MARSH JLT SPECIALTY

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The Belt and Road Initiative: Challenges and Opportunities Amid COVID-19

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Contents

Introduction

The Belt and Road Initiative (BRI) is a Chinese government infrastructure development strategy encompassing an area that accounts for 30% of global GDP, 40% of GDP growth, and 60% of the world's population. Heading into 2020, there were nearly 3,000 active BRI projects, involving more than 2,600 companies, with a combined value of close to USD4 trillion.

Although this represents significant progress for the BRI, in the seven years since the project launched, it has arguably never faced a more challenging risk environment. Managing political, economic, and investment risks has been made more difficult by COVID-19.

BRI projects are often highly politicized in their host countries, as governments' balance the need for infrastructure investment with the perceived political and economic implications of Chinese lending. Even before the pandemic, the difficulty in finding that balance highlighted tensions and fractures between China and several host countries, in conceiving, developing, and executing BRI infrastructure projects. Now, amid the COVID-19-induced global economic downturn, the issues of debt sustainability and asset seizures are growing concerns among both investors and insurers.

BRI projects are likely to face delays and difficulties getting off the ground, as banks and financial institutions scale back funding in response to the challenging economic outlook. Chinese development banks – such as the Silk Road Fund, the New Development Bank, and the Asian Infrastructure Investment Bank – are main sources of BRI funding.

In this white paper, we outline the opportunities and challenges facing investors in the BRI, and provide updates on recent developments in Malaysia, Bangladesh, Philippines, Indonesia, and Myanmar.

A total of 184 new BRI projects with a combined project value of USD137.43 billion were announced in the first quarter of 2020. This is down from 218 new projects announced in the same period last year, a 15.6% year-over-year contraction. The total value of new projects declined 64.4% year-over-year. More than USD90 billion of China-linked BRI projects were delayed, temporarily halted, or abandoned in the first three months of 2020.

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COVID-19 significantly disrupted global manufacturing and supply chains, causing delays to BRI projects throughout the world and impairing Chinese GDP growth. In the short term, the BRI faces a slowdown in activity due to restrictions on the movement of Chinese labor and materials, and a broader strategy to contain COVID-19. China's domestic challenges, including its long-term response to the virus, and support for its financially stressed small and medium enterprise (SME) sector, will take precedence.

This will likely divert focus and resources away from the BRI in the next 12 months. However, over the medium to long term, the quality of BRI opportunities should improve, owing to greater participation of the private sector and foreign companies.

Servicing Debt

COVID-19 is likely to intensify concerns around the sustainability of BRI-linked debt. Debt service on Chinese lending accounts for 60% of all principal and interest payments due this year, for the 73 countries eligible for an eight-month moratorium offered by the G20 group of countries.

BRI host countries' ability to meet their payment obligations in the immediate future is uncertain as the pandemic creates additional financial pressures, stalls economic activity, and threatens a decline in export revenues. This could precipitate growing efforts to renegotiate BRI-linked debt, or lead to an increasing number of defaults.

Pakistan is one of the countries which recently opened debt renegotiation talks with China. Pakistan is due to pay China USD615 million of bilateral debt between May 2020 and June 2021.

Emerging markets with significant BRI-linked debt vulnerability to China now face extraordinary fiscal pressures, in order to combat the economic impact of COVID-19 domestically.

