



Shariah-compliant financing of CPEC Projects: Opportunities for Islamic Banks

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Preamble

The Islamic finance is at present growing at an astonishing pace, something around fifty percent faster than the conventional banking, with further growth potential. The current size of global Islamic finance market is estimated to range between US\$1.66 trillion to US\$2.1 trillion and it is expected to reach the level of US\$ 3.4 trillion by the end of 2018. Based on US\$1.66 trillion estimation, Islamic finance assets represent just 1% of global financial market of US\$127 trillion in assets.

The Shariah-compliant modes of financing are also gradually gaining ground over the globe, especially in Islamic countries and replacing the conventional modes of financing. In many countries, even financing of infrastructure projects such as construction of roads, highway, bridges etc. are being fully or partially made by Shariah-compliant banks and financial institutions. In this perspective, the government in Pakistan is also contemplating to utilize the funds of Islamic banks for infrastructure development.

There is a great opportunity for Islamic banks to particularly focus on projects coming up under the China-Pakistan Economic Corridor (CPEC) which envisages US\$ 46 billion investments. It is satisfying to note that Islamic finance industry in Pakistan is fully alive to these regional developments and the government has also taken some good initiatives and policy measures to expand the financing role of Islamic banks in infrastructure development and CPEC-related projects. In this paper, we will briefly cover all these aspects.

Islamic Infrastructure Financing: Global Initiatives

According to the World Bank, total annual spending on infrastructure by the developing countries is estimated at around US\$ 1trillion which is expected to rise to US\$ 1.5 trillion by the year 2020. Similarly, the estimated infrastructure investment required in emerging markets is around US\$ 15.7 trillion by 2020. As per Asian Development Bank (ADB), an estimated amount of US\$ 800 billion infrastructure financing will be required on annual basis in Asia over the next decade.

Since infrastructure funding requires hefty and long-term investments, the emerging countries are finding it difficult to mobilize funds through public investment or through conventional banking channels. In this backdrop, there is a growing realization around the global, especially in the Islamic countries, about utilization of Islamic finance or other alternate asset-based financial modes for long term infrastructure financing. Sukuk or Islamic bonds are also being used as a possible financing

mode. In few countries like Turkey, Islamic finance has been re-branded as 'asset-based' or participatory financial institution to reduce the sensitivity associated with the religious aspect of Islamic finance.

In the developed nations, the United Kingdom (UK) leads in Islamic finance industry and unarguably it has now become the leading centre for Shariah-compliant finance. UK has also become the first non-Muslim country in the world which has issued an Islamic bond i.e. Sukuk @ 200 million pounds in 2014. The London Stock Exchange transacts around 57 Sukuk worth over US\$ 51 billion. There are six fully Shariah-

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compliant Islamic Banks in UK whereas over twenty conventional banks offer Islamic financial products. In addition, there are over 70 education institutions in UK which are imparting Islamic finance courses and degrees at undergraduate and post graduate levels - the most in any developed country. Furthermore, there are Islamic Finance Departments in almost all big accountants, consultants and professional service firms in UK. No doubt, the large Muslim population of around 2.8 million in UK has played a contributory role in the accomplishment of these milestones by UK in Islamic finance market.

Some of the mega infrastructure projects which were completed in UK through Islamic financing are:

- o Shard – The tallest building in London (Islamic financing from State of Qatar)

In the light of government's intention to use surplus liquidity of Islamic banks for funding of CPEC projects, it is expected that major portion of money would be mobilized through different modes of Islamic finance, preferably Sukuk.

- o 2012 Olympic Games Village
- o Battersea Power station, London (Islamic financing from Malaysia)
- o London Gateway – UK's first deep-sea container Port (Islamic financing from Dubai)
- o 6500 and above homes in North-West of England and Midlands are financed by a £700m investment by Gatehouse Bank, a fully Shariah compliant bank.

The governments in many EU countries such as Germany, Italy, Spain and France, are also taking regulatory initiatives to provide a level playing field to promote Islamic financing in their jurisdictions. However, more need to be done by these countries to reap the true benefit of Islamic financing for economic growth. Similarly, in USA, there are 25 Islamic Financial Institutions, including three Islamic Banks viz. American Islamic Finance House, University Islamic Financial and Harvard Islamic Finance Program. J. P Morgan also started Islamic banking services in 2013. The Standard Chartered Bank

of USA also offers Islamic Banking Products to the clients in Middle East, Asia, Europe and USA.

