



# CHINA: FORGING THE NEXT PHASE OF GROWTH



MARCH 2017





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# CEO Message

I am pleased to present “China: Forging the Next Phase of Growth”, a report reflecting on the promise that Islamic finance holds for China.



**Khaled Al Aboodi**

Chief Executive Officer

Islamic Corporation for the Development of the Private Sector (ICD)



On that note, I would like to thank Dagong Global Credit Rating Co., Ltd for their valuable contribution to Section 2 of this report.

I believe that the path a country ought to take in reform efforts that support economic and social progress is a nationwide commitment to sustainability. In this regard, China has taken positive steps in recent years in rebalancing its economy and achieving sustainable growth, evident in its leadership role in pushing the global sustainability agenda which include combating climate change and its advocacy campaign on green financing, among other initiatives.

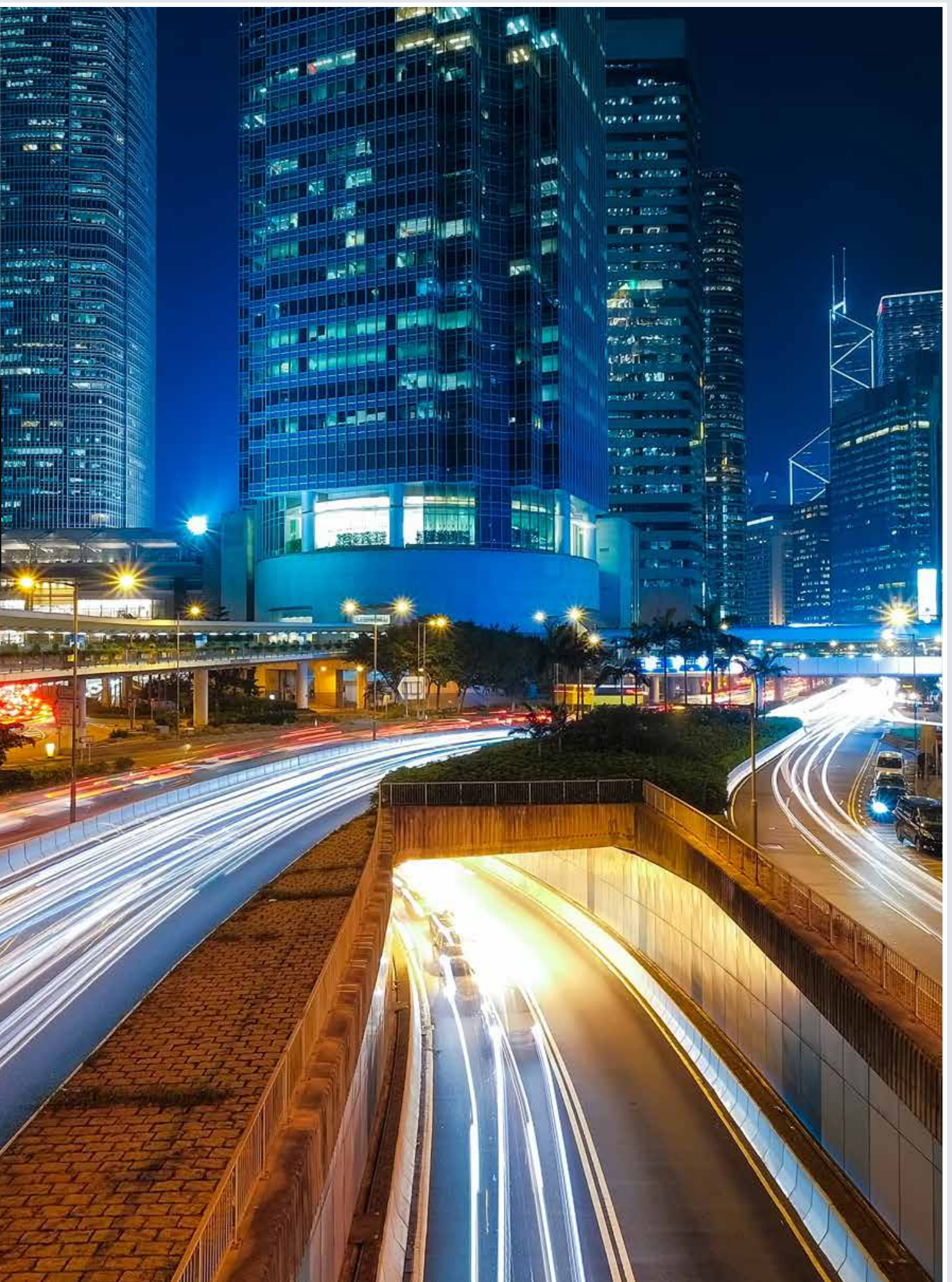
In tackling its sustainability challenges, China has utilised a number of tools to help make the necessary adjustments. The process has begun primarily in areas where economic development is the most advanced, and has involved policies, innovative technological solutions, and awareness and engagement drives. On this front, I believe Islamic finance can help China achieve its objectives. Indeed, Islamic finance holds the key in fostering sustainable, inclusive growth as it

connects the financial sector with the real economy and enjoys in-built strengths and features that promotes social equity and welfare.