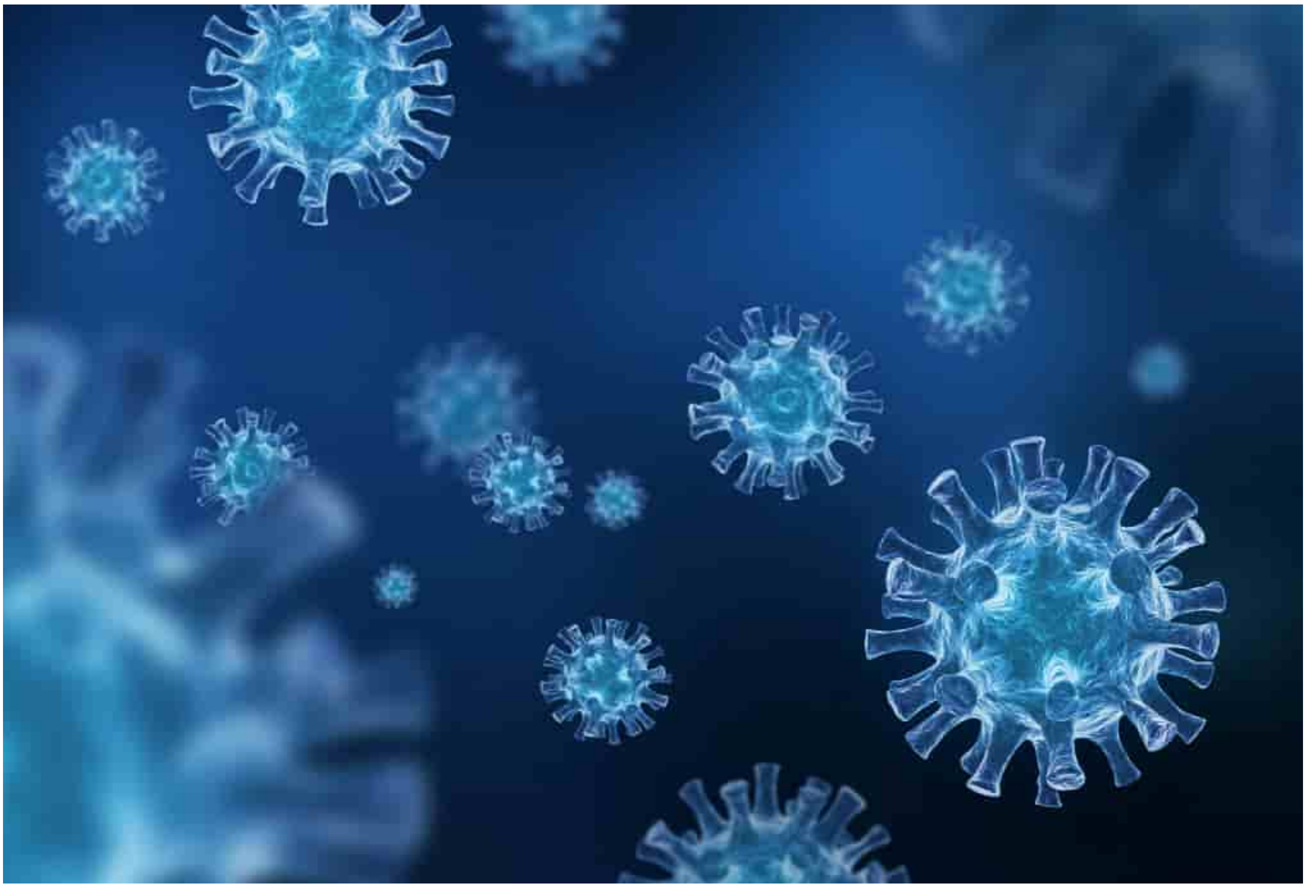
The rising likelihood of debt distress among BRI countries increases the risk of asset seizures. Angola, Malaysia, Mozambique, Vietnam, and Zambia are among those BRI host countries most vulnerable to debt distress in the next 12 months.

To date, the BRI has enjoyed relatively wide support. However, its political future depends on implementation and delivering economic results, which have been made more challenging by COVID-19.

Managing political risk is likely to become even more critical in the year ahead. Many countries are prioritizing health care and welfare spending over new seaports and airports. As a result, infrastructure projects face acute financing pressures and political opposition.

In recent years, changes in government led to the review and suspension of BRI projects in Malaysia and Sri Lanka. In 2020, elections in Mongolia and Tajikistan may increase political opposition to the BRI, with both countries displaying debt vulnerability and worsening economic outlooks.

Legal and regulatory risks linked to the BRI will continue to concern investors. Given the increased likelihood of non-payment risk by BRI host countries in the next 12 months, debt renegotiations and contractual agreement repudiation are also of growing concern.



