MARSH JLT SPECIALTY

INSIGHTS | SEPTEMBER 2019

The Belt and Road Initiative: Assessing Shifting Attitudes

MARSH

Contents

The Belt and Road Initiative

Comprised of the Silk Road Economic Belt and 21st Century Maritime Silk Road, the Belt and Road Initiative (BRI) is a US$1 trillion Chinese scheme aimed at developing integrated trade corridors across Asia, Europe, Africa, and the Middle East. Under the BRI, China is expanding its domestic and overseas investment in transport, as well as the associated energy, power, and industrial infrastructure required to strengthen trade links.

BRI was first mentioned by President Xi Jinping in September 2013 as he announced the Silk Road Economic Belt, which focussed on enhancing overland links. This was followed in October 2013 with the proposal of the 21st Century Maritime Silk Road, a sea-based route passing through Southeast Asia, Africa, and the Middle East.

In December 2014, China established the US$40 billion Silk Road Fund to finance the BRI. The introduction of the China-led US$100 billion Asian Infrastructure Investment Bank in January 2016 has also supported the initiative. To date, 170 agreements have been signed with 125 countries, totalling US$90 billion in investment. In March 2019, Italy became the first G7 country to join the initiative.

BRI was not conceived as an aid programme - the Chinese government aims to reap political, economic, and financial benefits from its investments. By financing capital-intensive infrastructure projects abroad, China is working to relieve domestic overcapacity in steel, cement, coal, and other sectors. To date, most lending under BRI has been conditional on the involvement of Chinese companies, whether in construction, operation of projects, or supply of materials. By financing overseas projects, China also aims to loosen links to the US dollar, diversify foreign-exchange reserves, and build the renminbi as a global currency.

However, since its inception six years ago, many countries have shifted their attitudes regarding BRI. While participating countries still recognise the value of Chinese financing that comes without conditions of economic or political reform, they have increased their scrutiny of the initiative. Criticism of BRI has focussed on corruption allegations, onerous financing terms, rising BRI-related debts in participating countries, and weak project implementation.

BRI projects are often highly politicised in their host countries, as governments balance the need for infrastructure investment with the geopolitical and economic implications associated with Chinese funding. This has led to a number of reviews and project cancellations following elections in countries such as Malaysia and Sri Lanka as incoming governments seek to reduce costs and improve transparency.

In recent months, China has demonstrated its willingness to respond to these concerns, using the second Belt and Road Forum in April 2019 as an opportunity to soften BRI's image. Chinese rhetoric at the forum highlighted that BRI is mutually beneficial for China and participating countries, and stressed that China would focus on delivering quality projects. China is also addressing key issues of debt and corruption. In Myanmar, Pakistan, and Malaysia, China has been willing to renegotiate the terms of specific projects to reduce costs, while also signalling a greater role for private financing. In July 2019, China's Central Commission for Discipline Investigation revealed plans to expand its aggressive domestic anti-corruption programme to international projects, embedding officers within key BRI projects.

The ongoing China-US trade dispute will have a mixed impact on BRI countries. Recent trade data suggest that China has expanded trade relations with states participating in BRI in an effort to offset reduced trade with the US. In particular, BRI countries in Africa and Latin America appear to be benefitting from increased demand in China for agricultural imports. Similarly, some Chinese companies are moving production processes to BRI countries, such as Vietnam, to avoid the impact of tariffs. However, this may result in increased US scrutiny of the origins of goods. In May 2019, the Trump administration introduced tariffs on Vietnamese aluminium and steel, highlighting that the country was being used by China to avoid duties.

The trade dispute may also affect financing for BRI projects. Anecdotal evidence suggests the financiers are increasingly cautious of funding projects where the credit quality of participating Chinese firms may weaken as a result of trade tensions. As a result, financing is likely to become more selective, favouring projects in those countries most likely to benefit from the trade war, such as Vietnam and Bangladesh.

In this paper, we outline the shifting attitudes to BRI and assess recent developments in Bangladesh, Indonesia, Malaysia, Myanmar, and Philippines. We also provide an overview of the cover and capacity available in the private political risk insurance market, which may be used to address key risks in BRI markets.

