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## **Combined Chinese and Islamic Financing in the China Pakistan Economic Corridor (CPEC)**

### **Abstract**

*The China Pakistan Economic Corridor (CPEC), the component of China's Belt and Road Initiative which runs through Pakistan, is the largest infrastructure development project in Pakistan's history. Of the \$50 billion budget projected for CPEC, \$35 billion is earmarked for energy projects while \$15 billion is for infrastructure, industrial zones and mass transit.<sup>1</sup>*

### **Introduction**

CPEC is expected increase Pakistan's GDP and improve infrastructure significantly by increasing the national power grid by an additional 5900 megawatts, expanding the Gwadar Port as well as adding \$10 billion worth of railway projects, an international airport, and a fiber optical cable running from China to Islamabad. China will benefit by streamlining its supply lines, thereby dramatically decreasing shipping time and distance, as well as linking China with the Middle East. Along the route, China plans to build free trade zones which are meant to help boost the economies of both countries.<sup>2</sup> Beijing's agreement to fund the project utilizing a combination of Chinese and Sharia Compliant Islamic financing will be a boon to Islamic financing in the region and around the world.

### **The Growth of Islamic Banking**

For Islamic financing to be Sharia compliant, it must meet several basic criteria: The investment must represent legitimate trade and be asset-based investment, the use of money to make money (interest or riba) is forbidden, and investments must be ethical. Risk should be shared, harmful activities are prohibited, and investments should contribute to the public good. As there are strict prohibitions in Islam against gambling, certain types of extremely complex or risky financial investments are also off limits. This includes such as speculating on the stock market, exotic and derivative stock options, shorts and margin selling.<sup>3</sup> Islamic financing may be in the form of "murabaha", a form of trade credit, "ijara" which is a lend-lease agreement that is often used in Muslim mortgages, and "sukuk" or Islamic bonds. Emirates Airlines regularly use ijara for its expansions.<sup>4</sup> Sukuk are often used by governments to finance large projects and are presently being used in CPEC.<sup>5</sup>

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From 2000 to 2016, Islamic banks' capital has grown from \$200 billion to around \$3 trillion. In spite of this massive growth, Islamic banking still only accounts for around 5% of the global total; however, it is one of the fastest growth sectors.<sup>6</sup> Islamic banking, while Sharia compliant, is not for Muslims only. Sukuk financing has been issued to given to the United Kingdom, France, Germany, Japan, Luxembourg, Hong Kong, and South Africa.<sup>7</sup> The US is now home to 25 Islamic financial institutions, the largest of which include The American Islamic Finance House, University Bank (through its subsidiary University Islamic Financial) and Harvard Islamic Finance Program. Additionally, institutions such as J.P. Morgan has offered Islamic banking services to clients in the US since 2013. Standard Chartered Bank provides Islamic banking products through Saadiq, its Islamic banking division while Saturna Capital manages more than \$3.5 billion in Sharia compliant mutual funds.<sup>8</sup>

Islamic banking is also growing in Europe. German Finance Minister Wolfgang Schaeuble told the G-20 that Islamic financing needed to be integrated globally.<sup>9</sup> In 2014, Britain issued its first Islamic bond (sukuk) worth over \$250 million.<sup>10</sup> Britain is home to five British Islamic banks as well as more than 20 banks offering Islamic finance products as well as Islamic funds with combined assets of \$300 million.<sup>11</sup> There have been 31 sukuk listings at the London Stock Exchange (LSE) worth a total of nearly \$20 billion.<sup>12</sup> In Germany, apart from Deutsche Bank issuing sukuk, three Islamic indices were created: the STOXX Europe Islamic Index, the STOXX Europe Islamic 50, and EURO STOXX Islamic 50.<sup>13</sup> The rise in Islamic financing has impacted financing education as numerous universities across the continent have begun offering training in Islamic banking and financing ways.