Country Insights

Malaysia

Malaysia is a key player in the BRI. It ranks third in the world in terms of BRI-linked project value, at USD160 billion. Malaysia also ranks ninth in the total number of BRI-linked projects, with approximately 60 underway heading into 2020. Key projects include the East Coast Rail Link (ECRL), which forms part of the overland belt connecting Malaysia and China; and the Melaka Gateway development and Kuantan deep-sea port expansion, which are part of the growing Maritime Silk Road.

BRI projects in Malaysia face increased risk of contract alteration in the next 12 months. Following the election of Prime Minister Mahathir Mohamad in 2018, Malaysia has adopted an assertive stance on the BRI and the long-term implications of BRI-linked debt sustainability. The government faces a challenging year, in which the Malaysian economy is forecast to contract by 1.5%. Malaysia's debt-to-GDP ratio is forecast to increase from 72% in 2019 to 77% in 2020.

BRI projects are likely to receive strong support from the Malaysian government if they advance both domestic and foreign policy objectives. Despite renegotiation in 2019, the BRI-backed ECRL has received continued support from Malaysia because the new route will help to bring back approximately USD66 billion worth of indirect trade with China that is currently directed through the Port of Singapore.

Projects at risk of delays and suspension include Forest City, a USD100 billion luxury mixed-use development in the state of Johor, which has slowed due to supply chain disruptions caused by COVID-19. Built and financed largely by Chinese loans, only one of the project's eight development phases has been completed ahead of a project completion date of 2035.

On March 1, 2020, Muhyiddin Yassin became Malaysia's eighth Prime Minister, following the resignation of Mahathir Mohamad. Prime Minister Muhyiddin leads a coalition government with a small majority, increasing the likelihood of political instability in the next 12 months. Policy priorities of Prime Minister Muhyiddin will become clearer when the government delivers its 2021 budget in October.

BRI projects in Malaysia are at increased risk of contract alteration in the next 12 months.

KEY PROJECT UPDATE	VALUE
East Coast Rail Link (ECRL)	**USD10.6 billion**

The ECRL is a major infrastructure project, laying 640 kilometers of standard gauge double-track railway between states on the east coast and west coast of Peninsular Malaysia. When completed, in 2026, the ECRL will run through 20 stations in the states of Kelantan, Terengganu, Pahang, Negeri Sembilan, Putrajaya, and Selangor. It will reduce the travel time between the route's origin in Khota Bharu, Kelantan, and Putrajaya from four to two hours.

In 2018, Prime Minister Mohamad delayed construction on the ECRL project, citing concerns over cost. In May 2019, Malaysian and Chinese authorities agreed restructured financing for the ECRL, leading to the project's total cost reducing from USD15.8 billion to USD10.6 billion.

Under the new arrangement, China Communications Construction Company is working alongside the Malaysia Rail Link under a 50-50 joint-venture framework. Local workers now account for 70% of the jobs created by the ECRL project.

Bangladesh

Bangladesh ranked sixth, globally, in the number of BRI-linked projects, as of January 2020. It is the second-largest recipient of BRI loans in South Asia, and a component of the Bangladesh, China, India, and Myanmar Economic Corridor (BCIM).

On average, the BCIM's economies are projected to experience a 3.2% reduction in shipment times to the rest of the world, and a 4% reduction with other corridor economies, by 2030. The reduced trade costs, due to improved connectivity, will also improve real income, potentially bolstering the popularity of the BRI among BCIM partner countries. According to the World Bank[1], the BRI will facilitate greater access to global export markets, presenting large gains of 6.9% in real income across Bangladesh.

Bangladesh has historically benefitted from its strategic position between the competing powers of China and India. The geopolitical rivalry between China and India could open up new investment opportunities for Bangladesh. As evidence of strengthening Sino-Bangladeshi relations, in July 2020 China granted duty free access to 97% of Bangladeshi export products. Bangladesh also requested an additional infrastructure fund from China worth USD6.4 billion — USD 1.6 billion of which will expand the existing Payra Port. Other proposed projects include USD1.2 billion for a 10-kilometer bridge connecting Barisal and Bhola in the Ganges delta.

