

Fears for Hong Kong's future as leasing hub

Dominic Lalk

17/11/2020

The concessionary tax regime for aircraft leasing introduced by the Hong Kong SAR government in 2017 was designed to lay a solid foundation for Hong Kong to develop into an aircraft leasing centre. Dominic Lalk investigates whether the city's status quo has changed amid ongoing dissent and political changes.

Any conversation about the city of Hong Kong's future has become a political hotbed marred by controversy amid the ever-growing influence mainland China is seeking, not least with the recent implementation of China's National Security Law.

There is never a shortage of opposing views in Hong Kong, and this spills over into the debate over the feasibility of the city's leasing ambitions. There are two factions: those who believe that investor confidence has been completely eroded, and who will argue that droves of companies, multinationals and high-income nationals are leaving the city because they feel their basic rights have been infringed on, and those who say that nothing has changed and that Hong Kong's future as a leasing hub looks more secure than ever.

"The excellent fundamentals and infrastructure contributing to the success of Hong Kong as an international financial centre, a commercial and aviation hub, have not changed. Stability, which is an indispensable component of a first-rate business environment, has been restored. Hong Kong continues to rank the freest economy in the world in 2020," says BCLP Hong Kong partner William Ho.

"The economy will rapidly recover once the Covid-19 pandemic retreats. The concessionary tax regime for aircraft leasing introduced in 2017 has laid down a solid foundation for Hong Kong to develop into an aircraft leasing centre. The prominence of Hong Kong as an aircraft leasing hub will grow steadily when the aircraft leasing market picks up steam," adds Ho.

Hong Kong's "homegrown" aircraft lessor, China Aircraft Leasing (CALC), agrees with BCLP's assessment.

"We see Hong Kong's role as a leasing hub for the future more promising than ever as business and transactional activities gravitate increasingly towards aviation markets in Asia, led by the recovery from the pandemic in China, which will emerge as the world's biggest market in a few years.

"This prospect is further secured by endorsements from the Chinese government and support policies to reinforce the 'One Country, Two Systems' competitive advantage of Hong Kong and the city's strategic importance in China's continuing reforms and opening up," CALC chief executive Mike Poon tells *Airfinance Journal*.

"Reports of Hong Kong's demise as an Asian and global aviation finance hub have been greatly exaggerated, most often by wishful-thinking naysayers with an agenda. I am sitting drinking my favourite cocktail, Thyme N' Pisco Sour, overlooking a very busy Hong Kong financial district that now appears almost indistinct from how it looked 18 months ago," says Paul Jebely, co-chair of asset finance and Hong Kong managing partner at Pillsbury Winthrop.

"What, exactly, has fundamentally changed about Hong Kong that is not the experience elsewhere? Was it the protests last year, the Cooties early this year, or the enacting of a par-for-the-course National Security Law more recently?" asks Jebely.

"Certainly, none of it has stopped the tide of IPOs [initial public offerings] in Hong Kong, which have refortified the city's position as one of the freest, deepest and most liquid pools of capital in the world – with a domestic market capitalisation that, for example, makes the Singapore Exchange look like the Tehran Stock Exchange in comparison to the NYSE. I mention this as I wonder if our sector now has a better strategy than to follow the money? If so, I would love to hear it," he adds.

Not everyone, however, agrees with these rosy and colourful visions. Many financiers and lawyers *Airfinance Journal* has spoken to since the enactment of the controversial National Security Law in the city say that Hong Kong's ascent to an aviation leasing hub could end quicker than

it began, although an unprecedented number of aircraft finance bigwigs in the region have refused to comment on the matter.

“The violent protests have damaged confidence, not only of investors, but also of mainland Chinese, HK people, and expats who live in and love HK. Where Hong Kong was once considered a safe haven for international business, and a comfortable multicultural oasis for expats to relocate to, this image has been tarnished, perhaps irrevocably,” says Lune Wang, director and deputy general manager of Comsys Leasing.

“Companies may well be hesitant to invest, or dispatch foreign talent to a potentially unstable or unsafe jurisdiction – a beneficial tax regime can offer financial advantages only if its infrastructure and social climate are conducive to the smooth running of a business.

