making decisions, on IF by banks by taking into account pre-finalised or pre-implemented regulations as well as uncertainties about their specific requirements and timing. In addition, pre-finalised and pre-implemented regulations directly or indirectly affect "factors" that are responded in the FSB survey as non-regulatory factors (e.g., "institutional factors") through transmission channels inside institutions such as a risk appetite framework and an asset allocation policy. Furthermore, it is undeniable that national regulations which are also not included in the scope of this analysis have effects on the profitability of IF transactions and others. (See our responses to Questions 7 and 11 for details.)

Accordingly, we request the FSB to state in its report to the G20 that regulations yet to be implemented and national regulations may have effects on banks' behaviour, and to describe that, if such effects are considered, the conclusion on the degree of regulations' effects may change.

In addition, we request to include the statement that ongoing follow-up will be conducted on the evaluation of effects of regulations, and to consider carrying out a survey approach that is more focused on a qualitative survey for banks' behaviour and other related matters that are difficult to capture through a quantitative survey.

Our comment on the conclusion of evaluation results

This FSB's survey concludes that the effect of the G20 financial reforms on IF is of a second order relative to other factors, such as the macro-financial environment, government policy and institutional factors. However, macroeconomic, government spending and supports have been recognized in the market as structural factors that affect infrastructure spending and financing before regulatory reforms. Effects of regulatory reforms have occurred independently from these factors, and hence concluding that such effects are relatively little by directly comparing with aforementioned continuously occurring structural factors may lead to a misleading impression that the effects of the regulations are de-minims and do not warrant being raised as an issue.

Therefore, we request the FSB to pay attention not to deliver messages in its final report in a manner to underestimate the effects of the regulatory reforms. We also request evaluating regulatory reform itself whether its specific requirements and level are appropriate in light of the balance between stability of the financial system and economic growth, in addition to relative comparison with other factors as already done.

Addressing social challenges (Mobilizing private sector funding for IF)

The Asian Development Bank estimates that USD 1.7 trillion of annual investments are necessary to sustain the momentum of growth in Asia until 2030. According to the Organisation for Economic Co-operation and Development, global infrastructure spending required between 2007 and 2030 amounts to USD 71 trillion.

Similar to 2018, the G20 in 2019 is also expected to discuss the development of IF as one of important agendas, and hence increasing the number of financing providers is an urgent challenge.

Given the role banks play in IF as early fund providers(see our response to Question 14 for details), it is significant to further enhance commitment by leading banks which have been key players in IF market already, and to expand range of banks which can support IF, in order to enhance private sector funding for infrastructure projects.

This FSB document states that downsizing or exiting from IF by banks with weaker financial profile is not necessarily a consequence unintended by the regulations. However, if IF loans remain to be an asset class which can be offered only by a very limited number of banks with superior financial strength, it is difficult to expect enhanced mobilization of private sector funding hereafter.

The ultimate objective of the regulations is to contribute to sound growth of the real economy as well as to stability of the financial system. We expect that the IF market will be open to a wider range of market participants through reduced uncertainties (see the paragraph below for details) and excessively conservative treatment in regulations (see response to Questions 7, 9 and 11 for details).

We request the FSB to describe in its final report the necessity to consider on an ongoing basis whether specific requirements and level of the regulations are appropriate in light of new social needs requesting the expansion of the IF market.

Comments on the Basel requirements related to specialised lending (SL)

We strongly support the decision made in the Basel III finalisation in December 2017 to retain the application of the advanced internal rating-based (AIRB) approach to specialised lending (SL). If the AIRB would not have been permitted, it could have had a significant impact on IF due to a decline in risk-sensitivity and an increase in capital charges. On the other hand, the Basel Committee on Banking Supervision (“BCBS”) states "the Committee will review the slotting approach for specialised lending in due course." Since the result of such a review may have an impact on IF, the banking industry has been conducting its operations whilst closely monitoring the regulatory developments. We request the BCBS to make careful and extensive considerations on this.

In addition, we request to describe in the FSB’s final report the possibility of reviewing excessively conservative calibration for project finance (see our responses to Questions 7 and 11).

[Our responses to the questions]

<u>Supporting the approaches provided in the report and our supplemental suggestions from practical perspectives</u>

We appreciate that this FSB’s survey is designed and implemented to reflect various data and opinions on global regulations which have already been implemented by combining empirical analysis and qualitative surveys.

We would like to provide following additional comments primarily on practical issues that would be difficult to adequately consider through this survey.

Question 5: Has the trend in IF volumes been more muted in EMDEs than in AEs since the global financial crisis? If so, what are the main reasons for different trends across regions, and where (if anywhere) does financial regulation feature as a reason?