[1] World Bank. 2019. Belt and Road Economics : Opportunities and Risks of Transport Corridors. Washington, DC: https://openknowledge.worldbank.org/handle/10986/31878

KEY PROJECT UPDATE	VALUE
Payra Thermal Power Plant	**USD2.5 billion**

The 1,320-megawatt power plant began test production in January 2020. After facing delays due to COVID-19, it began supplying electricity to the national grid in May 2020. The mega-project currently has one operational unit, supplying 660 megawatts of electricity to the national grid.

The second unit of the plant is likely to face operational delays. The project is currently staffed by around 1,500 workers, against a usual staff of 4,000, due to COVID-19 labor safety measures. The project forms part of the government's objective to produce 40,000 megawatts of energy by 2030.

Philippines

Deficiencies in transport infrastructure have long constrained the Philippines' economic growth. The BRI can facilitate increased competitiveness in the country's economy, if executed effectively. However, political disruption in the Philippines remains a major risk to infrastructure investors.

Despite President Rodrigo Duterte's geopolitical pivot to China upon election in 2016, the upcoming 2022 election, in which Duterte is ineligible to run, carries the risk of a policy change. The Philippines has precedent, having changed course on the China-backed Northrail project, linking Manila with Malolos in the Bulacan province. The infrastructure project began procurement during the government of Gloria Arroyo and discontinued under the administration of Beningo Aquino, with no alternative provided.

Project implementation has been stifled by delays and modifications to development plans. Projects are occasionally at risk of delay due to local opposition, and the lack of an established national framework to coordinate feasibility studies.

In 2016, the Pulangi 5 hydropower project being developed by PowerChina Guizhou and the Philippines' Greenergy Development Corporation encountered regulatory challenges. The project suffered delays because of investor concerns over the Bangsamoro Basic Law (BBL), which granted a high level of autonomy, including some aspects of Sharia law, to Muslim areas of southern Philippines. Major investment projects in the Mindanao province were temporarily delayed while investors conducted feasibility studies and reviewed the implications of the BBL.

The Philippines is vulnerable to the global economic slowdown. At least 13 domestic industries, with a collective value of over USD300 billion, could face a decline in exports in 2020. The Philippines' total exposure in terms of exported goods to China — its largest trade partner — is worth around 1.6% of its GDP. The Philippine National Bank (PNB) estimates that COVID-19-related supply chain disruption could reduce national output by up to 2% over the next 12 months.

Within the BRI, Beijing and Manila focus on five key areas of cooperation: policy coordination, trade and investment facilitation, infrastructure development, financial integration, and people-to-people connectivity.

On infrastructure development, China pledged more than USD9 billion in loans for large-scale Philippine infrastructure projects, as part of President Duterte's "Build Build Build" program, upon his election in 2016. However, by 2019, only USD924 million in Chinese loans and grants had been administered to the Philippines.

Progress on the BRI in the year ahead is likely to be limited by the economic downturn and delays in trade, investment, and people-to-people exchanges between China and the Philippines. Even as economic activity in China begins to normalize in the second half of 2020, the risk of supply and demand shocks remain, with COVID-19 cases continuing to rise in the Philippines. As of August 2020, the Philippines had the highest number of COVID-19 cases in Southeast Asia.

KEY PROJECT UPDATE	VALUE
South Pulangi Hydropower Project	USD800 million

The USD800 million dollar South Pulangi Hydropower project is at risk of delays, particularly if the political situation pivots back away from China in the coming years. The project is located north of Mindanao City, the home city of President Duterte, and aims to improve power supply reliability and resilience in the wider Mindanao Province.

However, projects in the Philippines can face opposition from local communities, driving an increased protest risk. If the South Pulangi Project were to face protests, activists and local communities would likely set up roadblocks, increasing the risk of business disruption. However, protests are unlikely to cause property damage.

Indonesia

Indonesia ranks eighth in the number of BRI-linked project value and the total number of BRI projects in the country. More than USD60 billion was invested in over 70 BRI-linked projects, as of the first quarter of 2020. Indonesia is Southeast Asia's largest economy, and China considers the country a key stakeholder in the BRI. Bilateral relations have remained stable, due to a mutual desire to foster a strong maritime partnership and cooperate on infrastructure development.

