THE ROAD AHEAD

The much-discussed Belt and Road Initiative has had its name changed, its priorities set vaguely and commentators can't stop debating it. But what does the expected expenditure of US$1 trillion on Asian infrastructure really mean for the future of Hong Kong's financial services industry?

STORY **LIANA CAFOLLA**

ABOVE The Yiwu - London Railway Line is a freight railway route covering roughly 12,000km and is part of the ambition to establish a 'modern day Silk Road'.

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The Belt and Road Initiative, the sprawling signature policy of Chinese President Xi Jingping, has been gathering pace and headlines. In May, Beijing hosted the Belt and Road Forum for international cooperation, a two-day summit hosted by President Xi and attended by about 30 world leaders. The number of countries covered by the initiative has grown from about 60 to 70, and the 57 founding members of the Asian Infrastructure Investment Bank (AIIB) – the multilateral development bank that will be a major source of funds – increased to 77 in May, when another group of signatories signed up, including Hong Kong. In June, Deutsche Bank, the biggest European bank, signed a US$3 billion (HK$23.4 billion) agreement with China Development Bank to fund infrastructure in Belt and Road countries, and a few weeks later the AIIB made its first equity investment with a US$150 million commitment to the India Infrastructure Fund.

The increase in interest resulted in many questions. What will be the key projects? Where are the best investments? What does China hope to gain from the project? Who will pay for it? And what are the opportunities and risks for Hong Kong?

Many of those questions are still unanswered. But on the last question, a consensus of sorts appears to be emerging among Hong Kong's business and financial experts: the Belt and Road Initiative will bring a broad spectrum of lucrative opportunities to Hong Kong, and the city is extremely well placed and prepared to take advantage of them.

Despite the gilded talk, there are some serious risks and challenges as well. Hong Kong will have to compete against some formidable rivals to win those opportunities. It's also likely that not all of the projects on offer will be deemed profitable after going through rigorous risk assessments. There are political risks, as firms try to curry favour with Beijing and its state-owned enterprises, thus exposing themselves to the prospect of dealing with politically driven white elephant projects.

And some projects will require decades to bring results and returns. Many of the proposed Belt and Road countries are themselves difficult investment locales. Pakistan's Gwadar Port, a key component of the Belt and Road Initiative, recently saw an attack by gunmen, which killed ten construction workers. The attack was committed by the Baloch Liberation Army, which claims that locals have not benefitted from oil and gas wealth, and which advocates for independence from Pakistan. Pakistan has responded to violence by reportedly creating a special army division tasked with protecting Belt and Road related projects that connect Xinjiang with Gwadar.

Other countries and regions that are investment targets, such as the Central Asian nations, are rated as highly corrupt, according to Transparency International.

ON THE ROAD, AGAIN

The Belt and Road initiative, or BRI, was first announced in 2013 when it was launched under the name of One Belt, One Road (OBOR). Broadly, BRI is a development strategy designed by China and based on the old silk road trading route. The stated aim is to promote economic and trade cooperation and to connect Central Asia, Europe and Africa through its twin trajectories, which are known as the Silk Route Economic Belt – the land route – and the 21st Century Maritime Silk Road – the sea route. The project has five stated goals: policy coordination, facilities connectivity, unimpeded trade, financial integration and people-to-people bonds.

To help finance the BRI, China set up a US$40 billion Silk Road Fund that will invest mainly in infrastructure and resources. China also launched the AIIB, which opened in January 2016 and will focus on developing infrastructure and other productive sectors in Asia, including energy, power, transportation, and telecommunications, among others.

While many countries and potential investors are still pondering the meaning and substance of BRI and how they might get involved, some of Hong Kong's biggest companies have wasted no time getting into the scheme.

"If you talk to the MTR, the Airport Authority, CLP, even the telecom people, basically everyone is actively working in the BRI projects," says Nicholas Kwan, director of research at the Hong Kong Trade Development Council.