BRI Country Updates

Malaysia

BRI projects in Malaysia have faced additional scrutiny following Prime Minister Mahathir Mohamad's surprise election victory in May 2018. Immediately following the election, Mahathir criticised growing Chinese investment in the country, citing the sizeable debt that Malaysia was incurring. Total government debt is forecast at 72% of GDP in 2019, up from 68.4% in 2017. BRI projects were subsequently reviewed and three China-backed projects were suspended. In July 2019, the Malaysian government seized US$243.5 million from China Petroleum Pipeline Engineering's (CPP) in relation to a cancelled pipeline project. Mahathir justified the seizure by stating that while the project had been 80% paid for, it was only 13% completed upon cancellation.

However, project reviews do not necessarily suggest a wholesale rejection of BRI. The Malaysian government continues to recognise China's importance as a trade and investment partner, and has highlighted that the review of projects was primarily in response to rising debt levels and a desire to address suspected corruption under the previous government. In April 2019, Mahathir asserted his view that Malaysia could benefit from China's investment strategy.

Going forward, the Malaysian government is likely to take a project-specific approach to reviews, renegotiating terms where they are perceived to have a negative impact on domestic finances. For example, in April 2019, the Malaysian government announced that one suspended project, the East Coast Rail Link (ECRL), would be resumed after it had renegotiated terms with China. Under the revised deal, local participation in the construction phase will be increased from 30% to 40%, and the completed line will be operated under a 50-50 joint venture. Moreover, construction costs were reduced to US$10.7 billion from US$15.9 billion. For its part, China's renegotiation of project-specific terms with Malaysia is indicative of a greater willingness to address the concerns of partner states.

The ongoing China–US trade dispute will have a mixed impact on BRI countries.

KEY PROJECT UPDATE	VALUE
East Coast Rail Link	**US$10.7 billion (Phase I and II)**

Construction work on the 640 kilometre railway restarted in July 2019, following a one-year suspension, after the Malaysian government renegotiated terms with China. The line, which is about 10% complete, will connect Malaysia's East Coast states with Negeri Sembilan, Selangor, and the Federal Territory of Putrajaya.

Bangladesh

Bangladesh has participated in BRI since 2016, with total Chinese investment in the country estimated at US$38 billion. This makes Bangladesh South Asia's second-largest recipient of loans under the BRI banner. In July 2019, Bangladesh Prime Minister Sheikh Hasina signed nine instruments with China, including agreements for US$1.7 billion in loans for the development of the power sector.

In contrast to other Asian states, sentiment in Bangladesh toward Chinese investment appears to have remained largely positive in the last 12 months. Typically, China has proved itself willing to finance infrastructure projects that Western financiers had refused, including the Padma Multipurpose Bridge project.

However, Bangladesh has been prudent in its engagement with BRI, aiming to engage with China only on viable projects. For example, the government cancelled the Chinese-funded US$2.2 billion Sonadia deep-sea port in favour of a similar project at Matarbari proposed by the Japanese. The Bangladeshi government also appears confident that it can avoid the debt-trap facing other BRI economies in South Asia. Bangladesh's gross external debt burden stood at 21.7% of GDP in December 2018, and had an average repayment period of 31 years in June 2018. Given Bangladesh's elevated growth rates (forecast at 8.1% in 2019) the country is in a resilient position to incur additional debt.

KEY PROJECT UPDATE	VALUE
Payra Thermal Power Plant	**US$2.5 billion**

The 1,320 megawatt coal-fired power plant is a joint venture between Bangladesh and China, with China providing 85% of funding. The plant was due to be operational in early 2020, but completion was delayed by unrest in June 2019. Violence between Chinese and Bangladeshi construction workers left one Chinese national dead, while a directive control system went missing and hydraulics systems were suspended. The cost of damage inside the site has not been released. Construction work resumed at the plant on 3 July 2019.

Philippines

Since President Rodrigo Duterte took office in 2016, the Philippines has pursued a closer relationship with China, while allowing engagement with the US to cool. Since 2017, the Duterte administration has implemented its "Build, Build, Build" strategy, which aims to spend between US$160 billion and US$180 billion on infrastructure projects. Government officials have suggested that BRI complements these domestic infrastructure projects. In 2018, China pledged US$930 million in investments to the Philippines, and in April 2019 the two countries signed 18 agreements totalling US$18 billion. The agreements cover a variety of industries, including power, manufacturing, and infrastructure.

The Philippines' relationship with China is complex given overlapping territorial claims in the South China Sea (SCS). Duterte has faced growing domestic pressure to challenge Chinese activity in the SCS, following his decision to set aside an international arbitration ruling that invalidated China's territorial claims in exchange for greater investment levels. As a result, in April 2019, the Filipino government accused China of infringing upon its sovereignty after it allowed hundreds of vessels to pass close to an island claimed by the Philippines. A significant territorial dispute between the two countries could pose risks to BRI-related projects in Philippines.