The re-election of President Joko Widodo in May 2019 bodes well for the success of the BRI, given that infrastructural development formed the basis of his re-election campaign. Government spending of USD412 billion has since been earmarked for the 2020-2024 infrastructure program, of which China is expected to play a major role as an investor.

The Indonesian government continues to take a concerted risk management approach toward the BRI, by targeting Chinese investment in business-to-business activities. This approach allows the Indonesian government to act more as a facilitator of investment and development. BRI investment targets industries that add high value and involve technology transfer between partners.

KEY PROJECT UPDATE	VALUE
Jakarta-Bandung High-Speed Railway	**USD6 billion**

Indonesia's Jakarta-Bandung high-speed railway is a key project in the BRI. The high-speed railway line is set to cut travel times between Jakarta and Bandung by at least four hours. However, the rail project is facing a one-year delay due to supply chain disruption caused by COVID-19. The Indonesian government imposed a temporary ban on all flights to and from China in February, thereby cutting off the flow of Chinese labor and imports.

Myanmar

Myanmar underlined its strategic importance to China under the BRI in January 2020, signing 33 additional bilateral agreements on the first visit of a Chinese leader to Myanmar in 19 years. The agreements, signed by President Xi Jinping and Myanmar State Counsellor Aung San Suu Kyi, include a commitment to accelerate the development of railways linking China to Kyaukphyu on the Bay of Bengal in Rakhine state, and the construction of the Kyaukphyu deep-sea port and special economic zone.

China is Myanmar's largest trading partner and its third-largest source of inward foreign direct investment, reflecting deepening ties between the two countries. The government-appointed Myanmar Investment Commission estimates there was over USD21 billion in approved Chinese foreign direct investment, as of the first quarter of 2020. The centerpiece of this investment is the 1,700-kilometer China-Myanmar Economic Corridor (CMEC), which represents more than 30 BRI projects, and is designed to deepen bilateral integration. Projects include the high-speed Muse-Mandalay railroad linking southern China with Myanmar's norther border, the central city of Mandalay and Myanmar's southern coastline.

However, the risks of project delays and contract alteration remain a concern. In 2018, Myanmar renegotiated the Kyaukphyu deep-sea port project down to USD1.3 billion, from an initial cost of USD7.3 billion. This was amid fears that the debt incurred on the project was unsustainable. The risk of contract alteration is likely to intensify, given uncertainty in the current domestic political climate.

The ruling National League for Democracy (NLD), led by Aung San Suu Kyi, has stated that it is not in favor of seeking a coalition partner for the next election, meaning a contest between the NLD and the military-backed Union Solidarity and Democracy (USDP) party is the most likely outcome.

The NLD's failure to uphold its 2015 election promises, including negotiating a peace agreement with insurgent groups, will have weakened its support base. Given the existing security and economic challenges, some voters are likely to support alternatives to the NLD ahead of Myanmar's parliamentary elections on November 8, 2020. However, the NLD will likely use Myanmar's low reported number of COVID-19 cases relative to other Southeast Asian countries to generate support for political continuity over the coming months.

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KEY PROJECT UPDATE	VALUE
Kyaukphyu Deep-Sea Port	**USD1.3 billion**

The Kyaukphyu deep-sea port will complete the final section of the China-Myanmar Economic Corridor, connecting industrial parks in the southern Chinese province of Yunnan with the industrial region of Kyaukphu in Myanmar.

The 25-meters deep-sea port will connect oil and natural gas pipelines to the Indian Ocean. Currently, 80% of China's oil travels through the Malacca Straits chokepoint, leaving it vulnerable to blockades in disputed waters around the South China Sea. The deep-sea port would grant both China and Myanmar a strategic advantage, consolidating trade and economic ties, while contributing to regional development and growth of a local economy in Kyaukphyu. The port is currently at the early stages of development: The Chinese state-owned enterprise (SOE) CITIC Group Corporation began environmental and social impact assessment in February 2020.