Since its inception in 1999, ICD has attained some important milestones in its efforts to reach a balance between economic and social interests. As the private sector arm of the Islamic Development Bank Group, the world's largest Sharia'a compliant multilateral development bank, we at ICD are committed to addressing global development challenges that require significant attention. Moving forward, we will continue to work at further strengthening this positive fundamental attitude and to use it as a driver to help accelerate the change we would like to see in the world.

I hope this report is successful in providing constructive and valuable insights to stimulate debate on the potential growth of Islamic finance in China. I invite you to reach out to ICD and our partners to share your experiences and ideas in order to ensure the successful take off of Islamic finance in the country.









2016 population (estimate):  
**1.3846 billion**  
 1950: 552.0 million



China has  
**more than 160 cities**  
 with a population of  
**greater than 1 million**



**260 million**  
 urban households (adding  
 100 million in next 10 years)



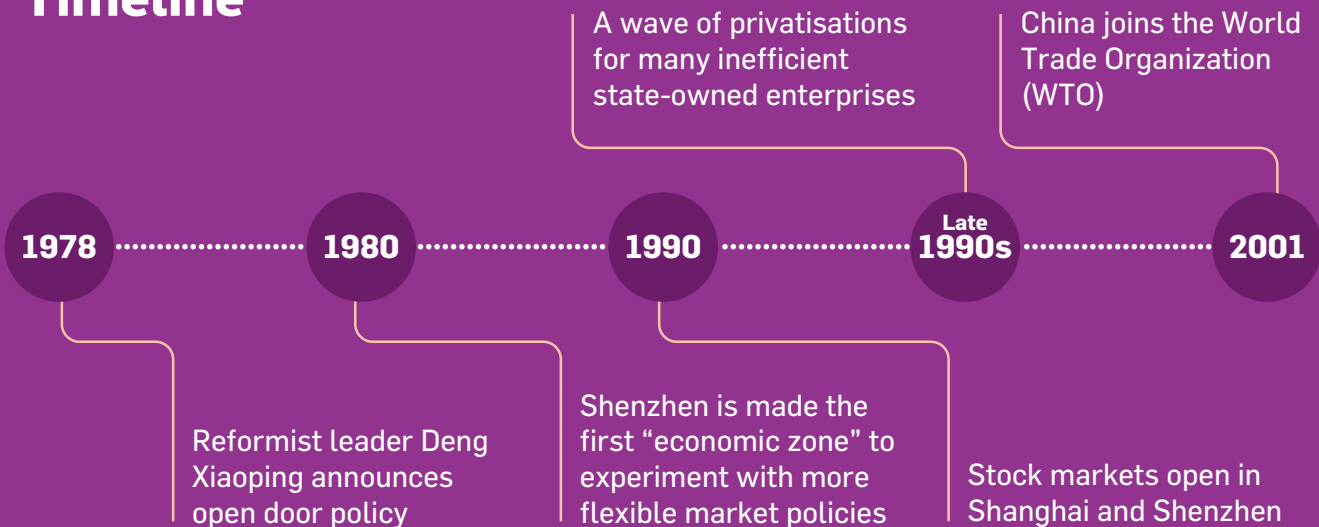
Currently  
**the 2<sup>nd</sup> largest economy**  
 in the world widely predicted to  
 surpass the US by 2020



China is  
**the second largest provider and top receiver**  
 of foreign direct investment (FDI) in 2016

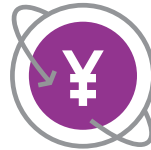


## Timeline





China has the largest foreign currency reserves in the world in 2016:  
**USD3.0 trillion**



China is **the world's largest exporter and the second-largest importer** of merchandise goods in 2016



China is **the world's second-largest oil consumer** in 2016



China houses **the second most billionaires in the world** in 2016 (number of billionaires: **260**; total wealth held by billionaires: **USD675 billion**)

China overtakes Japan as the world's second-largest economy

International Monetary Fund approves reserve currency for Renminbi

The National People's Congress approved China's 13th Five Year Plan (FYP). Dubbed the "greenest" FYP to date, 10 out of 25 priority targets are related to environmental policies all of which fall under a group of 13 binding targets which must be achieved by 2020

2005

2010

2014

2015

2016

600 million lifted out of poverty since 1981, according to World Bank, and overtakes Britain, France and Germany to become world's fourth-largest economy

China formally launches the 'One Belt, One Road' initiative









Section 1:

# The History of China's Economic Development

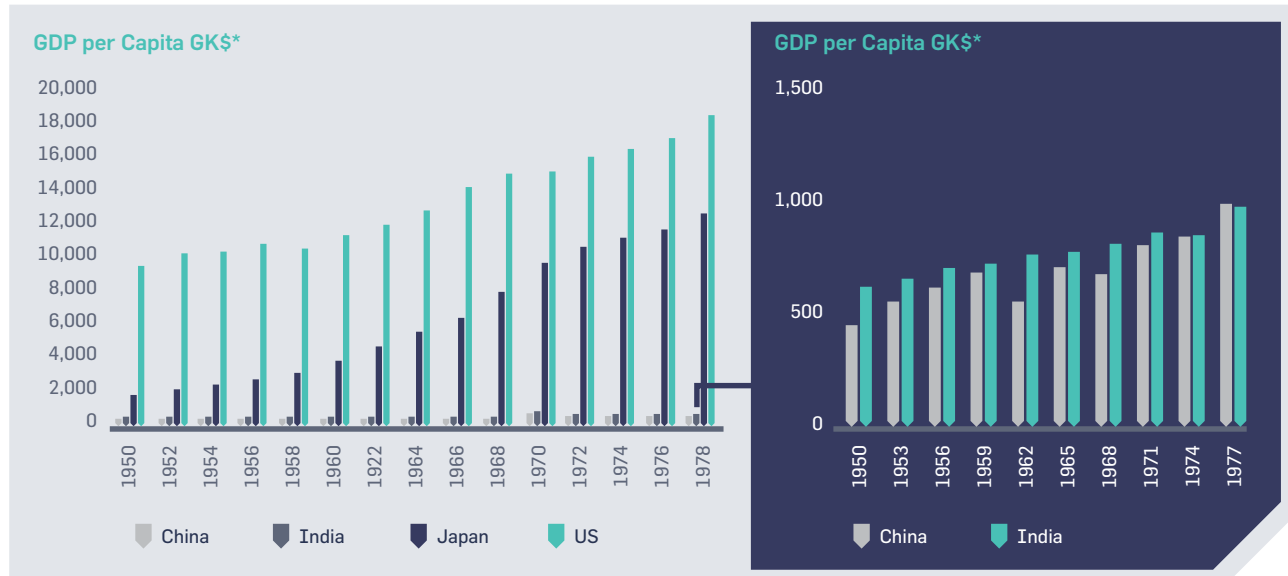
## China's Economy Prior to Reforms



Communist Party leader Mao Zedong established the People's Republic of China in October 1949 in the wake of disruptions arising from an eight-year battle against the Japanese and several years of civil strife between Communist and Kuomintang (Chinese National Party) forces. With an economy whose growth potential was obscured by the ravages of war and inflation, the new ruling government swiftly implemented an orthodox mix of fiscal and monetary policies to restore fiscal balance, quell hyper-inflation, and facilitate economic recovery.



## China's GDP per Capita before Economic Reforms vs. Selected Countries (1950-1978)



Source: The Maddison-Project, <http://www.ggd.net/maddison/maddison-project/home.htm>, 2013 version

\*The Geary-Khamis dollar (GK\$), more commonly known as the international dollar, is a currency unit used by economists to compare the values of different currencies. It reflects the current year's exchange rate with current purchasing power parity (PPP) adjustments

During his reign, Mao Zedong's main goal was to rapidly transform China from an agrarian economy into an industrial giant. Under his leadership, the central planning of industry was introduced in the 1950s, largely modelled on the annual and five-year plans of the Soviet Union<sup>1</sup>, albeit a more decentralized version. As a result, China's vast population was re-organized, where farms were collectivized into large communes and resources were shifted to the heavy industry in order to develop labor-intensive methods of industrialization. Under the commune system, also known as the 'Great Leap Forward', a process of decentralization occurred, with substantial authority vested in provincial and local plan bureaucracies. By 1958, private ownership was entirely abolished, and emphasis were placed on the development of small backyard steel furnaces in every village and urban neighborhood, which were intended to accelerate the industrialization process.

The inefficiency of the communes and the large-scale diversion of farm labor into small-scale industry severely impacted China's agriculture sector and created distortions in the economy, which, coupled with drought and poor weather, led to a massive famine and reportedly the deaths of up to 45 million people<sup>2</sup>. Efforts to revive forward momentum in the early 1960s met with some success, however the economy suffered further setbacks in the mid-1960s when a political campaign known as the 'Cultural Revolution' sparked a new reversal in economic policies and incentive mechanisms.<sup>3</sup> Prior to reform, China recorded slight gains with regard to India, but lagged far behind Japan and the United States (US).

### The Great Leap Forward

An economic and social campaign by the Communist Party of China designed to transform the country's agrarian socioeconomic culture towards an industrialized one

<sup>1</sup> Brandt, Rawski. 2008. "China's Great Economic Transformation"

<sup>2</sup> New York Times, Editorial, 15 December 2010. "Mao's Great Leap to Famine"

<sup>3</sup> Wong, Christine. 1986. "Ownership and Control in Chinese Industry" Joint Economic Committee, US Congress. China's Economy Looks Toward the Year 2000, vol. 1. Washington, DC: Government Printing Office, pp.571-603

## The Introduction of Economic Reforms in 1978

# China

SEZs and Economic Development Zones along the coast are destinations for rural-to-urban shift migration



### Legend

- — Special Economic Zone
- — Economic and Technical Development Zone
- — Key Economic Hub



# The Introduction of Economic Reforms

In 1978, Deng Xiaoping became leader and embarked on a series of ambitious economic reforms, dubbing him the architect of China's economic reforms.