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Those companies are mostly working on infrastructure projects that will take years to negotiate and build, but much more business is set to come Hong Kong's way, particularly in the city's areas of expertise in logistics, financial services, legal services, general trade and finance, and investment. Because of its long international experience and high standing in these areas, Hong Kong is where foreign companies will want to be based. In particular, Hong Kong's use of the common law system and its understanding of China's continental law system will make it an excellent partner in the legal process throughout projects as well as in dispute resolution, Kwan says.

Kwan cites a major US power company whose biggest project is the China-Pakistan power project. They told him that they use Hong Kong as a base rather than Pakistan or China because Hong Kong offers a better operating environment and easy connectivity to the US.

"What helps people here is that it is a very clear and simple platform, legitimate, so that you will be free from all the bureaucracy and all the hidden costs," says Kwan. "We are a free port not just in the sense of shipments, but also the free flow of capital, of information as well as products. This is critical for anyone who manages global business or international business. That goes back to the original saying about the strength for Hong Kong: we connect China with the rest of the world," says Kwan. Even if Hong Kong doesn't send a single engineer to work on the project, "there could be quite a substantial set-up providing all the information support, logistics support and technical support for this project. If this is one of the largest projects in the world of this kind, then supporting all this could still be quite sizeable."

Mabel Chan, president of the Hong Kong Institute of Certified Public Accountants and head of outbound investment at Grant Thornton, has visited several of the countries along the BRI route. She believes that prospective investors will want to take advantage of Hong Kong's use of international financial reporting standards, which may not be used by less developed countries, and will seek the expertise of the city's accounting professionals before making decisions.

"Before they put in their money, they need services like due diligence – what is the value of those investments? What are the risks attached to those investments? What is the focus of the cash flow and returns of the investment, and is it justified in terms of the risk profile involved?" she says.

Later, when efficient infrastructure is in place, she says other opportunities will materialise from tourism and trade with the countries along the route. "It's good to help support the development of all these countries," she says. "They (the residents) are people, just like you and me, and they want a better city; they want a better living environment."

The Asian Development Bank estimates the infrastructure investment requirement in the region at US$1.7 trillion *annually* for the next 15 years. Hong Kong has been positioning itself as the prime location for arranging the financing under the leadership of the Hong Kong Monetary Authority and its Infrastructure Financing Facilitation Office (IFFO), which attracted investors with around US$4 trillion in total assets under management to its inaugural high-level debt financing and investors' roundtable in March this year. The IFFO aims to be a platform to match capital and large-scale infrastructure projects and help the investments succeed so as to attract private capital to help the BRI.

Hong Kong is also home to the biggest RMB offshore market, which is likely to prove another attraction for investors. As well as its international finance expertise, Hong Kong is home to many global banks and asset managers, and can provide a "one-stop shop" of financial services, including investment and financing, professional services and risk management, says Enoch Fung, general manager of the HKMA IFFO.

RISKS AND RETURNS

Despite all of this expertise, Fung does not have an easy task. The scale of the funding means private sector participation is essential, but he says it is difficult to get private funds to finance infrastructure. One challenge is the difficulty in channelling capital to infrastructure projects in developing countries.

"At the country level, political, legal and regulatory risks might undermine the feasibility of a project. At the project level, construction risk, cost overrun, demand risk, currency risk, and refinancing risk would negatively impact the project's profitability." And when the projects are cross-border, these risk factors all increase, Fung adds.

Another problem is the lack of a developed project bond market in Hong Kong, which Fung says is actually an Asia-wide problem. "The key is for corporates to broaden their source of financing by tapping into the bond market, in addition to relying on bank lending," he says.

The new bond connect scheme, which opened in late June and links China's onshore bond market to international investors via Hong Kong, could become a source of financing. "The opening up of the Chinese bond market will increase opportunities for China to raise capital in local currency – either onshore or offshore – with the objective of funding OBOR's build out and expanding global links," said Mark McFarland, chief economist Asia, Union Bancaire Privee, in a statement. China, McFarland noted, was getting ready to sign free trade agreements with many of the BRI countries, and he expects more details about the plan to emerge from the 19th party congress meeting in October.