(Our response)

The FSB's survey indicates that the post-financial crisis IF market has grown primarily in advanced economies, and market-based finance, such as bonds, has become the main source. Such a mechanism is feasible only in limited areas in advanced economies (e.g., North America and some European economies*) where the capital markets are highly developed against the background of a wide-ranging funding providers, such as institutional investors, and there is a high probability of take-out by bonds. In these limited markets, there is a high probability of asset control (and income-earning opportunities) by distributional activities of banks and markets, such as take-out by bonds and trading of the loans in secondary market. In addition, financing is generally structured in shorter term such as the mini-perm style, on the assumption that refinancing risk can be taken. Therefore, the necessity for banks to control their origination activities taking into account pre-implemented regulations (see our response to Question 6) is exceptionally low.

Bank loans are inextricably related to other financing in the meaning that bank loans can be originated more actively in markets where other financing tools are actively originated and traded. Specifically, smooth take-out activities will shorten the average life of loans on banks’ balance sheet and as a result the accumulation of banks’ assets will be limited.

As discussed above, while global IF is in a growth trend, its main growth driver is market-based finance provided in some of advanced economies, and hence emerging and developing economies that need IF most have rarely received benefits from this growth, as pointed out by the FSB. In light of the concept of sustainable development and inclusiveness of global economy, the current course of development of IF market is not necessarily as hoped for.

* According to Project Finance International, the top 5 countries, including United States (30%), UK (14%), Mexico (7%), Canada (6%) and UAE (5%), accounted for more than 60% of the global project bond market (USD 63.7 billion in total) in 2017, whereas Japan is 0.1%.

Question 6: How do the financial reforms rank relative to other factors (e.g. macroeconomic and financial conditions, political risks, institutional impediments) in terms of their influence on IF?
Question 8: Are there any major transmission channels in terms of the effects of financial regulation on IF that the evaluation has not considered?

(Our response)

Effects of Basel III finalisation which was reached in December 2017 are not included in the scope of analysis in this survey. While it is difficult to quantitatively evaluate effects of regulations yet to be implemented, in practice, it has been observed that conservative actions are taken in developing a policy, and making decisions, on IF by banks by taking into account pre-finalised or pre-implementation regulations as well as uncertainties about their specific requirements and timing. In addition, pre-finalised and pre-implemented regulations directly or indirectly affect “factors” that are responded in the FSB survey as non-regulatory factors (e.g., “institutional factors”) through transmission channels inside institutions such as a risk appetite framework and an asset allocation policy. Japanese banks which have relatively high financial stability have driven the expansion of the IF market after the financial crisis. However, their potential has not necessarily been fully demonstrated due to regulatory uncertainties and market capacity (see responses to Questions 11 and 5), as well as their amplification through transmission channels inside institutions as mentioned above.

Question 7: Are Basel III and OTC derivatives market reforms the most relevant G20 reforms for IF? Which other reforms may also be relevant for the purposes of the evaluation? Please elaborate.

(Our response)

As described in our response to Question 6, the Basel III final agreement yet to be implemented has potential effects on IF market already.

Project finance is expected to be subject to significantly disproportionate risk weights compared to the current IRB through introducing SA floor under the Basel III finalization, considering it rarely obtains external credit rating due to its complexity and the information control purpose of project details. (See the table below (the left table shows the average values of CR6 Specialised Lending disclosure of major Japanese banks)

Given that the composition of IF in the banks' balance sheet merely accounts for a few percent according to the FSB report, risks in the financial system are limited and hence excessively conservative treatment is not considered to be appropriate. We therefore request to propose in the final FSB report to review excessively conservative calibration for project finance.

PD IRB Specialised Lending as of March 2018	Average RW	Average PD	Total EAD (in million yen)		Average Maturity (in years)
			Actual Amount	% of total	
0.00-0.15%	23.23%	0.07%	¥2,342,412	45.2%	3.9
0.15-0.25%	35.08%	0.19%	¥1,255,182	24.2%	4.1
0.25-0.50%	51.04%	0.33%	¥1,011,623	19.5%	4.0
0.50-0.75%	66.92%	0.57%	¥270,271	5.2%	4.1
0.75-2.50%	84.40%	1.36%	¥533,248	10.3%	4.1
2.50-10.00%	116.48%	4.75%	¥84,898	1.6%	3.5
10.00-100.00%	167.68%	14.45%	¥56,025	1.1%	3.5
Average/Total	42.33%	1.34%	¥5,179,435	100.0%	4.0

BaselIII Finalisation SA Risk Weight for project finance					
Rating	(Moody's PD*)	rated	unrated		
AAA	0.01%	20%			
AA	0.14%	20%			
A	0.46%	50%			
BBB	1.02%	75%	high quality & operational phase	(a)	80.00%
BB	4.72%	100%	operational phase	(b)	100.00%
B	15.94%	150%	pre-operational phase	(c)	130.00%
below B	29.79%	150%	pre-operational phase	(c)	130.00%

* 4yrs global corporate, 2017 actual from "Default and Rating Transition of Japanese Debt Issuers, 1990-2017"

Capital Floor 72.5% applied	(a)	58.00%
	(b)	72.50%
	(c)	94.25%

IF, which generally has a longer credit period, usually uses derivatives transactions to hedge interest rate and currency risks. Regulations on derivatives counterparty and CVA risks being introduced by Basel III have been one of factors causing a decline in profitability of IF transactions for banks and therefore limiting an increase in IF assets.