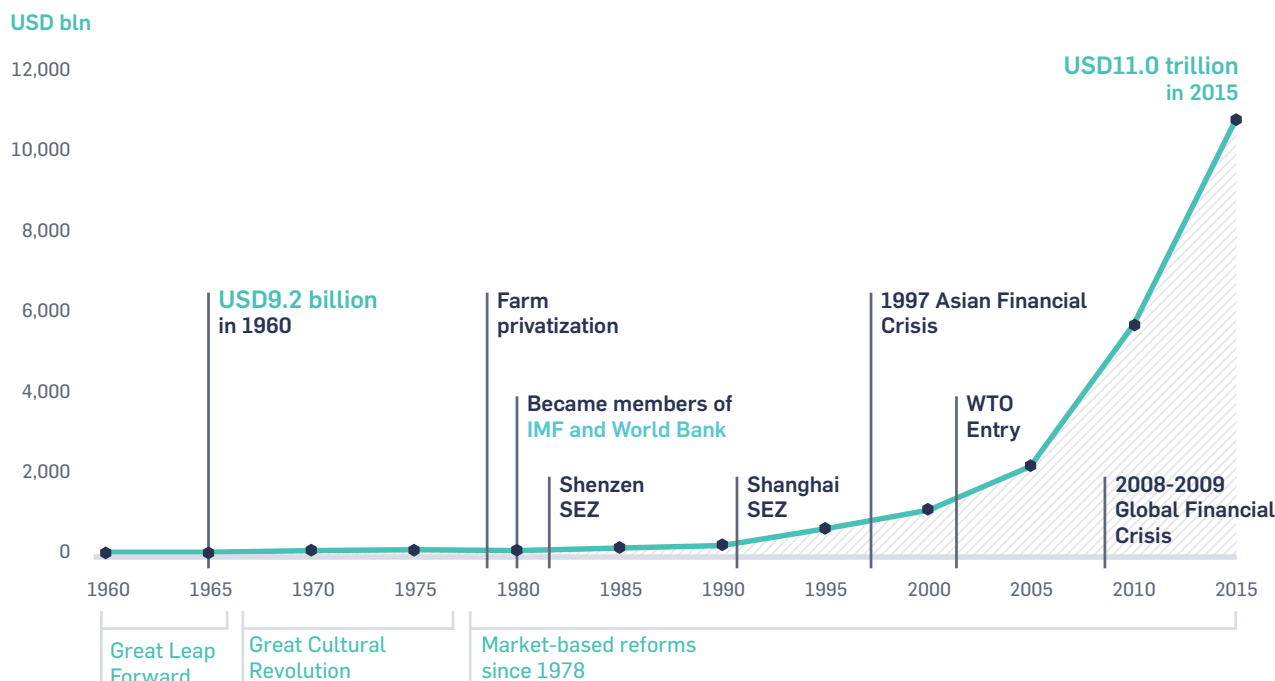


The reforms decentralized the state economy by replacing central planning with market forces, and there was a shift from the heavy industry to consumer-oriented industries, in addition to reliance on foreign trade and investment through joint ventures. Efforts were further boosted via the creation of Special Economic Zones (SEZs) along China's southern coastline, with the first one being set up in Shenzhen, along with the establishment of 12 state companies to control imports and exports. Following the success of Shenzhen Special Economic Zone, additional coastal regions and cities were designated as open cities and development zones, which allowed them to experiment with free market

reforms and to offer tax and trade incentives to attract foreign investment. In 1982, collective farming was dismantled, initiating a "responsibility system", which freed farmers to choose what crops to grow and to sell any surplus for profit in private markets.

Since embarking on economic reforms and introducing open-door policies in December 1978 aimed at raising rates of foreign investment and growth, the country has undergone a major transformation, evidenced by a variety of indicators that demonstrate an upsurge in China's economic welfare in the last 35 years.

## China: Nominal GDP in USD Trillion (1960-2015)



Source: World Development Indicators 2016, World Bank

Rapid advance in output per capita has elevated hundreds of millions from absolute poverty. Ravallion and Chen (2004) report a steep decline in the proportion of rural Chinese mired in absolute poverty: using an early official poverty indicator, the share of impoverished villagers drops from 40.65% in 1980 to 10.55% in 1990 and 4.75% in 2001<sup>4</sup>. A second indicator shows higher proportions living in absolute poverty, but indicates a comparable trend (75.7% impoverished in 1980 and 12.49% in 2001).

With an impressive average economic growth rate of almost 10% over a period of 35 years, no other country in the world can boast a similar performance over this period. The fact that the world achieved its UN millennium development goal of halving extreme poverty was largely driven by China, which accounted for more than three quarters of global poverty reduction between

1990 and 2005. This unparalleled success was underpinned by a combination of a rapidly expanding labour market, driven by a protracted period of economic growth, and a series of government transfers such as an urban subsidy which aimed to increase incomes of urban dwellers and the introduction of a rural pension.

In urban centres in China, poverty has been virtually eliminated. However, China's development has been driven by the coastal east, while development in the rural west is lagging behind. Its per capita income is still below the world average, showing the amount of development still to be done.

