Unlocking Islamic Finance Potential in CPEC and Beyond

Conference Proceedings

Objective

What does US$ 62 billion Chinese investment in China Pakistan Economic Corridor (CPEC) mean for Islamic Financial Institutions (IFIs)? Is there business opportunity beyond CPEC in Pakistan? To shed light on these questions, IBA Centre for Excellence in Islamic Finance, Karachi, Pakistan conducted an International Forum on Unlocking Islamic Finance Potential in CPEC and beyond on 17 January 2017. High profile speaker panel at the event, comprising of renowned academicians, regulators, Islamic Finance practitioners, Shari'ah advisors and international experts, critically analysed and discussed the possibilities of Islamic Financing opportunities present in the current economic landscape of the project between China and Pakistan.

Key Discussion Points

- In his opening statement Mr Ahmed Ali Siddiqui, Director IBA CEIF, highlighted the need to act fast and capture opportunities presented by CPEC, given that it is only a part of the 'One Belt One Road' initiative. CPEC passes through 27 Muslim countries, including Pakistan. Hence, the role of Islamic Finance cannot be ignored in this context.

- Dr. Farrukh Iqbal, Dean and Director IBA, emphasized that Islamic Finance is a vehicle for long term development with enormous potential that has not yet been fully explored in Pakistan.
- Mr Saeed Ahmed, Deputy Governor of SBP, said that the global Islamic Finance industry has reached a size of over US$ 2 trillion. In October 2016, Pakistan issued US$ 1 billion worth of Sukuk. He pointed out that a critical area where Islamic Financing can be used is in adjusting the risk-sharing structures of these projects. He mentioned Regulation, Taxation, Capital Markets and Awareness as the four main sub-committees of the Implementation Committee for Islamic Finance.
- Dr. Muhammad Nadeem Javaid, Chief Economist, Planning Commission of Pakistan discussed the four covenants of CPEC. The first and most important is energy to take the fuel mix away from furnace/oil based to less expensive coal-based. As a result of this initiative, unit cost of energy is to be reduced to PKR 9.1/- from PKR 9.69/- while power production is to be increased by 8,000 MW. The other three would be Infrastructure Development, Gwadar Port and Industrial Cooperation. Development of road and rail networks comes under infrastructure developmental projects and spill over benefits will, as a by-product, have an impact on housing, cement, steel, stone crushing and other related industries.

- Mr. Li Xiaoxin David, Deputy CEO ICBC, highlighted that many Chinese firms have approached ICBC for setting up businesses in Pakistan. Relocation of business from China is another potential opportunity which will result in job opportunities for over 85 million employees globally. It is estimated that if only 4 percent of Chinese trade is routed through Pakistan, it will amount to US$ 180 billion. Chinese banks claim tax exemptions on the interest income on lending to CPEC projects in the energy sector. This tax break is a huge incentive for Chinese banks and businesses to enter Pakistan's market.
- Dr Sulaiman Lu, from Al Sadiq Consulting China, presented the perspective of Chinese banks on CPEC related projects. He explained that they preferred RMB-based investments, e.g. RMB Sukuk, to lock in the currency exchange rate risk. He mentioned that Pakistani and Chinese Governments have signed currency swap agreements to stabilize the economy in the possibility of currency devaluations.