KEY PROJECT UPDATE	VALUE
Chico River Pump Irrigation Project	**US$80 million**

The project aims to provide irrigation for 8,700 hectares of land in Kalinga and Cagayan provinces, supporting the agricultural sector. However, the project has become a focal point for criticism of growing debt owed to China, after a Philippines Supreme Court associate judge warned that China could seize Filipino territory if the country fails to repay Chinese debts. China is financing 85% of the project, at an interest rate of 2%. The loan agreement outlines a 20-year repayment period with a seven year grace period, with national assets acting as collateral. Any arbitration processes will occur in Beijing under Chinese laws.

Indonesia

Despite being an early participant in BRI, Indonesia has taken a cautious approach to engaging with China on investment projects. The Indonesian government has stressed that projects should not add to government debt and should be private-sector driven. It has also opted to not provide government guarantees for any BRI projects, ensuring that projects are based on business-to-business cooperation with the government acting as a facilitator for investment. Indonesia's sources of foreign financing are relatively diversified, with Japan playing a significant role in developing Indonesia's transport infrastructure.

Indonesia recognises the value of BRI, and has sought to take advantage of Chinese investment where its own interests can be met. Under President Joko Widodo, Indonesia's government has prioritised an ambitious infrastructure development programme, with spending of US$412 billion slated for the 2020-24. Indonesia is likely to allow Chinese participation in some of these projects.

Widodo's re-election in April 2019 gives him a strengthened platform on which to expand Chinese engagement. Having sought to avoid a "pro-China" label in the run-up to elections, Widodo signed 23 memorandums of understanding with China, totalling US$14.2 billion, two days following his re-election. Moreover, in April 2019, Indonesia asked China to establish a special fund within BRI for investment in the Indonesian economy. The scope and scale of the fund has not been specified, but followed an Indonesian offer to China to participate in projects worth US$91 billion. Participation in projects was offered on the condition that Chinese investors use environmentally friendly technologies, maximise use of local labour, implement training programmes for local partners, and that projects add value for upstream and downstream industries.

KEY PROJECT UPDATE	VALUE
Kayan River Cascade Hydropower Project	**US$17.8 billion**

Developed in five phases, the 900 megawatt phase one will be Indonesia's second largest power project upon completion in 2023. The project is under development by Kayan Hydro Energy, while Power Construction Corporation of China was awarded the EPC contract.

Myanmar

Myanmar's strategic relationship with China has strengthened in recent years, as relations with the West cooled over the government's treatment of Rohingya in Rakhine State in 2017. Since then, Myanmar has looked to use China's diplomatic support, while also agreeing to participate in BRI projects. In September 2018, the two countries signed a memorandum of understanding on the proposed China-Myanmar Economic Corridor (CMEC), connecting Kunming in China's Yunnan province to Mandalay, Yangon, and the Kyaukpyu Special Economic Zone in Myanmar.

However, there is an elevated risk that projects will not be realised, given unease in some quarters over China's growing influence in Myanmar. For example, of 38 projects proposed by China under CMEC, only nine had been approved by Myanmar's lawmakers as of April 2019. Only three of these projects have been made public: the Muse-Mandalay railway, three economic cooperation zones in Kachin and Shan states, and a special economic zone in Kyaukpyu. Moreover, public opposition led to the suspension of the China-funded 6,000 megawatt Mytisone dam in 2011.

Government concerns regarding falling into a debt-trap have increased the risks of contract renegotiations. For example, in August 2018 Myanmar announced that it would scale back plans for the Kyaukpyu deep water port in Rakhine state. The cost of the project was reduced from US$7.3 billion to US$1.3 billion, and the port will now only have two berths, down from an initial 10. Myanmar's deputy finance minister also highlighted that no sovereign guarantees would be given for the project's financing.

KEY PROJECT UPDATE	VALUE
Muse-Mandalay Railway	**Unspecified**

In May 2019, China Railway Eryuan Engineering Group (CREEC) submitted the technical report for the 430 kilometre Muse-Mandalay line, which forms part of the CMEC. The line will be part of the larger Kunming-Muse-Mandalay-Kyaukpyu line, connecting the Chinese border with Kyaukpyu port in Myanmar. However, the project structure is currently unclear, and it has not been revealed whether it will be operated as a joint venture or public private partnership. The line will also pass through Shan state, the location of ongoing armed conflict in Myanmar, elevating security risks during the construction period.

