CLIFFORD CHANCE

BELT AND ROAD
INITIAL PHASE: INFRASTRUCTURE

— THOUGHT LEADERSHIP

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China's Belt and Road Initiative (BRI), is one of the most ambitious development projects in history. China's vision is to boost global trade and create vibrant economies along its route, which covers 74 countries. President Xi describes it as a vehicle for China to take a greater role on the international stage by funding and developing global transport and trade links. Its strategic importance was reinforced in October 2017 at the Communist Party of China's (CPC) 19th Party Congress when BRI was officially written into the CPC's Constitution – a clear statement of China's determination to push it forward. It also means that Chinese enterprises have the political imperative to make BRI a success.

BRI is notable not only in terms of its scale, geographical reach and the political will behind it, but also for the lack of any roadmap. This has led to criticism that it is vague, lacks clear direction and its success is difficult to predict. What is clear however, is that the initial phase of BRI focuses on infrastructure, particularly transportation, energy and communications. The second phase of the BRI will focus on trade, financial services, education and medical care, amongst other sectors.

Initial phase: Infrastructure development

The initial phase of BRI focuses on infrastructure development, which is much-needed in the Asia-Pacific region. According to a report published by the Asian Development Bank in February 2017, meeting Asia's infrastructure needs, and taking into account climate change investments and adaptation costs, requires investments of USD26 trillion, or USD1.7 trillion per year, from 2016 to 2030. Of the total estimated investments, over 85 per cent is needed for power and transportation projects.

The majority of BRI projects that have been completed to date, or that are under construction, are in the transportation sector, mainly for ports and railways. These include:

- China to London Railway Project
- Gwadar Port, Pakistan
- Jakarta – Bandung High-Speed Train
- China-Laos Railway
- Ethiopia – Djibouti Railway
- China – Europe Freight Train Services, which connects 32 cities in 12 European countries

According to the Ministry of Commerce (MOFCOM), China signed USD144.32 billion worth of construction contracts with 61 countries along the belt and road routes in 2017. This compares with USD126.03 billion and USD92.40 billion in 2016 and 2015 respectively.

Where is the money coming from?

By the end of 2016 China's two state policy banks, China Development Bank (CDB) and The Export-Import Bank of China (CEXIM) had extended USD200 billion in loans to BRI projects, whereas China's three stated-owned commercial banks (the Industrial and Commercial Bank of China, Bank of China and China Construction Bank) had extended USD250 billion in total.

BRI, if fully realised, is likely to cost some trillions of US dollars over the next decade. Popular estimates for Chinese investments under BRI range from USD1 trillion to USD8 trillion, but there does not appear to be any publicly available official estimate. In any case, even based on the lowest estimate of USD1 trillion, China is unlikely to be able to finance the capital costs of BRI projects on its own. However, a number of programmes have been developed to either invest in, or lend money to, BRI infrastructure projects. These include: a USD124 billion pledge to the Silk Road Fund; China is empowering numerous smaller development funds for various regions, which total over USD76 billion; and China Development Bank and The Export-Import Bank of China are setting up special lending schemes worth RMB150 billion and RMB130 billion to support the implementation of BRI.

Issues and challenges

There are a number of common challenges facing BRI projects:

- **Political risks:**
  Many countries on the belt and road routes are subject to political upheaval, which can have a huge impact on the development and success of infrastructure projects. A number of Chinese infrastructure developments in Sri Lanka, for example, have not gone according to plan owing to the intractability of local politics.

  China Export & Credit Insurance Corporation (often known as Sinosure) plays a key role in BRI, providing much-needed political and commercial risk insurance cover to investors and financiers on belt and road projects.

According to Sinosure, the total insured amount under the Sinosure insurance policies attributable to exports to, and/or investments made in, the belt and road countries amounted to nearly USD510 billion by the end of Q3 of 2017, with the aggregate amount of claims paid amounting to approximately USD2 billion. The Sinosure insurance policy is a single bank product, and is not designed by syndicated financing deals. We believe that, in the long run, given the wide usage of Sinosure insurance products on BRI deals and the desire to mobilise private capital and international funding to jointly support BRI projects, the Sinosure insurance policy will need to be reformed and developed in line with its counterparts, such as UK Export Finance or Japan's JBIC, in order to be more easily acceptable to international financiers.