Recent events have thrown that into doubt, to the benefit of other competing jurisdictions. While investment is inevitably slowing during the current Covid environment, Hong Kong may struggle to maintain its importance as an investment destination once the industry warms up again if it cannot win back the confidence of global investors in the meantime,” says Wang.

The questions many are asking include a recurring argument that goes along the lines of: while it may be true that some global investors may be turning their backs on Hong Kong for the moment, an ever greater influx of mainland money into the city should well cover the temporary shortfall. This could, however, result in Hong Kong’s future as a leasing hub essentially taking the shape of a mainland free-trade zone (FTZ) such as Nansha, Zhoushan or Tianjin, some have said.

“Unlike the aircraft leasing platforms in mainland China’s free-trade zones, such as Dongjiang and Nansha, which are used by aircraft leasing companies to conduct domestic aircraft leasing business in mainland China, Hong Kong positions itself as an international aircraft leasing centre. Hong Kong is rapidly expanding its tax treaty network. Aircraft leasing companies are using their aircraft leasing platforms in Hong Kong to lease aircraft in the Asia-Pacific region and, gradually, all over the world,” says BCLP’s Ho.

“Hong Kong already has the best tax treaty with mainland China, which attracts the lowest withholding tax, and Hong Kong is keen to further improve the terms of such a tax treaty. Hong Kong will soon become the lessor jurisdiction of choice by aircraft leasing companies which are leasing aircraft into mainland China. Hong Kong remains among the top three IPO markets globally in 2020. By building up aircraft portfolios in Hong Kong, aircraft leasing companies may easily tap into the Hong Kong IPO market for funds,” he tells *Airfinance Journal*.

“Hong Kong, with its special positioning, is ready to leverage its established infrastructure to cooperate with the leasing hubs of Tianjin, Shanghai and Nansha to exploit future opportunities, especially those emerged from industry consolidation and increasing aircraft leasing penetration in the post-pandemic period,” says CALC’s Poon.

“CALC has been proposing to the free-trade zones a number of lease structures that benefit from Hong Kong’s legal system and favourable tax regime, including but not limited to the lease-in-lease-out structure. Cooperation in this area will extend the reach beyond the domestic market. We believe Hong Kong will become a major hub for Chinese lessors for leasing and trading activities in the overseas markets to facilitate endeavours for expanding their shares in the global aviation industry,” adds Poon.

“Mainland China will surely support HK during these dark times to the best of its ability. They are doing pretty well so far, in my opinion. As to whether HK will evolve to resemble the mainland hubs, my opinion is no. On the contrary, mainland FTZs like Nansha, or Tianjin are taking the shape of HK,” says Comsys Leasing’s Wang.

“HK has evolved as a sophisticated centre for the industry, combining an attractive tax regime, developed infrastructure, an impressive talent pool and a reputation as a jurisdiction with few linguistic, cultural, or other barriers for international investment. This cannot quickly be cloned by other locales. All the local FTZs in China are competing with each other to attract investors and talent to the best of their ability. They will evolve and find their own advantages. Even Tianjin is facing huge challenges from Shanghai, Nansha, Hainan, etc,” adds Wang.

“In 10 years’, HK will still be a top leasing hub, I believe, although in 20 years’, who knows? By then, there might be many ‘HKs’ in China and newly arisen FTZs,” she notes.

The one to pay particular attention to is a new aviation super FTZ under development in Hainan Island. “Everybody is looking at Hainan. It is also an island, still a green field, and the cost of investment to start from scratch is comparatively low. Look at Shenzhen 30 years ago and now. I wouldn’t be surprised if Hainan is the biggest competitor of HK in 30 years’,” says Wang.

The trade tensions between China and the US have only continued to worsen since Hong Kong agreed the implementation of China’s National Security Law in the city that was supposed to be safeguarded from any material political changes until 2047. In one of the most recent escalations of tensions, the US imposed sanctions on several Hong Kong SAR leaders, including its chief executive, Carrie Lam.