FIGURE
1

Contractual agreement repudiation risk highest in Africa, Middle East

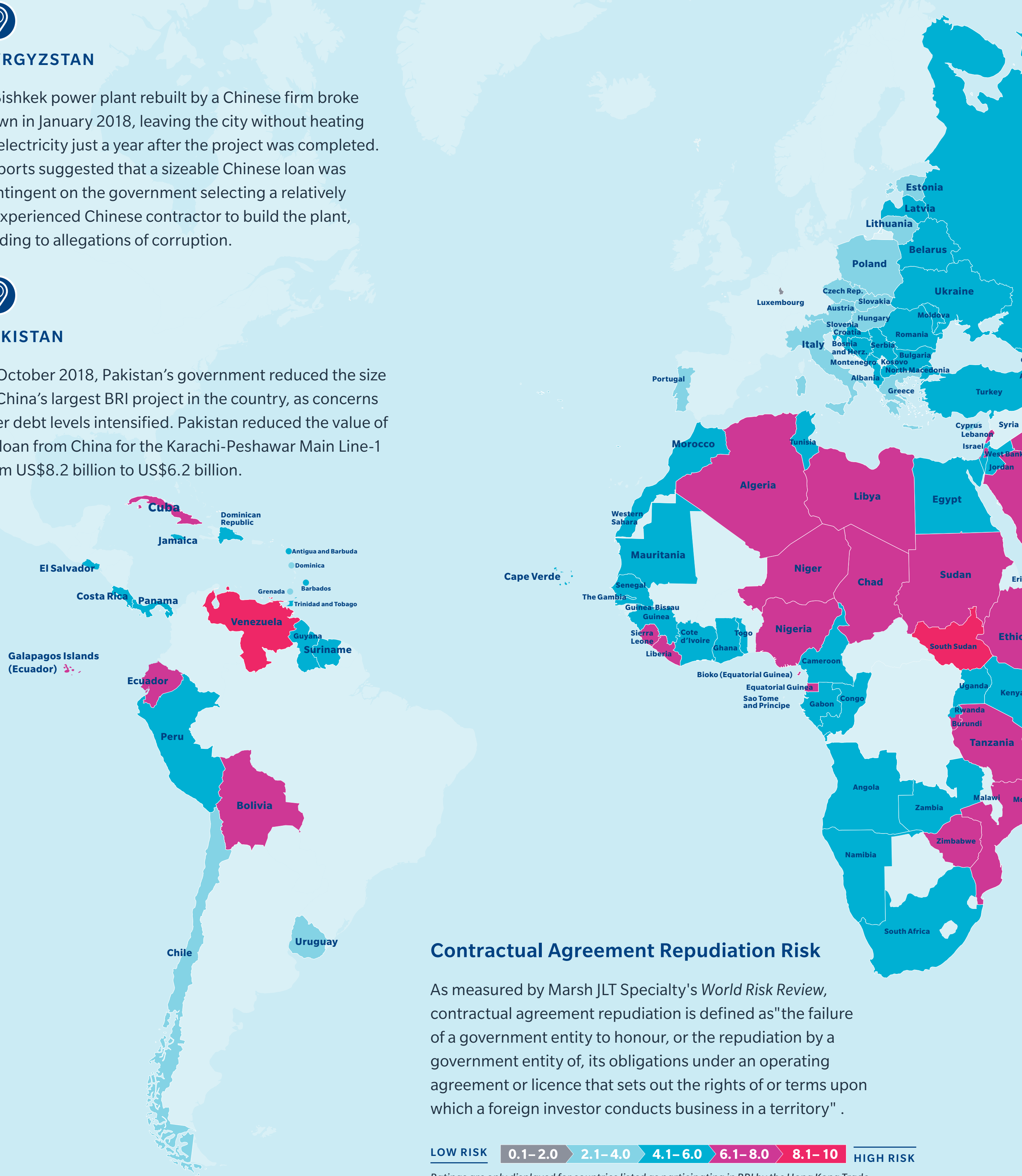
SOURCE: MARSH JLT SPECIALTY WORLD RISK REVIEW

KYRGYZSTAN

A Bishkek power plant rebuilt by a Chinese firm broke down in January 2018, leaving the city without heating or electricity just a year after the project was completed. Reports suggested that a sizeable Chinese loan was contingent on the government selecting a relatively inexperienced Chinese contractor to build the plant, leading to allegations of corruption.