As analyzed by the FSB, the main currency of IF is currently USD. In addition to a decline in the supply of U.S. dollar by U.S. banks subject to the liquidity regulation introduced by the BCBS, regulations established at respective jurisdictions have an impact on USD funding cost of foreign banks (e.g., a sharp decline in CP/CD issuance due to MMF reforms in the U.S.), leading to a reduction in the number of transactions that can be offered due to declining profitability.

Question 9: Is the analytical approach used to evaluate the effect of reforms appropriate? Are there other approaches to consider for this or future evaluations?

(Our response)

Page 23 of the FSB report notes that "financial regulation is not seen as the dominant driver of IF," indicating the following as a reason: "Banks rank financial regulation as second to currency risks in terms of importance as a negative driver."

However, factors such as currency mismatch, undeveloped capital markets, and a low volume of supplying bankable transactions are structural challenges unique to the IF market which have been pointed out for a long time before the implementation of regulatory reforms. Meanwhile, effects of regulatory reforms have occurred independently from these factors. Concluding that the degree of regulatory effects are relatively little by directly comparing with aforementioned continuously occurring structural factors may lead to a misleading impression that the effects of the regulations are de-minims and do not warrant being raised as an issue.

Therefore, we request the FSB to pay attention not to deliver messages in its final report in a manner to underestimate the effects of the regulatory reforms. We also request evaluating regulatory reform itself whether specific requirements and level are appropriate in light of the balance between stability of the financial system and economic growth, in addition to relative comparison with other factors. .

Question 11: The evaluation’s results suggest that financial reforms have not had a disproportionate effect on IF compared to other types of finance. Is this consistent with your view of the market?

(Our response)

IF has the following well-known characteristics that will cause difficulty in controlling assets in a flexible and timely manner. As such, it is necessary for an origination activities of banks to play a major role as asset controller, and hence IF appears to have a characteristics and structure which prompts banks to take conservative actions to pre-implemented regulations.

- Long-term and complicated financing, in particular, project finance;
- Lower possibility of obtaining external ratings;
- Limited investor universe as a result of above-mentioned factors; and
- Constraints on salability of loan assets (significant gaps across regions) and a risk of longer life time on the firm’s balance sheet

Also, since the structuring of project finance requires a high degree of expertise, there is less substitutability among funding providers than other financing. With respect to bank loans, the top 20 banks account for 50% of the market share, and effects of regulations on market participants is more likely to spread than in highly fragmented markets.

According to the league table published by Project Finance International, recently, the shares of European and Japanese banks have peaked as they have conducted a prudent business operation to address current or pre-implemented regulations, while banks in other regions have increased their shares. We consider that these differences in banks’ behaviour will provide a clue for evaluating effects of regulations and hence request the FSB to perform a further analysis going forward.

Question 14: Has there been a partial substitution of bank financing by market-based financing and, if so, to what extent have the reforms contributed to this trend? Is there other information on substitution that should be considered by the evaluation?

(Our response)

The FSB survey indicates that a greater diversity of participants such as market-based finance has contributed to stability of IF markets. However, from the perspective of funding costs and time required for structuring, banks remain to be a core IF funding provider at the inception of a project. Therefore, the prerequisite for IF is that banks provide funds at the entry stage in order to transfer the funding provider role to subsequent diversified funding providers, including market-based finance.

However, the FSB survey shows that the size of IF bank loan market remains flat in both advanced and emerging/developing economies and shows little growth potential.

The reasons for banks with weaker financial profile have downscaled or exit from IF among various asset classes, or banks that have increased offering of IF have not fully demonstrated their potential, include its long-term characteristics and salability restrictions described above, and therefore the possibility of being subject to future adverse regulatory treatment, and actually punitive risk weight treatment in Basel III finalisation, compared to its actual risks.

Question 17: Are there any other issues or relevant factors that should be considered as part of the evaluation?

(Our response)

As noted in the FSB survey, another impediment to growth of the IF market is the limited supply of bankable projects, particularly in emerging and developing markets. In terms of actual situations of the market which are not apparent from statistics, banks and investors are concentrated to a small number of bankable transactions in the Asian region, which is leading to low margins, while cost gaps with general projects that are less bankable are widening. As such, there are obstacles for both cases to ensure its sustainability.

To improve bankability, national governments are expected to develop project bond and FX hedge markets in emerging/developing economies, as well as in advanced economies with poorly developed capital markets, and to improve the finance structure in quality through proper risk sharing among governmental organizations and private sectors. In parallel with these efforts to improve risk profiles, encouraging firms to obtain external ratings is also important to support an expansion of the investor universe.