- **Legal and regulatory issues:**
  The legal system and local law in a large number of belt and road countries have probably not been tested for foreign investments or large-scale infrastructure projects before. The USD5 billion Jakarta – Bandung high-speed rail line is currently on hold owing to land ownership issues for nearly 40 per cent of the land. The project began in January 2016, and was expected to be completed by 2019. The current target for completion is now 2024 – potentially a five year delay. Another example is the USD5.2 billion China-Thailand railway project, which is currently facing delays owing to issues with environmental approvals in Bangkok. The same project previously suffered delays related to investment sharing and development rights.

- **Stranded assets:**
  Certain forms of security customary for project finance transactions (e.g. account security, security over contractual rights and floating charge over all assets) may not have an equivalent under PRC security law. Importantly, most large-scale onshore Chinese projects are carried out by state-owned enterprises (SOEs), and Chinese financiers are used to seeking recourse directly from SOEs (instead of the project itself). Hence, project finance is not a common form of financing in China, and Chinese banks do not have as much experience in analysing and allocating risks on infrastructure projects when compared with international commercial banks and multilateral development banks. The lack of expertise in this regard may result in less robust commercial and financing terms of a deal, which may, in turn, give rise to issues further down the line, resulting in stranded project assets. Such a domino effect can be disastrous. The sustainability of the belt and road hinges upon the attractiveness and recyclability of project capital, which is particularly important given the huge capital needed to achieve the BRI vision.

Which countries are benefiting the most?

A number of countries were particularly mentioned in the annual summary of MOFCOM as destinations for BRI investments in 2017: Singapore, Malaysia, Laos, Indonesia, Pakistan, Vietnam, Russia, the UAE and Cambodia. Of these, Pakistan has benefited the most. The China-Pakistan Economic Corridor (CPEC) was launched in 2014, and China has recently described it as the most effective of all its BRI projects. Pakistan has attracted up to USD55 billion in investment, the majority of which is in the development of energy projects. The Gwadar Port Project, strategically located on the Arabian Sea near Iran and the mouth of the Persian Gulf, is a key project along the CPEC, linking the land-based belt connecting countries from China to the Baltic, the Persian Gulf and the Mediterranean, and the "road," a maritime route starting from the coast of China and stretching to the Indian Ocean and South Pacific. The aim is to create a commercial, industrial and shipping hub, which will provide China with a shorter and more secure trading route to the Middle East and which will boost Pakistan's economy.

Our view

The Chinese government reports that Chinese enterprises are currently the main players in BRI and that BRI has created an unprecedented opportunity for Chinese enterprises to venture abroad. The Chinese are well aware of the gaps in their skills and experience and the steep learning curve that lies ahead. They therefore welcome international cooperation. To this end, a number of memorandums of understanding have been entered into between China and foreign or international organisation to promote BRI. For example:

- An MOU was entered into between the Ministry of Finance of China, the Asian Development Bank, the Asian Infrastructure Investment Bank, the European Investment Bank, New Development Bank and the World Bank in 2017, to jointly promote the BRI.
- China Development Bank and Standard Chartered Bank have signed a USD1.6 billion MOU to set up a strategic partnership to fund BRI projects.
- An MOU was entered into between the PRC and United Nations Development Programme in September 2016, to create a framework for strategic cooperation.

It is clear that China cannot, on its own, finance the BRI or bring it to success. Whilst the BRI has been much criticised for benefitting only the Chinese, that applied to the embryonic stages of BRI and more opportunities should naturally and logically open up for foreign investors in the years to come, particularly when there are more successful BRI stories to provide a track record. The credit rating agency Moody's recently estimated that, overall, the BRI would generate more positive than negative effects both for China and the recipient countries. This is certainly a space to watch.

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CONTACTS

Dauwood Malik
Partner
Hong Kong
T: +852 2826 3485
E: dauwood.malik@
cliffordchance.com

Nicholas Wong
Partner
Singapore
T: +65 6410 2218
E: nicholas.wong@
cliffordchance.com

Maggie Zhao
Partner
London
T: +44 20 7006 2939
E: maggie.zhao@
cliffordchance.com

Huw Jenkins
Consultant
London
T: +44 20 7006 1392
E: huw.jenkins@
cliffordchance.com

Vicky Ma
Consultant
Hong Kong
T: +852 2825 8995
E: vicky.ma@
cliffordchance.com

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