PAKISTAN

In October 2018, Pakistan's government reduced the size of China's largest BRI project in the country, as concerns over debt levels intensified. Pakistan reduced the value of its loan from China for the Karachi-Peshawar Main Line-1 from US$8.2 billion to US$6.2 billion.

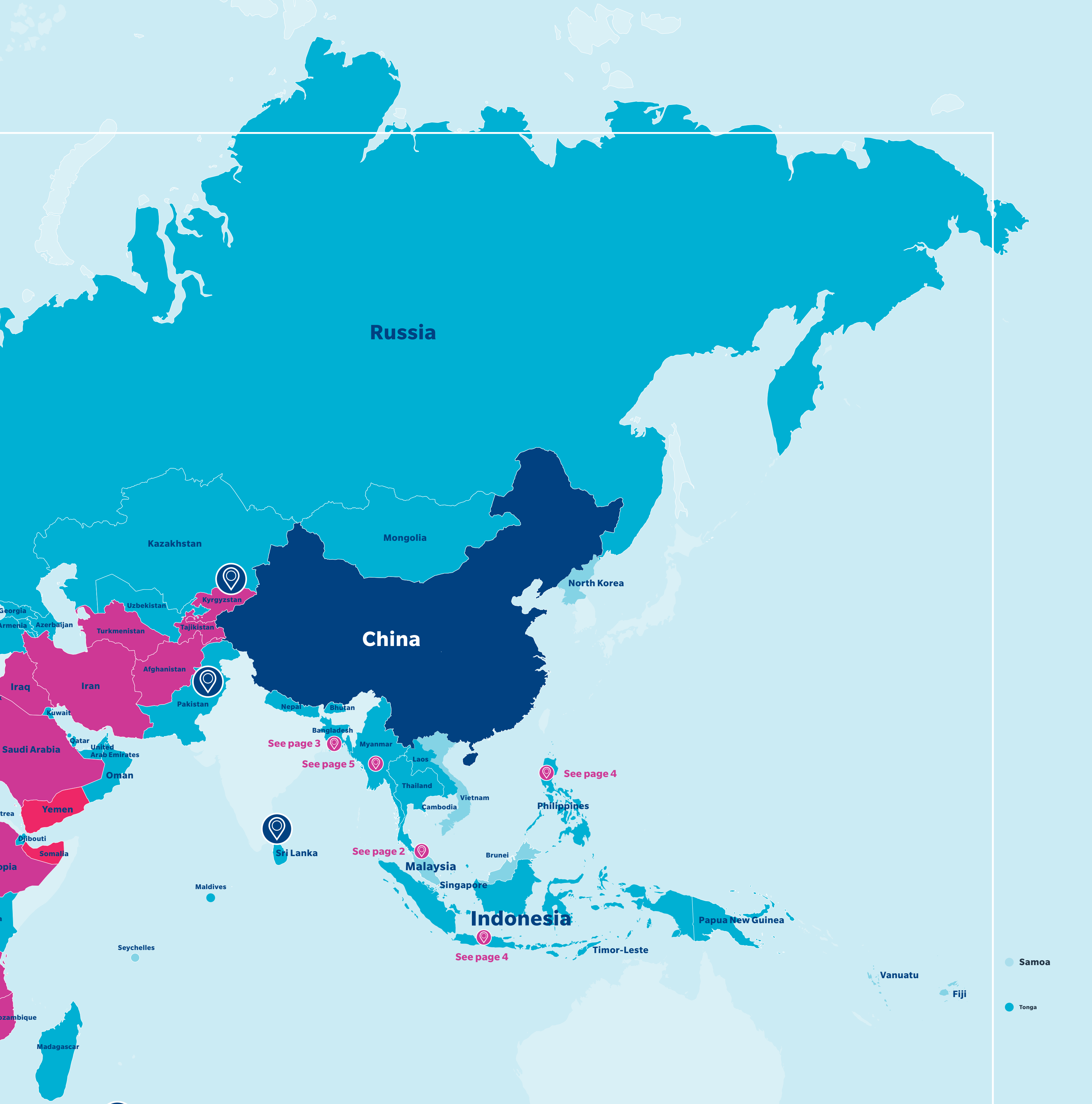


Contractual Agreement Repudiation Risk

As measured by Marsh JLT Specialty's *World Risk Review*, contractual agreement repudiation is defined as"the failure of a government entity to honour, or the repudiation by a government entity of, its obligations under an operating agreement or licence that sets out the rights of or terms upon which a foreign investor conducts business in a territory" .