<sup>4</sup> Ravallion, Martin and Shaohua Chen. September 2004. "China's (Uneven) Progress Against Poverty" World Bank Policy Research Working Paper 3408. Washington, DC: World Bank.





Section 2:

# Overview of China's Economic Landscape

## 2016 in Review

As the structural supply-side reform process continues, China's economy finished a tumultuous 2016 on a positive albeit slower, higher-quality growth.

The economy outperformed most forecasts in the final quarter of 2016 by growing 6.8% y-o-y, signalling stabilizing growth and bringing China's annual growth rate to 6.7%. Indicators such as industrial electricity consumption, retail sales, and fixed asset investment suggest an increasing momentum comparing to the first three quarters of the year. Notably, supply-side reform is evidenced by the rising Producer Price Index (PPI), which reached above zero in September 2016 for the first time since February 2012. The PPI stayed positive for the rest of the year which helped put the long ailing manufacturing sector on steadier footing, boding well for corporate earnings - particularly in upstream sectors.

2016 may have witnessed China's slowest pace of growth in 26 years, but it remains within the range for Beijing to meet its longer-term goal of doubling GDP and per capita income by 2020 from 2010 levels. Indeed, China is central to global growth—the country continues to be the single largest contributor to world GDP growth, contributing 1.2 percentage points according to IMF's latest estimates. China's share alone dwarfs the contribution of other major economies such as the US, which contributed just 0.3 percentage points to overall world GDP growth in 2016, or only about one-fourth of the contribution made by China.

Moreover, 2016 proved that China is on the way to more quality and sustainable growth. Firstly, the economy was increasingly driven by the consumption and services sector. The share of the services sector in GDP was up by 1.4 percentage points (51.6% in 2016 vs. 50.2% in 2015), and consumption accounted for 64.6% of GDP.

In addition, 2016's growth was more efficient, underpinned by a decrease of 5% in total energy consumption per unit GDP (TEC/GDP). This is in line

with continued efforts by the Chinese government to promote energy saving. In addition, the share of clean energy consumption also increased by 1.6 percentage points over the previous year, showing notable progress in the country's bid to make its economy grow in a cleaner and more efficient manner.

Nevertheless, challenges still remain on China's road to reform. This was demonstrated in soaring house prices in major cities throughout 2016, urging the authorities to focus on implementing additional measures to cool the overheated property market as it risks dragging down growth for the economy as a whole. Despite headwinds, the supply-side reform process will continue to strengthen the foundation of sustainable economic growth in China.

4Q16 GDP Growth

**6.8%**

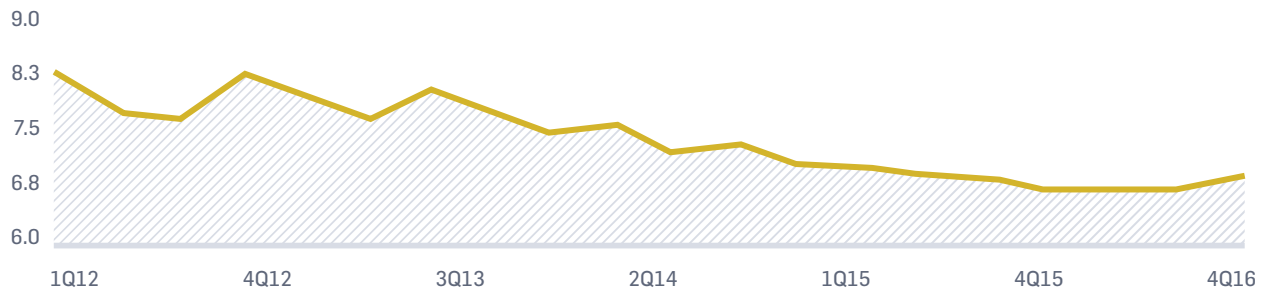
2016 Annual  
GDP Growth

**6.7%**



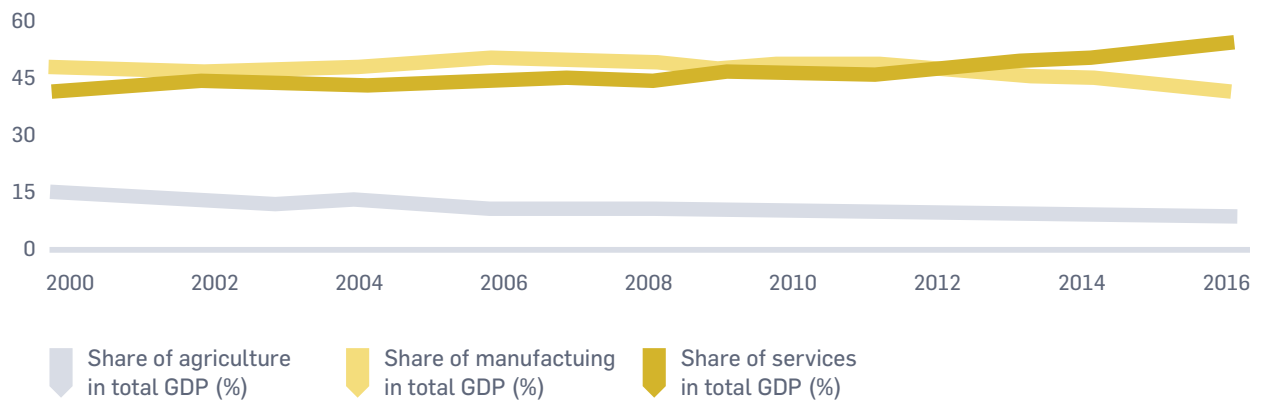
## Real GDP Growth Trend (1Q12 – 4Q16)