Asia accounts for about 20% of the global total of Islamic banking.<sup>14</sup> Projects across Asia are also increasingly turning to Islamic financing. The largest issuer of sukuk is Bank Negara Malaysia.<sup>15</sup> Regulators in Japan have begun looking into modifying current regulations to allow for an expansion of Japan's participation in Islamic banking. In 2008, Japan's Financial Services Agency (FSA) allowed subsidiaries of Japanese banks to conduct Islamic finance transactions such as a sukuk issued by Bank of Tokyo-Mitsubishi UFJ (BTMU) through its Malaysian subsidiary.<sup>16</sup>

Factors that have helped to increase the popularity of Islamic banking include more companies trying to enter markets in Muslim countries as well as the increased sophistication of Islamic financial instruments, which makes them more viable for use in a modern financial system.<sup>17</sup> One point that is dampening the growth of Islamic financing globally is that it tends to be concentrated in the oil producing countries, which are all experiencing general economic slowdowns due to a drop in oil prices.<sup>18</sup> The US turning inward under President Trump may be a disadvantage for the future growth of Islamic finance; however, China turning outward and demonstrating a willingness to experiment with Islamic finance may be beneficial to the future development of Islamic banking. Additionally, sanctions being lifted from Iran will help the sector grow, although Iran will need to review its policy of not allowing susku to be traded in foreign currencies.<sup>19</sup>

## **Islamic Banking in China**

The first Islamic financial institution founded in China was the Hezhou Islamic Financing Company in 1987, which provided both deposit and lending services. In 2006, Deutsche Bank launched its first Sharia'a-compliant mutual fund family, DWS Noor Islamic Funds PLC, which included DWS Noor China Equity Fund. Bank of Bahrain launched the first ever Sharia'a-compliant real-estate investment fund, Shamil China Realty Mudarabah. This fund invested in the Xuan Huang China Realty Investment Fund Limited, a joint venture between Shamil Bank and the China International Trust Investment Corporation (CITIC Group), a state-owned investment company.<sup>20</sup>

In 2008, Linxia Hui Autonomous Prefecture, a region of China with a significant Muslim population, established the Ningxia Halal Food International Trade Certification Centre which was the first halal certification body in China approved by the Certification and Accreditation Administration of People's Republic of China (CNCA).<sup>21</sup> In 2009, the Malaysian banking group CIMB established the CIMB Islamic Greater China Equity Fund. The same year, Saudi Arabia's Al-Rajhi Investments (ARI) brought Sharia'a compliant investments to China through the Shariah Asia Investment Fund (SAIF) in cooperation with the state-owned China Resources Corporation (CRC), who is a dominant player in China real estate. Together, CRC and ARI are determined to invest \$200 million in the Islamic fund.<sup>22</sup>

In 2009, CIMB Malaysia issued the Islamic Greater China Equity Fund which mostly invests in Sharia compliant investments. Also, Saudi Arabia's Al-Rajhi Investments (ARI), through its Shariah Asia Investment Fund (SAIF), introduced Sharia'a compliant investments into the Chinese market. Later that year, China became an associate member of the standard-setting body of the Islamic Financial Services Board (IFSB) with the aim of expanding Islamic finance in China.<sup>23</sup>

Hong Kong Separately Administered Region (SAR) is one of the fastest growing regions for Islamic financing. This growth is in line with an established goal of the Hong Kong government. In 2014, Hong Kong government passed a law allowing the Hong Kong Monetary Authority to issue sukuk. Later that year, Hong Kong became the first 'AAA' rated government to issue a sukuk.<sup>24</sup> The 2014 Hong Kong government sukuk used an Ijarah (lease back) structure to issue \$1 billion worth of bonds denominated in US dollars, which were both sharia compliant and S&P: AAA, as well as Moody's: Aa1.<sup>25</sup> This first sukuk was so successful that in 2015, Hong Kong issued a second one worth \$1 billion USD using Wakalah structure. Under this structure, one-third of the assets were collateralized by units in an office building and two thirds by Sharia'a-compliant commodities. The bonds had a credit rating of S&P: AAA and Moody's: Aa1.<sup>26</sup> Another connection between China and Islamic financing is that Islamic majority countries have issues sukuk related to the Chinese economy such as the exchangeable sukuk issued in China's water utility sector by Malaysia's Khazana National Berhad water utility sector.<sup>27</sup>

Today, MSCI Golden Dragon Islamic Index measures the performance of the large and mid-cap China securities and non-domestic China securities listed in Hong

Kong and Taiwan which are relevant for Islamic investors.<sup>28</sup> Islamic financing is increasingly being used by the Beijing government as a form of diplomacy with the Muslim world. The Asian Infrastructure Investment Bank (AIIB), which is also involved in financing CPEC, is increasingly offering Islamic financing as an option.<sup>29</sup>