LOW RISK 0.1–2.0 2.1–4.0 4.1–6.0 6.1–8.0 8.1–10 HIGH RISK

Ratings are only displayed for countries listed as participating in BRI by the Hong Kong Trade Development Council.



SRI LANKA

In 2017, Sri Lanka ceded control of the Hambantota Port and the surrounding 15,000 acres to China for 99 years. Sri Lanka hoped that the US$1.1 billion deal would help it to repay sizeable debts owed to China. In April 2019, the country's prime minister gave assurances that the port's security operations would remain under Sri Lankan control.

Today's Private PRI Market: Cover, Capacity, and Claims

Insurers in the private political risk insurance (PRI) market offer cover for the full spectrum of infrastructure projects.

The mandatory red line for any underwriter is sanctions from the EU, UN, OFAC, UK, and others. Where these are in place, private market PRI is not available.

Cover

Under the heading of PRI, the private market offers a menu-style set of political risk coverages that policyholders can buy individually or together as an all-encompassing blanket coverage to create a bespoke insurance programme to match their needs.

Financial institutions can purchase lenders interest coverage to insure their debt share of a project against default by a borrower under a loan agreement or lease as a result of specified political risk events. Lenders increasingly require sponsors to buy PRI for their equity share of a project as well, and will often only disperse funds once it is in place.

Underwriters offer tailored policy wording to cover default on scheduled payments or loss of equity investment caused by perils including:

- Abandonment due to political violence.
- Confiscation, expropriation, nationalisation, and deprivation.
- Contract frustration/cancellation.
- Currency inconvertibility and non-transfer.
- Deprivation.
- Export/import restrictions.
- Forced divestiture.
- Political violence including war.
- Non-honouring of an arbitration award by a government entity (breach of contract).

These insurable perils are not exhaustive; other insured causes of loss range from license cancellation to export embargo.

The most commonly sought coverage from insureds today is non-payment insurance, which can be broadly categorised as contract frustration or comprehensive credit insurance. Contract frustration cover protects an insured against the failure of a sovereign or majority publicly owned counterparty to perform its contractual performance or payment obligations for any reason whatsoever. Comprehensive credit cover protects an insured against the failure of a privately owned counterparty to perform its contractual performance or payment obligations for any reason whatsoever.

These coverage lines can be effectively combined with a PRI policy or purchased separately. The extensive scope of this cover and the performance of carriers is an important consideration as some insureds at times have questioned whether private market insurers would cover losses on such a wide basis.

FIGURE 2

Available capacity for some risks now exceeds $US3 billion.

SOURCE: MARSH JLT SPECIALTY

COMPREHENSIVE CREDIT

Up to 5 years	US$2.4 billion
Up to 7 years	US$1.9 billion
Up to 10 years	US$1.1 billion
In excess of 10 years	US$540 million

CONTRACT FRUSTRATION

Up to 5 years	US$3.1 billion
Up to 7 years	US$2.9 billion
Up to 10 years	US$2.1 billion
In excess of 10 years	US$1.1 billion

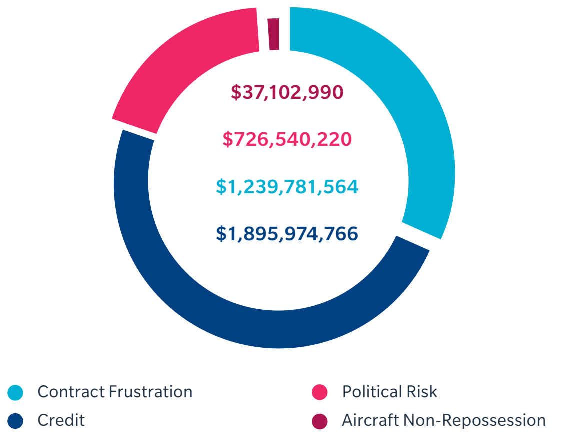
POLITICAL RISKS

Up to 5 years	US$3.1 billion
Up to 7 years	US$2.9 billion
Up to 10 years	US$2.3 billion
In excess of 10 years	US$1.2 billion

FIGURE 3

Political risk claims from 1997 to 2017.