% y-o-y



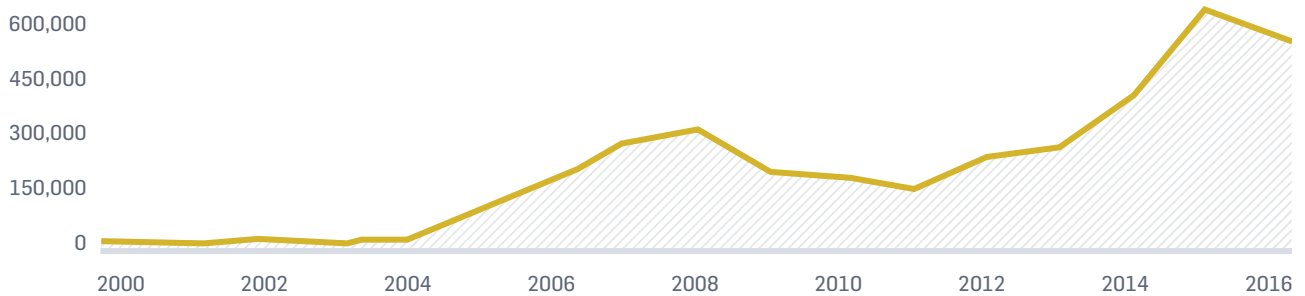
## Share of Industries in Total GDP (2000-2016)

% share of total GDP



## Net Export Performance (2000-2016)

USD mln





# 2017 Economic Outlook

In the short term, China's economy will continue to shift gears. In 2017, growth is projected to slow further to 6.5%. One of the adverse factors is the rapidly rising mortgages witnessed last year, which is anticipated to suppress the growth of households' capacity to consume in 2017.



Subdued international trade also poses headwinds. As China is one of the world's largest trading nations, the impact of rising protectionism by the new US administration would be significant. Going beyond the direct impact on China's export growth, a protectionist environment would also adversely affect corporate sentiment. However, at the same time, structural reforms will take the rebalancing process to a new stage. This is so because Chinese authorities are set to focus on the following five measures:

- 1) addressing overcapacity, 2) reducing inventory,
- 3) deleveraging, 4) lowering costs and 5) bolstering areas of weakness.

Meanwhile, the state-owned enterprise (SOE) mixed ownership reform is expected to continue, allowing more non-public sector involvement in the economy. By the beginning of 2017, the authorities have further loosened the regulations on domestic private investment as well as foreign investment.

Domestic private capitals are encouraged to participate in infrastructure projects through Public-Private Partnership (PPP) programs. Foreign capitals are allowed wider access to previously restricted industries such as manufacturing, mining, and financial services. In addition, an extended plan for a nationwide foreign investment approval system and the re-evaluation of a "negative list" are being considered by the authorities, which, once implemented, will enhance the foreign investment environment profoundly. In summary, China's slowdown is accompanied by structural reforms and rebalancing, which, despite short-term stress, is necessary for a healthy and more balanced growth in the long term.



## China's "One Belt, One Road" Initiative: Highlights

Designed to engage over 60 countries in six economic corridors, accounting for roughly 63.0% of the world's population and a collective GDP equivalent to 33.0% of the world's wealth, the "One Belt, One Road" (OBOR) initiative is a bold and innovative strategy. Ever since President Xi Jinping announced the initiative in 2013, resources have been earmarked at a great scale along the way, and breakthroughs were seen in various areas.

### 1 — Trade

According to Chongyang Institute for Financial Studies, from June 2013 to June 2016, the commodity trade volume between China and OBOR countries stood at USD31.1tln, accounting for 26% of China's total international trade. To boost trade relations with OBOR countries, China has been thriving on new trade arrangements. Firstly, bilateral free trade agreements (FTAs) have been intensively negotiated. By mid-2016, China reportedly signed 14 FTAs involving 22 countries in various regions, with eight more being negotiated and six more being arranged. Secondly, multilateral free trade negotiations are also on the way, including the Regional Comprehensive Economic Partnership (RCEP) and the China-Japan-South Korea FTA. Thirdly, China signed the Authorized Economic Operator arrangements with Singapore, South Korea, EU and Hong Kong SAR to provide more convenient customs clearance to corporations.



