Norman Chan: Hong Kong's pivotal role in infrastructure financing

Keynote speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Forum-cum-Dialogue on "Belt and Road Initiative: Infrastructure Financing", Hong Kong, 15 October 2018.

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Carrie (Leung), Susie (Cheung), Tony (Neoh), distinguished guests, ladies and gentlemen,

1. I am pleased to be invited to attend today's Forum. Before I talk about what role Hong Kong can play in facilitating the financing for infrastructure projects, it would be useful if I refer to the enormous gap between the gigantic funding needs of infrastructure projects in the emerging market economies (EMEs) and the huge pool of global capital looking for investment opportunities.
2. It is beyond doubt that many EMEs do have a desperate need to bring in foreign investments in infrastructure, such as power plants, ports, airports, roads, railways, etc., all of which will certainly help them raise not only their living standards but also their capability in production and external trade. There is also no doubt that on the other side, there are billions or trillions of dollars eagerly looking for investment opportunities, especially those that can bring in steady long-term returns to the investors. When I ask investors or bankers why they are not putting their money into infrastructure projects that are waiting to be built and financed, the answer is there is a lack of "bankable" or "investible" projects. This may well be the true answer or reality, but it is rather disappointing if not frustrating that the wide gap between demand and supply has continued to exist.
3. So the natural question for us would be how we can close that gap and bring about a win-win outcome for project proponents and operators on the one hand and financiers or investors on the other. And in this connection, I should say that Hong Kong is uniquely well positioned to play a pivotal role in facilitating and catalysing investment flows to infrastructure projects in the region. We have well-developed capital markets and a deep pool of professional talents, in addition to Hong Kong being a leading centre in arbitration and dispute resolution, all of which are essential building blocks in support of infrastructure investments and their financing. It was against this background that the HKMA set up the Infrastructure Financing Facilitation Office (IFFO) in July 2016. IFFO has the following mission:

    (a) provide a platform for the key stakeholders to get to know each other and share experiences;

    (b) enhance the capacity of the investing and recipient countries in infrastructure financing; and

    (c) facilitate infrastructure investment and financing flows.

4. IFFO now has 90 stakeholders from Hong Kong, Mainland China and overseas joining as Partners. They include project developers or operators, commercial and investment banks, multilateral development financial institutions, asset owners and managers and professional service firms. In the last two years, IFFO has accomplished a lot. IFFO has organised 12 workshops and events in collaboration with top experts in the field such as the International Finance Corporation and the Multilateral Investment Guarantee Agency under the World Bank Group, Harvard Kennedy School, and key industry associations on risk mitigation and

capacity building. Two high level roundtables for debt and equity investors were held in March 2017 to discuss innovative ways of making projects more bankable and investible. A reference term sheet for infrastructure investments was also developed in the equity roundtable, listing out various factors to be considered in equity investment in infrastructure projects. The next high level roundtables will be held later this month. We also held a high level roundtable two months ago with 10 major Mainland China enterprises which have extensive investments in EMEs. The theme of that roundtable was the pivotal role that Hong Kong could play in facilitating the financing and management of infrastructure investments in the region. Separately, the HKMA is exploring the opportunity of co-investment in infrastructure projects with some like-minded investors. This is still work in progress and we hope we can say more on this later on.