In 2015, a bank following Islamic traditions was opened in China's northwestern Qinghai province, whose population is 20% Muslim. The Jianguo Road Branch of Xining Rural Commercial Bank was established to meet the needs of the local Muslim community.<sup>30</sup> China is uniquely poised to institute Islamic banking as China trades heavily with Organization of Islamic Cooperation (OIC) member countries. The OIC is the second largest intergovernmental organization in the world after the United Nations (UN), and is composed of 57 member states across four continents. China accounts for 11% of OIC exports.<sup>31</sup> In 2015, over 17% of OIC total imports were from China, making China OIC's largest trading partner.<sup>32</sup> Furthermore, 25 OIC nations have joined the Belt and Road initiative, and another 20 are founding members of the Asian infrastructure Investment Bank (AIIB).<sup>33</sup>

In order to increase its participation in Islamic banking, China is drawing expertise from Gulf Cooperation Council (GCC) countries, namely Qatar. In April 2015, Qatar International Islamic Bank QSC and QNB Capital LLC signed an agreement with China-based Southwest Securities Co. to develop Sharia'a-compliant finance products in the country while also seeking access to investors primarily in Qatar and the Middle East.<sup>34</sup> In 2015, the Islamic Corporation for Development (ICD) signed a memorandum of understanding (MoU) regarding financial leasing to develop Islamic business in cooperation with China's largest bank the state-owned Industrial and Commercial Bank of China (ICBC).<sup>35</sup>

### **Chinese-Islamic Financing in CPEC**

The Islamic banking sector has grown faster in Pakistan than has the traditional banking sector. This is due in part to a five-year plan by the Central Bank of Pakistan.<sup>36</sup> Pakistan's Islamic finance industry has enjoyed double digit growth for the last five years and is targeting a 20% market share by 2020.<sup>37</sup> As a result, Pakistan ranks among the nine largest countries for Islamic Banking. Bahrain, Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, Turkey, Kuwait and Pakistan together account for over 90% of the global total. The China-led Asian Infrastructure Investment Bank (AIIB) is prepared to integrate Islamic financing into the China-Pakistan Economic Corridor (CPEC). A Memorandum of Understanding (MoU) was signed in 2016 between Pakistan's Meezan Bank Limited and China regarding the issuance of Islamic financing in connection with CPEC.<sup>38</sup>

In order to integrate Islamic financing into the Belt and Road Initiative as well as CPEC, a number of issues must first be resolved. Across the region, banks are struggling to demonstrate the viability of Sharia'a-compliant financing vehicles in the most important sectors of the economy, including telecommunications and transportation. Another important area where Islamic financing is being considered is in small and medium enterprises (SME) along the Corridor, which will be instrumental in job creation. However, the banks are lacking in "talent development, advocacy, applied research, regulations, capital markets, product

*Combined Chinese and Islamic Financing in the China Pakistan Economic Corridor* design, accounting and rating.”<sup>39</sup> Pakistan's Islamic banking sector is also suffering from a lack of liquidity, as well as cumbersome legal procedures, complex documentation requirements, a lack of Islamic finance talent and a general distrust of sukuk among the populace. This all results in a dearth of sukuk, and is driving issuers to rely on traditional corporate bonds.<sup>40</sup>

Proponents of Islamic financing see CPEC as a tremendous opportunity for public-private cooperation to promote the use of Islamic financing particularly in the areas of hydropower, energy, and construction. It has been proposed that much of the \$45 billion CPEC investment could be parked in Islamic financial instruments; however, a lack of talent is one of the major obstacles in realizing this proposal. It has been estimated that in order to manage that quantity of money, 15,000 trained personnel will be needed.<sup>41</sup>

## **Conclusion**

Islamic financing is one of the fastest growing areas of global finance. Many non-Muslim majority countries are expanding their Muslim banking business and even issuing sukuk to finance infrastructure development. China is perhaps the most important non-Muslim country in promoting Islamic financing. The CPEC projects seem to meet many of the requirements for Islamic financing; they represent legitimate trade, are ethical, and asset-based with risk being shared. CPEC investments are not harmful and they contribute to the public good. The use of Islamic financing in CPEC will help build bridges between China and the Muslim world. CPEC will also add to the growth of Islamic financing in Pakistan and showcase Islamic financing to the world.

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