### 2 — Investment

In the first six months of 2016, China's investment in OBOR countries reached USD51.1bln, accounting for 12% of China's total FDI abroad during the same period. Meanwhile, OBOR countries invested USD3.36bln in China, accounting for 4.8% of total FDI in China during the same period. China signed bilateral investment agreements with 104 OBOR countries, and tax agreements with 53 OBOR countries, improving the investment environment for corporations in these countries. In addition, China transformed its borders, setting up five border development zones, 17 border economic cooperation zones, and one cross-border economic cooperation zone. Currently, 11 cross-border economic cooperation zones are in the midst of being established.



### 3 — Infrastructure

Since the launch of the OBOR initiative, infrastructure has been one of the central issues. As OBOR countries focus on infrastructure development to boost their economies during which China seeks to deal with excess capacity, there comes a win-win game. From September 2013 to June 2016, Chinese SOEs participated in 38 large-scale transportation projects in 26 countries and 40 energy projects in 19 countries along the OBOR route.



# Monetary Policy and Inflation



In an effort to deleverage and address soaring asset prices, the People's Bank of China (PBoC) has pledged to maintain the "prudent and neutral" monetary policy in 2017. As major central banks across the world start to reassess, or in some cases even retreat from their super-accommodative monetary policies, the PBoC is on board. Despite continuing to innovate its toolkit to provide liquidity to the market, the PBoC is becoming more cautious. On 24 January 2017, the PBoC raised the interest rate on its one-year Medium-term Lending Facility (MLF), after higher-than-expected bank lending growth in December 2016. This was followed by the decision on 3 February 2017 to raise interest rates PBoC charges in open-market operations and

on funds lent via its Standing Lending Facility (SLF) to rein in asset prices and inflation. Meanwhile, regulations were upgraded in order to curb the 'barbarian growth' of shadow banking. Following the rise of PPI in the fourth quarter of 2016, CPI is expected to climb in 2017. To this end, the PBoC is envisaged to take action to avoid higher-than-expected inflation. As a result, it is envisaged that the PBOC will keep cautious and be ready to curb liquidity. However, underpinned by the high debt of local governments and non-financial corporates, China's monetary policy will stay at a relatively accommodative level to keep the financial system stable.

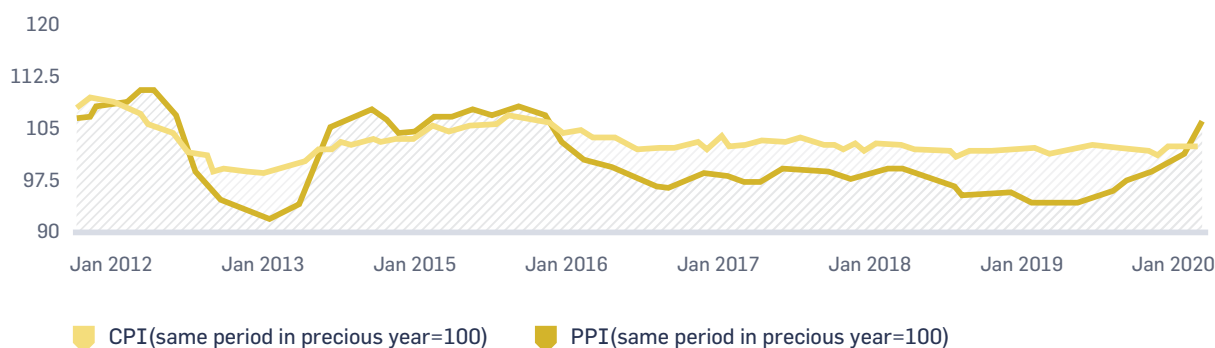
One-year policy lending rate

**4.35%**

Seven-day repo rate

**2.35%**

## CPI & PPI Trend (January 2008- December 2016)





# Renminbi Performance

Since the late 2000s, China has been seeking to internationalize the Renminbi (RMB). After establishing the dim sum bond market and expanding the Cross-Border Trade RMB Settlement Pilot Project in 2009, the PBoC went further by expanding its pilot program for macro-prudential management of cross-border financing from free trade zones to nationwide. On 1 October 2016, the RMB was formally included in the basket of currencies that compose the Special Drawing Rights (SDR), joining the other four other currencies and was assigned a share of 10.92%. By including the RMB in the basket, the IMF confirmed the view that the RMB is “freely usable”, which is a milestone for the internationalization process of the RMB.

Despite the achievements of the internationalization, the RMB has been experiencing a devaluation pressure since the exchange rate reform on 11 August 2015. From mid-August 2015 to mid-January 2017, the RMB depreciated by about 9.0% against the USD. To defend the value of the RMB, foreign reserves declined by 9.6% in 2016. One of the major reasons is believed to be the persistent, yet gradual capital outflows due to the slowdown of China's economic growth. However, a closer look suggests

that the RMB is mainly devaluating against the USD as the Federal Reserve enters an interest-rise track, and that the RMB is resembling the performance of most other major currencies in the world. Therefore it is seen as more of an appreciation of the USD than a depreciation of the RMB.