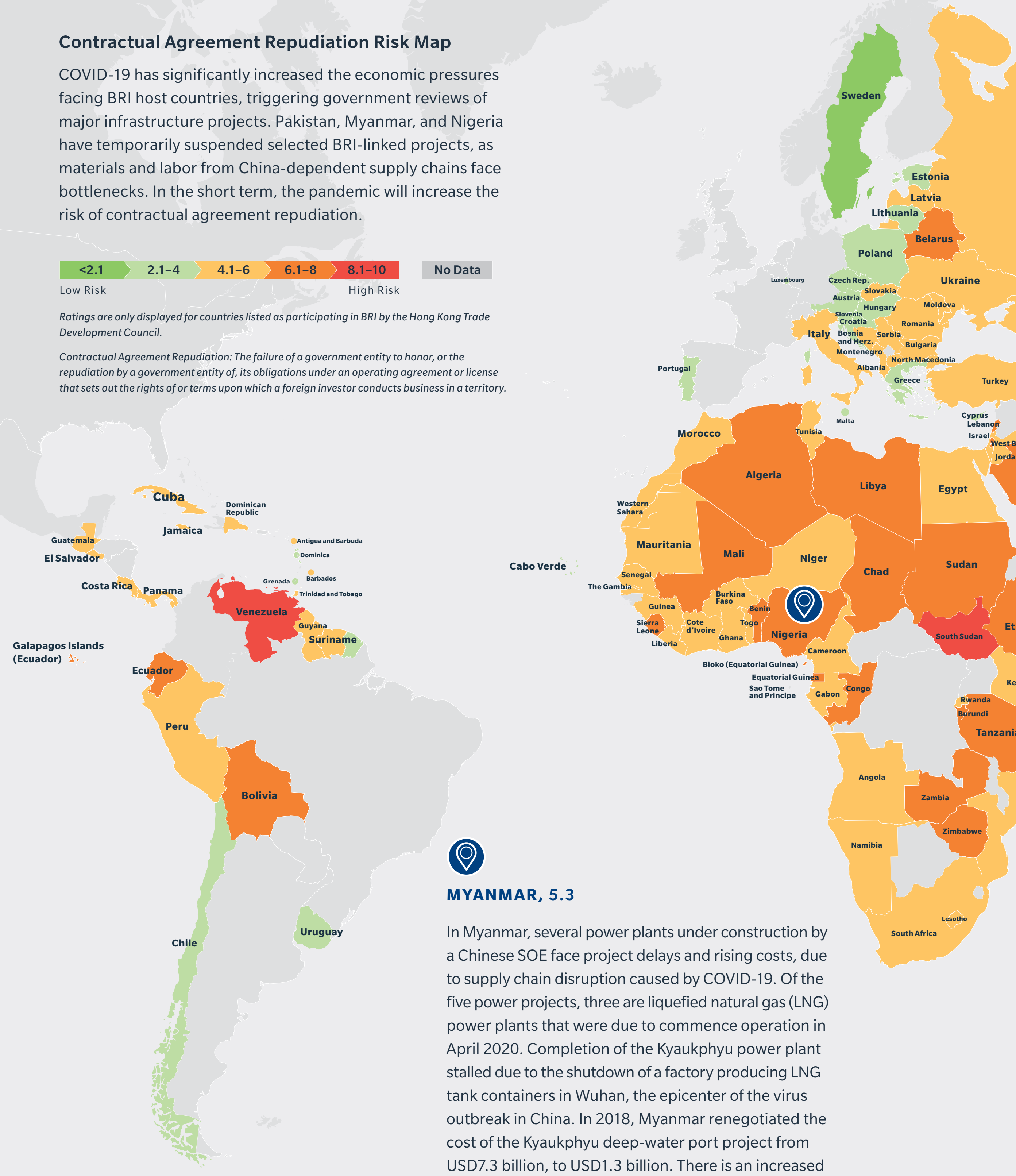
FIGURE 1

Contractual agreement repudiation risk has recently risen in many BRI countries.