One source of funding could be Europe. Private and public European co-financing of BRI projects are set to increase, says Alicia Garcia Herrero, chief economist for Asia Pacific at Natixis, a French investment bank. "European banks are already the largest providers of cross-border loans to Belt and Road countries so it is only a question of accelerating that trend," she wrote in a recent note. European banks, pension funds and investment funds could invest in BRI and Hong Kong could serve as their platform, she says.

But timeframes on projects and lack of information are the two biggest issues. "You need a platform for transparency of those projects," she says. "HKMA is trying, but I think we have a long way to go."

Political constraints such as sanctions are also an issue. Russia and Pakistan-based projects are off-limits for European investors, as is Iran, she notes, and these are likely to be some of the biggest recipients of BRI projects.

Once the hard infrastructure is built, many associated services will be needed, and this prospect is attracting strong interest of Hong Kong's professional services firms. "One of Hong Kong's most significant opportunities lies in its expertise in bringing deals together, particularly those relating to infrastructure," says Stephen Weatherseed, managing director of Mazars Hong Kong.

"I think the increase in trade flowing through Asia has to be a good thing for Hong Kong, as it will naturally lead to more activity, more people, and more wealth, while bringing Asia closer to the rest of the world. Overall, I think it is a very positive thing for Hong Kong."

"We have been helping a lot of Chinese companies to go to OBOR countries to help them invest," says Gabriel Wong, head of corporate finance at PwC. He says he sees a lot of big opportunities for his firm in areas including financial advisory, market entry analysis, tax structuring, customs analysis, tax office services, deal structuring and negotiating with counter-parties.

"It's not only about infra," he says, speaking from his office in Shanghai. "I think the infra sector will be huge in the upcoming three, five, seven years. Then will come insurance, property, financial services."

BRI is such a vast project that it can achieve various objectives for China at different points in time, Wong says. Countries along the route are investing in long-term projects such as increasing agricultural output with a view to servicing China's population once connectivity is in place, he says, and some are already talking about connecting the grid among the route's countries in 10 or 15 years, he says.

Beyond its expertise in raising capital for infrastructure, Hong Kong should use its digital infrastructure to help develop the BRIs soft infrastructure by digitising its trade facilitation and financing services, says Pindar Wong, chairman of Verifi Hong Kong, who helped set up the Belt and Road Blockchain Consortium. Wong proposes using the blockchain technology pioneered by Bitcoin to export legal, accounting and professional services. This is "a transparent, 'trustless' technology which lowers the cost of establishing and maintaining trust, and drastically simplifies financial settlement," says Wong.

Critics have said the BRI is a way for China to invest its US$3 trillion in foreign exchange reserves and export its excess production in sectors such as steel. China used only 67 per cent of its own steel capacity in 2015, according to Fitch, a record low and far below the average use of 80 to 85 percent in sectors that are considered healthy.

"In the very short term, China may be exporting spare capacity," PwC's Wong says. "But actually OBOR is multidirectional. As I participate in this, on the ground in China, I do really see this as one of the most inspiring moments in human history, if things really

ABOVE Chinese President Xi Jinping, Russia's President Vladimir Putin and Argentinian president Mauricio Macri at the Roundtable Summit Phase One Sessions of Belt and Road Forum at the International Conference Center in Beijing on May 15, 2017.

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happen, because the connectivity is up. It's not really about the short-term spare capacity, exporting, etc. It can promote lots of trade and multi-directional exchanges."

China's motivation for the BRI came under fire for other reasons in a note published by Fitch in January. "OBOR is a component of China's efforts to expand its strategic international influence and a means of securing access to key commodities," the note said. "This subjugation of market forces means there is a heightened risk of projects proving unprofitable."

"What is important, is what things the world allows to happen," says HKTDC's Kwan. "Even if China reaches out, some countries may not want to be reached."

In any case, BRI could be a strong force to counter the current anti-globalisation trend, he says. "We believe, from our own experience, not just from Hong Kong, China but many other developing countries, that this is one key way to improve our living standards and make the world better."