With the US expected to continue taking a tough stance on China and the “Hong Kong issue”, regardless of who is elected president, a

normalisation of relations between Hong Kong, China and also the Commonwealth of Nations is unlikely. What might this mean for Hong Kong's leasing hub ambitions?

"Whoever is being elected, it seems unlikely that they will warm relations with China under the current climate. Relations seem to be shifting to a Cold War-type scenario, unfortunately. It is a conflict not only of economy, high technology, AI, 5G and finance but also a propaganda war," says Wang, although she cautions that any such problems are "likely to be short-lived" in the longer term.

"Relations with the US are likely to be challenging over the near future, but, in the end, the US requires Chinese investment, resources and vendors, so regardless of the political games currently being played, it seems likely that economic practicalities will eventually persevere," according to Wang.

"International aircraft leasing companies benefit from the profits they make from leasing aircraft into mainland China. The macroeconomic concern of trade deficit is never an issue in the aircraft leasing industry. The US is always keen to export Boeing aircraft to mainland China. It is inconceivable that tough trade policies or even trade sanctions of the US against mainland China would ever touch on the aircraft leasing business. Normalisation of relations between mainland China and any other country is a political matter," says Ho.

"The aircraft leasing business is largely immune from political considerations. There is no reason to believe that any US conglomerate with a global reach would desert Hong Kong simply for political considerations. Notwithstanding the temporary setback caused by the Covid-19 pandemic, it is still anticipated that mainland China will need to lease a large number of aircraft to meet the demand for growing air transportation. Hong Kong is rapidly expanding its tax treaty network and improving its business environment for aircraft leasing companies to operate. Innovative leasing structures featuring Hong Kong and mainland China and providing optimal benefits to the participants are expected to come out. In terms of aircraft leasing, Hong Kong's role as a gateway into mainland China will not diminish, but grow," says BCLP's aviation specialist.

Another question often asked with regards to the robustness of Hong Kong's aircraft leasing hub model is why aircraft lessors and other financiers would need Hong Kong at all when their real intention is to do business with China. Why not set up shop in China directly?

"HK has been a buffer zone connecting mainland China and the world for many decades. HK is a leasing hub for international transactions, however, not for China transactions. We have already seen a trend that there are more and more non-Chinese leasing companies setting up entities in Tianjin, because Tianjin has won the reputation of being stable, transparent, supportive and efficient – a great gateway for an international company to enter the China market," says Wang, Comsys's Tianjin head.

"The government has tried to encourage cross-border deals out of Tianjin and implement quite a few incentives. However, why are people still hesitating? If there is a longer established and more familiar place to choose such as HK, why risk an exotic regime which has a different legal system and super-duper complicated and costly tax system?" asks Wang.

Another potential reason for not wanting to set up shop in China despite wanting to do deals with local airlines is that Chinese carriers are not easy clients to deal with.

"They demand a lot of communication, a deep understanding of the culture and language skills. It really depends on how much priority the lessor gives to the China market," says Wang.

"Chinese free-trade zones focus on domestic aircraft leasing. Using an aircraft leasing platform in one of the free-trade zones in mainland China, such as Dongjiang, Nansha, to own aircraft and to lease aircraft to Chinese airlines will give rise to difficulty in trading the aircraft overseas. International aircraft leasing companies have largely been put off by the limited tradability of aircraft assets stuck in the Chinese free-trade zones. The relatively unfavourable tax treaties entered into by mainland China commercially preclude the use of Chinese free-trade zones to lease aircraft overseas," says BCLP lawyer Ho.

This is where Hong Kong comes in handy. "With a low withholding tax rate on rent between mainland China and Hong Kong, which may go lower further in the near future, it is expected that a lease-in-lease-out leasing structure involving Hong Kong and a Chinese free-trade zone will be extensively used by market participants leasing aircraft into mainland China," predicts Ho.

He adds: "Rather than competing against Chinese free-trade zones, Hong Kong actually complements them by helping them solve the asset non-tradability problem."

Thank you for printing this article from Airfinance Journal, your essential intelligence resource for aviation finance. If you have been given this article by a subscriber, you can contact us through email at accountmanager@airfinancejournal.com or call us on +44 (0)20 7779 8015 to discuss our subscription options.