SOURCE: MARSH JLT SPECIALTY WORLD RISK REVIEW

Contractual Agreement Repudiation Risk Map

COVID-19 has significantly increased the economic pressures facing BRI host countries, triggering government reviews of major infrastructure projects. Pakistan, Myanmar, and Nigeria have temporarily suspended selected BRI-linked projects, as materials and labor from China-dependent supply chains face bottlenecks. In the short term, the pandemic will increase the risk of contractual agreement repudiation.

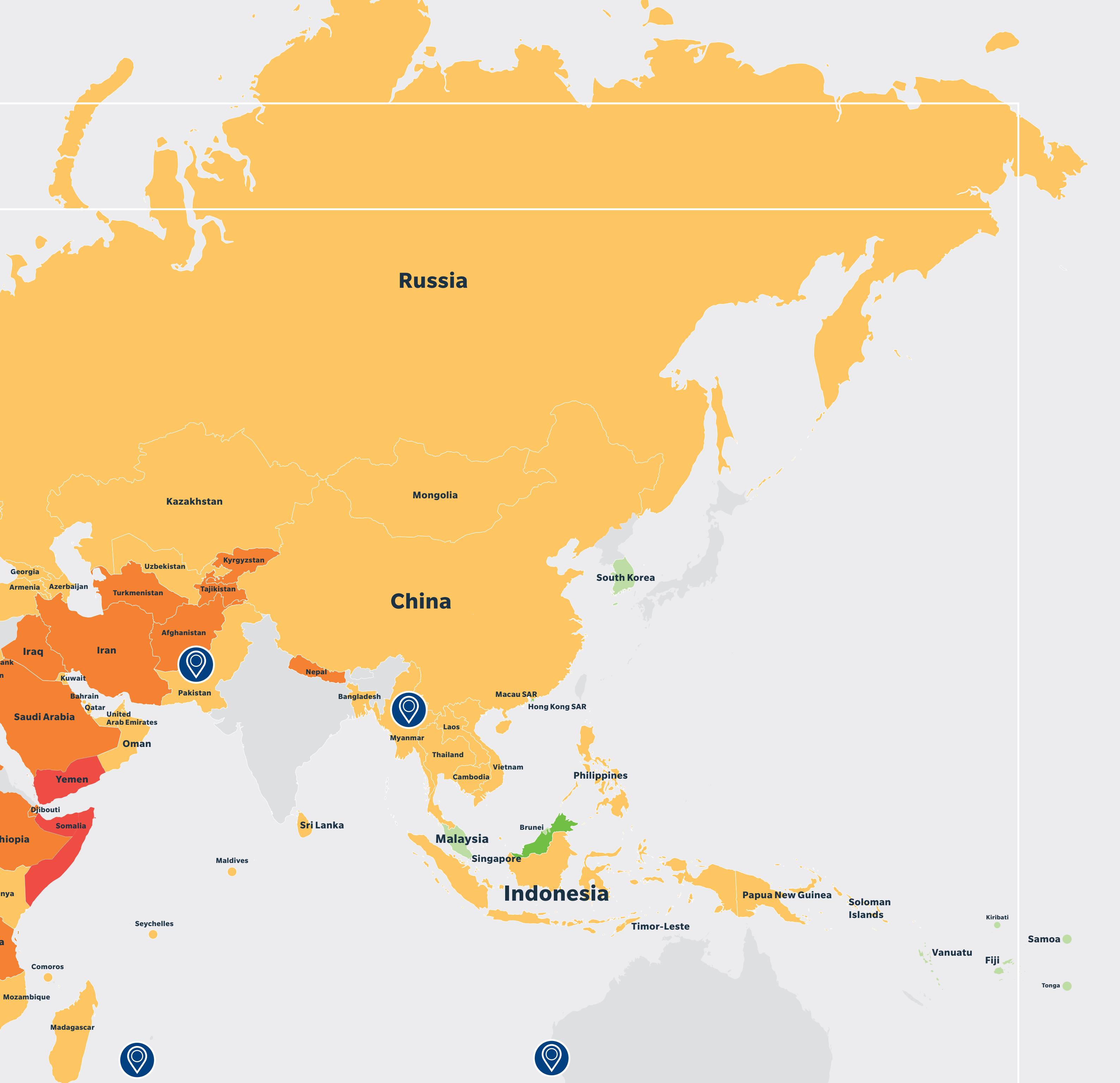


Ratings are only displayed for countries listed as participating in BRI by the Hong Kong Trade Development Council.