ELEPHANT SPOTTING

Pragmatic self-interest may be a driving factor in getting countries in the BRI sphere of influence to go along. Speaking of China's involvement in his country's power sector, Ahsan Iqbal, Pakistan's planning minister told the *Financial Times*, "We wanted power investments, but nobody came in. The Chinese spotted an opportunity." As developing countries in the BRI seek to meet their massive infrastructure deficit and build the connectivity needed to boost trade, they may similarly ask themselves who else but China is proposing a grand enough solution. That said, the China Pakistan Economic Corridor has been in development for years prior to President Xi's announcement in 2013.

The risk of white elephant projects is not underplayed by anyone, and if Hong Kong companies are involved, they have the potential to be detrimental to Hong Kong's international image, says Simon Lee, assistant dean (undergraduate) and senior lecturer of the School of Accountancy at the Chinese University of Hong Kong (CUHK) Business School. Lee reckons that, in seeking to gain business, Hong Kong banks or consulting firms may subject themselves to political pressure, contradicting their own commercial objectivity about the virtue of a given project. Mazars, which is known for its expertise in auditing financial models for infrastructure projects, reckons that Hong Kong is well equipped to deal with the risk of white elephant projects "by doing what it normally does", in other words, by applying adequate due diligence to prospective projects.

The question of white elephants is better looked at through the lens of the timeframe, suggests Herrero of Natixis. She says a project that appears in danger of becoming a white elephant may turn out to be valuable depending on trade routes that may not yet exist or be known about. The Chinese government may simply be taking a much longer-term view. A white elephant today may be a gold mine tomorrow, in this line of thinking, but in the absence of an existing need, will investors be willing to make a long term play on a Politburo directive? In the case of the Pakistani port of Gwadar, profitability seems to have taken a back seat to Chinese strategic concerns – the port allows China to bypass the Straits of Malacca.

The Port of Singapore Authority, which signed a 40-year agreement to run the Gwadar Port in 2007, withdrew from the agreement in 2013, despite generous concessions, because of profitability and security concerns.

"Maybe in the very long run, they may make sense, given future trade routes, in economically integrated areas, or free trade agreements along the BR where there is much more movement of goods and services etc," she says. "But nobody, no private investor, would be able to foresee that under the current circumstances, when they calculate their own risk and adjusted return, it wouldn't pay off today. "The point is, that timeframe is different: they don't have shareholders that are asking for returns tomorrow."

ABOVE
A Pakistani Naval personnel stand guard near a ship carrying containers at the Gwadar port, some 700 kms west of Karachi, during the opening ceremony of a pilot trade programme between Pakistan and China on November 13, 2016.