SOURCE: LLOYD'S PAID POLITICAL RISKS CLAIMS FROM XCHANGING



Political Violence Cover

Political violence (PV) is commonly stripped out of a policy and handled separately in the terrorism insurance market, if it is a short-term risk (12 to 24 months) and protects physical assets from losses incurred as a result of political acts and/or deteriorating security environments.

Insurable political violence risks include:

- Terrorism.
- Sabotage.
- Strikes, riots, and civil commotion.
- Insurrection, revolution, and rebellion.
- War on land.
- Civil war and coup d'état.
- Insurable losses from these events include:
- Physical damage.
- Business interruption following physical damage for losses including of net profit, revenue, and rent.
- Liability, including employee and public.
- Losses caused by nuclear, biological, chemical, and radiological (NBCR) terrorism.
- Industry-specific extensions, for example, control of well.

Once project sponsors, developers, lenders, and financiers have assessed their exposures and quantified their potential liabilities, they can purchase cover to create a unique insurance programme that satisfies their needs and those of associated stakeholders.

Typically, the private PRI market offers AA- and A+ rated underwriting security. Policy periods offered can be up to 15 years, illustrating the private market's ability to match ECA offerings and client demand. The theoretical capacity available for some individual risks now exceeds US$3 billion (see Figure 2). The capacity available for different covers and a range of tenors is outlined in more detail below.

Credit Losses Top the List of Claims

The private PRI market has a record of successful claims payments made in full for policies placed over the past 20 years. From 1997 to 2017, three categories of political risk claim accounted for 98% of the total US$3.9 billion paid out by insurers, according to Lloyd's (see Figure 3). Credit losses accounted for the highest percentage of losses (49%), followed by contract frustration (31%), and political risks (18%).

Contrary to popular belief, acts of war and/or terrorism are not the biggest source of PRI losses - credit claims generate the biggest losses, by far. Bespoke wording and cover options from the private market can ensure these losses are effectively covered.

According to Lloyd's Market Association and pooled broker agreements, from 2007 to 2017 Lloyd's received a total of 436 claims. Of these, 97% were paid in full and 3% received compromised settlements. The compromised settlements were all due to non-fulfilment of policy terms and/or obligations by the insured; on average these settled at 44% of the amount claimed.

The problems typically arose because the financial entities in question did not have sufficiently robust due diligence procedures in place, and had failed to identify and inform the market of information that could have materially affected the underwriter's decision to accept the risk. The market did not repudiate these claims, but worked with insureds to reach the stated compromised settlements. The total amount of claims made by financial institutions during this period amounted to US$2.7 billion, with US$2.6 billion paid in full, according to data from Lloyd's Market Association (LMA) and pooled broker information where collaboration has been agreed.

Over the years the private market has evolved its policy wordings to ensure there is a transparent route to indemnity for insureds, and to minimise grey areas. Bespoke wording and coverage options from the private market can help ensure that losses are effectively covered.

For further information, please contact your local Marsh office or visit our website at marsh.com, or contact:

ROBERT PERRY
Managing Director, Credit Specialties Leader - Asia
+65 6922 8035
robert.perry@marsh.com

MARK WONG
Managing Director, Political Risk & Structured Credit Leader,
Credit Specialties – Asia
+65 6411 9641
mark.wong@marsh.com

KOH WEI JUN
Regional Director, Political Risk & Structured Credit Leader,
Credit Specialties – Hong Kong
+852 2864 5336
weijun.koh@marsh.com

MARSH JLT SPECIALTY

We are specialists who are committed to delivering consulting, placement, account management, and claims solutions. We consider problems from every angle and challenge the status quo with entrepreneurial ideas and solutions.

With unparalleled breadth, our Marsh JLT Specialty global team is united by a determination to bring the most experienced and relevant specialist resources to our clients, regardless of where they are located. Our local specialists work seamlessly with global experts, together creating and delivering tailor-made risk and insurance solutions which address each client's unique challenges.

The Credit Specialties Practice delivers payment, performance and country risk, and insurance knowledge through a diverse and creative global team.
We specialise in using insurance risk capital to optimise our clients' results. We enable growth and enhance returns by facilitating sales, replacing collateral, securing finance, and releasing capital in a world of continuous change.

We have been one of the leaders in political risk insurance since the advent of the market in the early 1980s. We operate in 55 locations and have more than 750 colleagues.