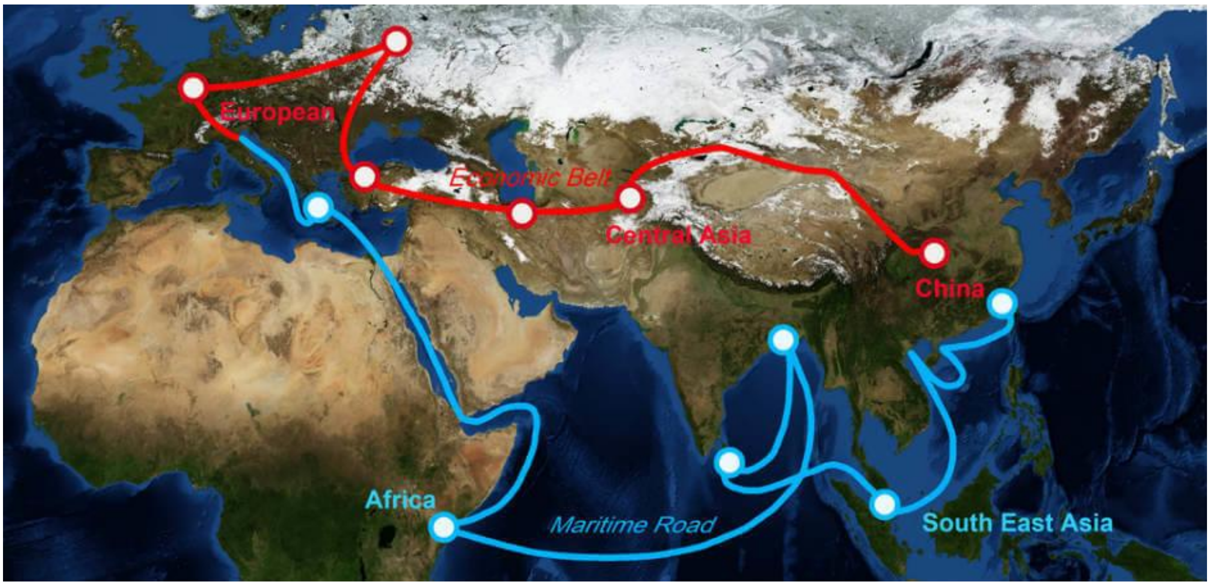
- Mr Irfan Siddiqui, CEO Meezan Bank Limited, mentioned that the Government of Pakistan had issued foreign currency Sukuk recently. Therefore, the possibility of issuing RMB Sukuk which are appropriate to these CPEC projects was certainly there.

Focus on Beyond CPEC

Strategy Paper

Overview

China has been increasing investment in Pakistan's infrastructure and energy projects since the inception of CPEC in 2015. Initially worth US$ 46 billion, China's approved financing has now reached US$ 62 billion. Development of Gwadar Port is extremely crucial to develop cohesion between the two nations. The lesser talked about 'Beyond' envisaging investment of US$ 250-350 billion by China offers an even more lucrative business opportunity for IFIs. Although more clarity is needed on the role of the two governments, the 'Beyond' part would entail sizable investment in Information Technology, Agriculture, Tourism, Water Management, Trade and Industry.



'One Belt One Road (B&R)' initiative will pass through 65 countries, including 27 Muslim countries, offering cross border Islamic financing opportunities. Chinese firms, with surplus manufacturing capacity, will be keen to explore investment opportunities in various sectors including, but not limited to, steel, cement, high speed railways and trains, electronic appliances, telecommunication, infrastructure, dams, bridges, highways etc. Furthermore, one of the key performance indicators of 32 provincial companies in China is to invest in a foreign country.

Fintech and SME Opportunity

Given Chinese expertise in Financial Technology (FinTech), local IFIs can benefit immensely from knowledge transfer in this area. The SME sector would be the prime investment target for Chinese manufacturers contemplating shift in operations to other countries due to increasing costs of production in their country. IFIs, especially Modarabas, can benefit from this opportunity by enhancing market share in the SME segment. IBA CEIF is currently conducting research on increasing Islamic Finance penetration in the SME and Agriculture sectors.