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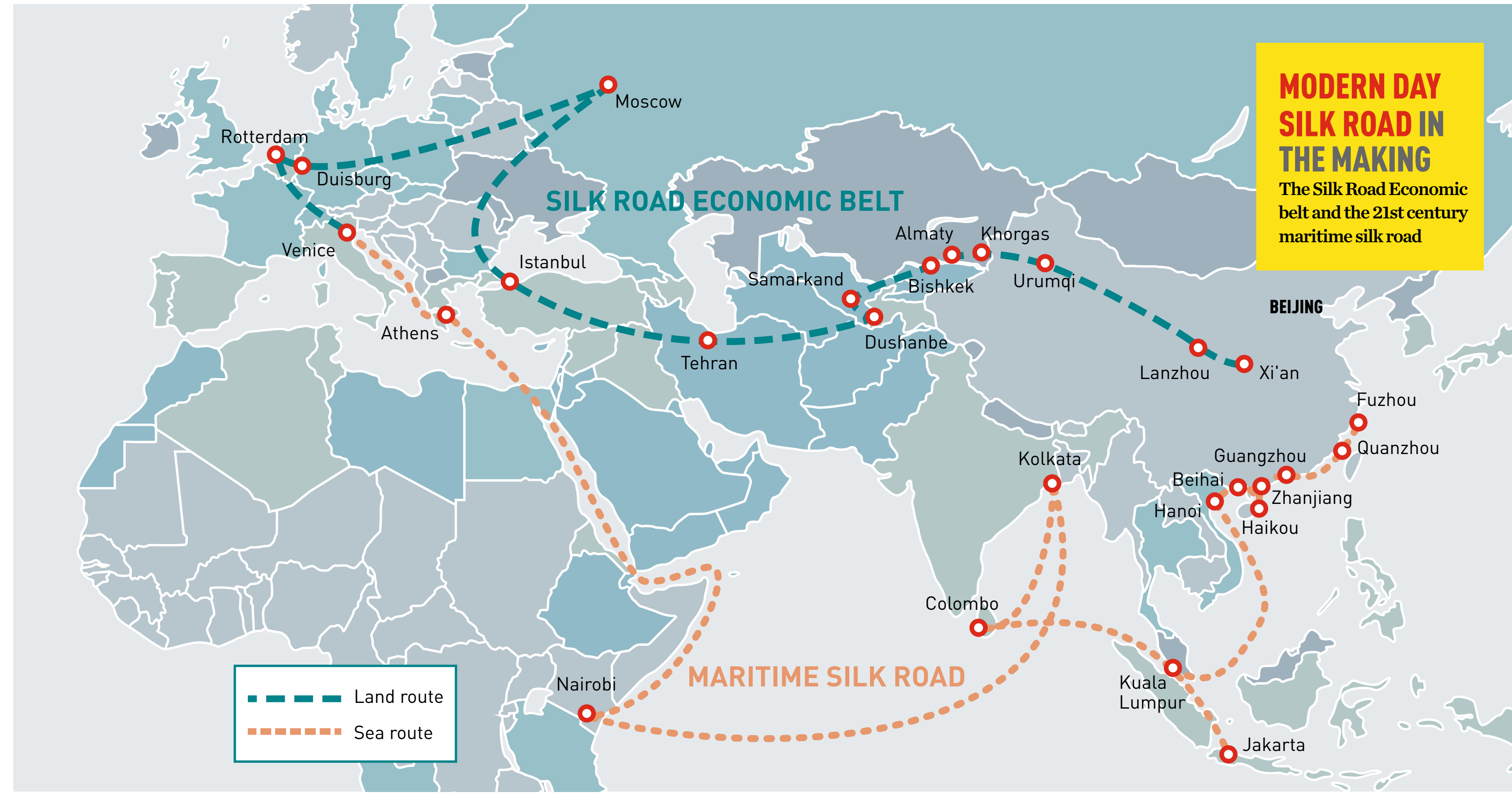

AS DEVELOPING COUNTRIES IN THE BRI SEEK TO MEET THEIR MASSIVE INFRASTRUCTURE DEFICIT AND BUILD THE CONNECTIVITY NEEDED TO BOOST TRADE, THEY MAY SIMILARLY ASK THEMSELVES WHO ELSE BUT CHINA IS PROPOSING A GRAND ENOUGH SOLUTION

The allure of big returns from Belt and Road projects is already colouring the debate about financial regulation in Hong Kong. The *South China Morning Post* reported in April this year that the Securities and Futures Commission would be more flexible in allowing listings of companies that are linked to the BRI.

One final risk brought for Hong Kong by the initiative is the risk of being left out altogether. "We should not underestimate the number of other international companies in the US and Europe and Japan who have more experience than us in dealing and working with many BRI countries for many years," says Lee of CUHK Business School. He cites the example of Indonesia. The archipelago nation is expected to play a prominent part of BRI initiatives and funding, yet Lee reckons that Hongkongers remain largely unfamiliar with it or other ASEAN countries.

Failing to grasp such opportunities risks sidelining Hong Kong's financial services industry. "I am not sure that the Belt and Road Initiative needs Hong Kong, as many of its functions could be filled by other regions. However, Hong Kong's uniqueness lies in the depth of its service sector and its geographic proximity to China, so the major risk that it faces is failing to take advantage of these opportunities," says Mazar's Weatherseed.