Islamic Infrastructure Financing: Pakistan Initiatives

In September 2016, the Finance Minister, Senator Ishaq Dar made a policy statement that 'Pakistan wants to make Islamic finance the 'first choice' for infrastructure and long term financing needs and also wants to shift 40% of its debt financing to Islamic sources of finance.' In this connection, the Finance Ministry has already been issued instructions to accord first priority to Islamic finance while raising funds. Shariah-compliant financing for infrastructure deals would definitely help promote long term development finance projects and channel surplus liquidity of Islamic banks into funding of infrastructure projects under CPEC. Let's have a look at some of the recent initiatives by the government for promotion of Islamic financing:

- o A special committee formed to develop a roadmap for expanding Islamic financial system so as to enable the Islamic banks and financial institutions to come up with innovative products to finance different energy and infrastructure projects under CPEC.
- o Amendments have been made in the State Bank of Pakistan Act to allow the Central Bank to issue Shariah compliant financial instruments.
- o KIBOR benchmark rate has been delinked for pricing under Musharakah, Mudarabah and Wakalah modes of Islamic financing.
- o Through Finance Act 2016-17, all Shariah compliant listed manufacturing companies in Pakistan have been provided tax concession of two percent (i.e. from 33% to 31%) in the corporate tax rate.
- o Amendments have been made in Income Tax Ordinance, 2001 to provide tax neutrality to Islamic bonds (Sukuk) by allowing certain tax exemptions that were earlier available to conventional securities only such as Term Finance Certificates (TFCs). Islamic bonds will now enjoy exemptions in withholding tax at various stages during sale of purchase proceeds and capital gain tax.
- o The first National Financial Inclusion Strategy (NFIS) launched by the government also includes Islamic Finance as a strategy area for achieving greater financial inclusion in Pakistan.



Strengths and Weakness of Islamic Financing for Infrastructure Projects

Strengths	Weaknesses
<ul style="list-style-type: none"> ● Riba-free and Shariah-compliant instrument ● Investor rather than lender of money ● Asset-backed securities ● Financial Stability as Islamic finance is more resilient to economic shocks ● Lower financing cost than conventional financing ● Flexibility in adjustment of risk profile of projects 	<ul style="list-style-type: none"> ● Limitation as Bridge or interim financing option ● Liquidity constraint short term deposits vs. long term investments ● Transaction cost and absence of required skill set

(Source: ICMA Pakistan Research)

- o The first All Share Islamic Index has been launched jointly by Karachi Stock Exchange and Meezan Bank to enable trading of shares according to Shariah and gauge performance of Shariah-compliant segment of equity market. The Islamic Index would act as a catalyst in bringing to the forefront the importance of Shariah compliant investment avenues.
- o Prudential Regulations for Infrastructure financing have been issued by the SBP as per which banks/DFIs are encouraged to adopt Islamic mode of banking, apart from conventional financing to develop infrastructure products as it is conducive to infrastructure financing.
- o Islamic Sukuk Bond have been launched by Pakistan in the international market to generate US\$ 1 billion at the lowest-ever prices of 5.5% and with maturity period of five years (2021)

Islamic Financing of CPEC Projects: Recent Initiatives

Some of the recent initiatives for Islamic financing of CPEC projects are summarized below:

- o Pakistan and China have signed financing agreement of around US\$ 1.95 billion for the development of the Thar Block II 3.8 MT coal mine project and two associated 330 MW coal-fired power plants in the Thar region of Sindh, Pakistan. The financing package includes US Dollars, Pak Rupee and **Islamic Shariah compliant** tranches. The project is expected to be commissioned by 2018.
- o The National Transmission and Despatch Company Limited (NTDC) has secured Rs. 18 billion in financing from a consortium of three local banks to install a 250 Km 500 Kilovolt transmission line from Thar Desert to Matiari District. The total cost of the transmission line project is estimated at Rs. 22.3 billion. This financing obtained from banks is a combination of Rs. 11.5 billion Shariah-compliant fund and Rs. 6.5 billion conventional mode of financing. The banks consortium was led by Dubai Islamic Bank as Shariah Advisor. The first phase of 660 MW of Thar coal-fired power project is expected to be completed by 2019.
- o A consortium of sixteen banks raised funds of Rs. 100 billion through Sukuk - a Shariah compliant tool, for the Neelum-Jhelum hydro power project which is Pakistan's biggest ever fund mobilization for any public sector entity. Sukuk was structured with a tenor of 10 years and backed

by sovereign guarantee by the Government of Pakistan. The National Bank of Pakistan (NBP) led the consortium with highest share of Rs. 35 billion and remaining shared by other 15 banks, including Meezan, BankIslami and Dubai Islamic Bank. On completion, the mega hydro-power project will be producing 5.15 billion of electricity annually.

- o Meezan Bank has signed a MoU with M/s. Al-Sadiq Consulting Ltd, China's first Islamic finance consultancy company, to explore opportunities for Islamic finance in CPEC and to identify series of projects in public and private sector with special focus on infrastructure and industrial development.

The Islamic finance industry, particularly banks need to form consortiums or syndicates to enter into public-private partnership ventures in energy and construction to invest in long term projects which would definitely have spillover benefits to other industries such as housing and construction, contracting, real estate, cement, iron and steel, pipes, marble industry etc.

In the light of government's intention to use surplus liquidity of Islamic banks for funding of CPEC projects, it is expected that major portion of money would be mobilized through different modes of Islamic finance, preferably Sukuk. It now all depends on the Islamic Banking industry how well they utilize the emerging opportunities by offering Islamic bonds (Sukuk) for CPEC and other development projects in Pakistan.

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The banking, capital market and insurance sectors of Islamic finance industry also need to play complementary roles in providing cost-effective and innovative products to finance projects under CPEC.