Need for Shari’ah Compliant Infrastructure Fund

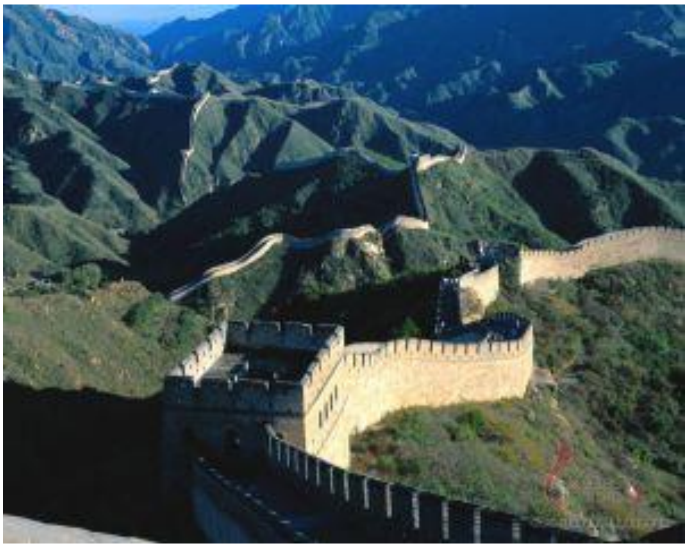
Local management companies may consider launching Shari’ah Compliant Infrastructure Funds to attract Chinese investment. Given the substantial infrastructure investment envisaged under CPEC and Beyond, and limited financing capacity of local DFIs, there is a strong business case for establishing a commercially viable Infrastructure Bank through private sector support. Islamic Finance players can take the lead in this area by collaborating with interested institutions in China.

Investment Banking Departments within IFIs should gear up to gain the maximum advantage of this opportunity.

Sukuk Innovation – Multi Currency Variants

RMB became the 2nd most used currency for trade and services, ranking 9th in forex trading during 2015. China's internationalization and foreign exchange (FX) reforms are evolving rapidly and full convertibility is expected over the next couple of years. Islamic Finance Consultants from China proposed that Cross Border/Offshore RMB Sukuk Fund can be set up to finance infrastructure projects. Multicurrency Sukuk can be another innovative instrument to deploy surplus funds with IFIs in light of dearth of Shari'ah compliant liquidity management instruments.

Islamic Finance at a Rudimentary Stage in China



Chinese consultants pointed out that 30 million Muslims in China are devoid of any Shari'ah compliant alternative to banking in China due to regulatory challenges. However, China is exploring Islamic Finance options. Asian Infrastructure Investment Bank (AIIB), headquartered in Beijing, in collaboration with Islamic Development Bank (IDB) and World Bank is working on Islamic Finance structures in China. Besides the three Muslim-majority G20 members, the AIIB counts other Muslim countries such as Kazakhstan, Pakistan, Qatar, Jordan and Oman as founding members. All have issued, or have plans to issue, sovereign Sukuk.

Decision makers in the Chinese Government should be made aware of the clause (Part 2, Chapter 2, Section 38 f) in Pakistan's constitution stating that '*the state shall eliminate Riba as early as possible*.' According to the Finance Minister Ishaq Dar, the Government of Pakistan plans to convert 20-40% of existing debt financing from conventional to Shari'ah compliant sources, in pursuing its aim to prioritize the use of Islamic financing modes to meet infrastructure and long-term financing needs. Chinese consultants are of the view that their government will respect the host country's constitutional requirement and would be willing to consider Shari'ah compliant financing structures.

Regulatory Support

State Bank of Pakistan (SBP) has also expressed keen interest in working on a future roadmap with the Chinese Government. The regulator has emphasized the need for building a platform where specific action points can be discussed and implemented accordingly. Work is in process on bilateral currency swap agreements. Regulatory support will be required by local IFIs to widen the product offerings in order to cater to unique requirements of the B&R initiative.

Way Forward

CPEC provides a unique opportunity for both Pakistan and China to promote bilateral trade and investment. Islamic Banks and Takaful players in Pakistan can collaborate with Chinese counterparts to enhance participation in CPEC and beyond

projects. Governments of both countries may consider establishing a Pak China Islamic Investment Company to provide innovative Shari'ah compliant financing solutions. CPEC and beyond is a golden opportunity for IFIs to deploy their excess liquidity in Sukuk.

It is becoming increasingly important to learn Chinese Language for effective communication with Chinese stakeholders. Therefore, academic institutions should encourage students to pursue Chinese as a foreign language. Interactive sessions between stakeholders from both Pakistan and China should be on-going so that an actionable strategy can be developed for gaining maximum benefit.