5. Apart from the work of IFFO, I would like to say a few words on what the Hong Kong Mortgage Corporation (HKMC), which is fully owned by the HKMA, is doing in promoting infrastructure financing. The HKMC's key mandate, as many of you are aware, is to develop commercially viable financial products that would facilitate market developments. It has spearheaded with great success mortgage securitisation and mortgage insurance in Hong Kong. It has launched credit guarantee for SMEs as well as retirement protection solutions such as the Reverse Mortgage Programme and, more recently, the Life Annuity Scheme. The HKMC is now considering a new line of business entailing the purchase of infrastructure loans for the purpose of securitisation.
6. It is generally acknowledged that infrastructure investments are probably the most difficult and complex amongst different asset classes. The typical infrastructure projects normally involve larger investments and for a longer period than many other types of investments. They also involve complicated land acquisition, environmental, labour and other social issues that require strong support or facilitation by the host government in their resolution. However, infrastructure investments, if properly designed and run, can bring about steady and long-term cash flow and good return to the invested capital. Moreover, the space of infrastructure in the developed world is getting increasingly crowded, with yields or returns steadily declining as there is an abundance of capital chasing after limited opportunities. In contrast, there is enormous headroom and potential for infrastructure investments in the EMEs. The crucial issue is how to channel the capital to the investments or turn more projects into "bankable" or "investible" projects.
7. In this context, banks and multilateral development institutions play a crucial part. They have the necessary technical expertise in the relevant fields and the requisite local knowledge to underwrite greenfield projects. This is a riskier phase of an infrastructure investment but banks are good at doing this. However, the new capital standards for banks do not make it attractive for them to hold on to these loans on a long term basis, even though the projects at the brownfield stage are operating smoothly. At the same time, there are many other investors, including insurance and pension funds, which may be looking for less risky investments that can produce steady long-term cash flow. Therefore I can see a good opportunity for banks to offload their loans to these long-term investors. However, it is easier said than done. There are many issues that need to be tackled. Just to name a few:

(a) the large transaction size of infrastructure loans makes concentration risk of collateral a more prominent issue to be addressed, say as compared to the securitisation of a portfolio of mortgage loans comprising a large number of loans but with each being relatively small in size;

(b) apart from being large in size, infrastructure loans tend to be significantly less homogenous than the other types of asset for securitisation. In fact, infrastructure loans tend to be "unique" rather than "common", and each can have its own risks and corresponding mitigation structures, which would pose challenges to the structuring, rating and assessment processes;

(c) given such unique nature of infrastructure loans, originating and managing an infrastructure loan portfolio require the asset manager to possess highly specialized skillsets and experience, and the track record of the asset manager is a key assessment criterion of rating agencies as well as prospective investors;

(d) the risk appetite of many long-term investors may need to adjust over time. Over the past few years, we have seen an increasing interest among conventional long-term investors like pension funds and insurance companies in infrastructure-related assets, possibly because the conventional fixed income instruments have failed to provide a decent return amidst the long-depressed yield environment. However, the appetite of such investors tended to focus on the small set of prime quality, investment grade-tranche of infrastructure loan assets, whereas many infrastructure loans may fall in the sub-investment grade domain.

8. Ladies and gentlemen, the reputation of financial derivatives was badly damaged during the Global Financial Crisis. The mortgage-backed securities, CDO, CDO2 and CDO3, etc. all got a bad name, for good reasons. While there are still widespread skepticism and even resentment to the label of financial derivatives or financial engineering, I think it is important for us to be able to differentiate between those structured finance products that are linked to and supportive of the real economy from those that have no useful links to the real economy. Clearly ordinary mortgage-backed securities with proper underwriting standards, not the kind of sub-prime mortgages in the US, are one of this kind of useful financial derivatives. Infrastructure loan backed securities can be another kind of useful structured finance because, if properly organised, they can bring about a win-win outcome for the investors, the recipient countries, the intermediaries and the capital markets. As I said earlier, infrastructure investments are one of the most difficult kind of asset class and to create a structured finance for these investments is not going to be an easy or short process, but as the Chinese saying “千里之行，始於足下” goes, no matter how long the journey is going to take, one has to make a start somehow. So here we are, the HKMC is going to take the first step in pursuing the securitisation of infrastructure loans in order to facilitate a more efficient flow of capital into infrastructure investments.
9. I note that in the afternoon there will be a session focusing on the prospects of structured finance in infrastructure investments. This is highly relevant and timely and I look forward to hearing the perspectives and insights from the experts on this subject. Finally, let me thank the Forum for inviting me and wish all the participants a very fruitful and productive day.
10. Thank you for your attention.