Contractual Agreement Repudiation: The failure of a government entity to honor, or the repudiation by a government entity of, its obligations under an operating agreement or license that sets out the rights of or terms upon which a foreign investor conducts business in a territory.

MYANMAR, 5.3

In Myanmar, several power plants under construction by a Chinese SOE face project delays and rising costs, due to supply chain disruption caused by COVID-19. Of the five power projects, three are liquefied natural gas (LNG) power plants that were due to commence operation in April 2020. Completion of the Kyaukphyu power plant stalled due to the shutdown of a factory producing LNG tank containers in Wuhan, the epicenter of the virus outbreak in China. In 2018, Myanmar renegotiated the cost of the Kyaukphyu deep-water port project from USD7.3 billion, to USD1.3 billion. There is an increased risk of contract renegotiation in the next 12 months as projects continue to stall.



NIGERIA, 6.2

Construction work on a USD6.7 billion railway line between Lagos and Ibadan stalled, due to the supply chain disruption caused by COVID-19. The Ibadan-Kano section of the 156-kilometer railway will undergo reconstruction in October 2020, raising project costs. COVID-19 cases are continuing to rise in Nigeria, which will increase pressure on the government to reprioritize spending on health care infrastructure. This may increase the risk of contractual agreement repudiation in Nigeria in 2020.

PAKISTAN, 5.9

In July 2020, Pakistan initiated a renegotiation of BRI-linked debt repayments, after it alleged that Chinese SOEs had inflated construction costs for two power plants. The audit alleged Huaneng Shandong Ruyi Energy and Port Qasim Electric Power — were overcharging by USD3 billion over the 30-year project lifetime. Pakistan is seeking to negotiate an extension of the debt repayment to 20 years, from the existing 10-year repayment schedule.

Risk Transfer Options

Insurers in the private political risk insurance (PRI) market are able to offer coverage for a variety of infrastructure projects.

The mandatory red line for any underwriter is sanctions from organizations such as the European Union, United Nations, US Department of Treasury's Office of Foreign Assets Control, and others. Where these are in place, private market PRI is not available.

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 program to match their needs.

Financial institutions can purchase lender's 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, nationalization, and deprivation.
- Contract frustration/cancellation.
- Currency inconvertibility and non-transfer.
- Deprivation.
- Export/import restrictions.
- Forced divestiture.
- Political violence including war.
- Non-honoring 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 categorized 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.

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

Political Violence Cover

Political violence can also be handled separately in the terrorism insurance market if it is a short-term risk (12 to 24 months). It 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 net profit, revenue, and rent.
- Liability, including employee and public.
- Losses caused by nuclear, biological, chemical, and radiological 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 an insurance program that satisfies their needs, and those of associated stakeholders.

Typically, the private PRI market makes available AA- and A+ rated underwriting security. Policy periods can be up to 15 years, illustrating the private market's ability to match Export Credit Agency (ECA) offerings, and client demand. The theoretical capacity available for some individual risks has reached nearly USD4 billion (see Figure 2).

FIGURE 2

Available capacity has reached nearly USD4 billion for certain risks.*

SOURCE: MARSH JLT SPECIALTY

Comprehensive Credit

Up to 5 years	USD3.5 billion
Up to 7 years	USD3.1 billion
Up to 10 years	USD2.5 billion
In excess of 10 years	USD1.3 billion

Contract Frustration

Up to 5 years	USD3.5 billion
Up to 7 years	USD3.5 billion
Up to 10 years	USD3.2 billion
In excess of 10 years	USD2.1 billion

Political Risks

Up to 5 years	USD3.95billion
Up to 7 years	USD3.9 billion
Up to 10 years	USD3.6 billion
In excess of 10 years	USD2.5 billion

*Capacity as of June 2020.

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