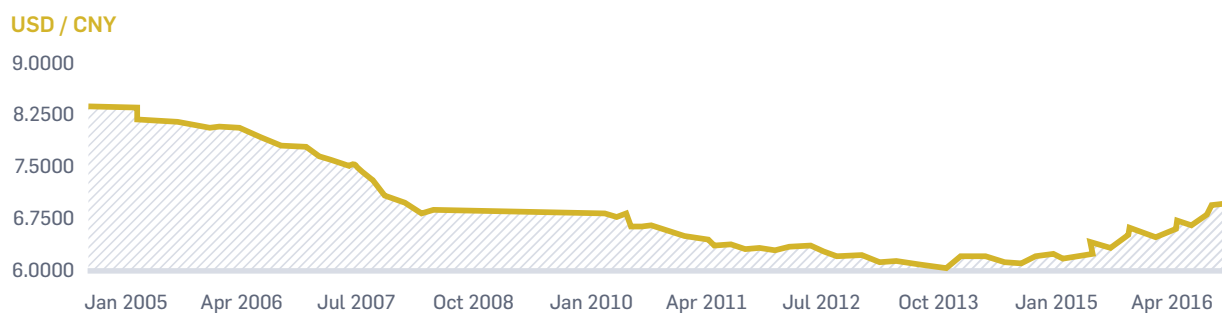
As the “new normal” goes on, further depreciation of the RMB is possible. However, backed by large foreign-exchange reserves, the probability of a sharp devaluation of the RMB is fairly low. By end-2016, the foreign-exchange reserves dropped nearly USD320.0bln to a sizeable USD3.0tln. Despite its decline, China still owns the world's largest stockpile of foreign-exchange reserves.

Moving forward, the PBoC will continue to defend the RMB and staunch capital outflows. Moreover, although more interest rate hikes by the Federal Reserve in 2017 is highly possible, the Trump administration's favour of a weaker USD is sending the market opposite signals, leaving a window for a halt of the USD appreciation track. As a result, it has reduced the depreciation pressure on the RMB and other currencies.

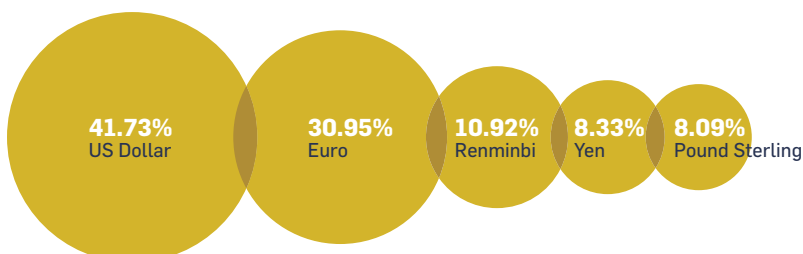
Largest foreign currency reserves in the world

**USD3.0 trillion**

## USD-CNY Performance (January 2005 – December 2016)



## IMF adds RMB to Special Drawing Rights (SDR) basket on 1 October 2016



Source: IMF

# Fiscal and Current Account Balance



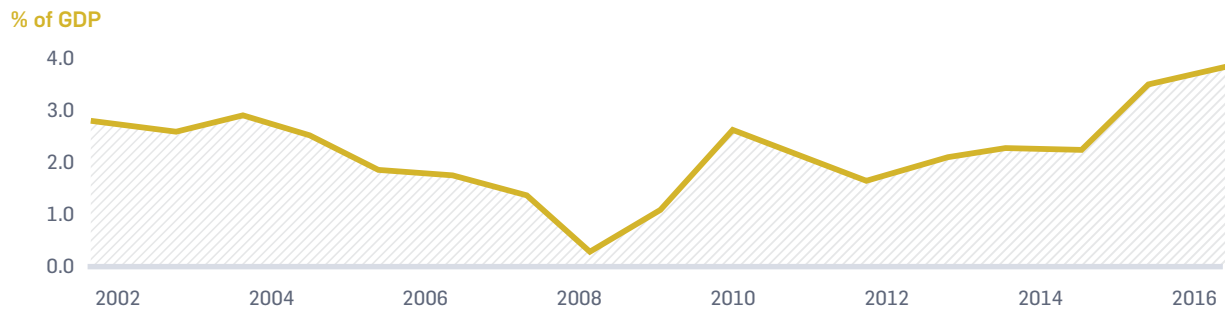
On the fiscal front, the government will maintain expansionary fiscal policies in 2017 to counteract the strong decelerating forces the economy is facing. The central government debt is envisaged to stay around 3.0% of GDP, while the local government may be allowed to slightly increase their debts to stimulate the local economy. Moreover, local government debt replacement will be expanded and transparency will be enhanced to keep the government finances at a healthy level. Government debt is estimated to remain well below 60% in the short-term, keeping the government solvent and well-financed.

On the current account front, the prolonged surplus will continue to narrow. Sluggish external demand is anticipated to continue, as rising protectionism and the anticipated policies of the new US administration will threaten exports. Meanwhile, the slowly rising commodity prices may bring import costs higher. However, both exports and imports can be supported by the RMB, of which the 2016 depreciation is envisaged to benefit the trade balance in 2017, and therefore maintain the current account surplus.

Fiscal deficit %  
of GDP (2017)

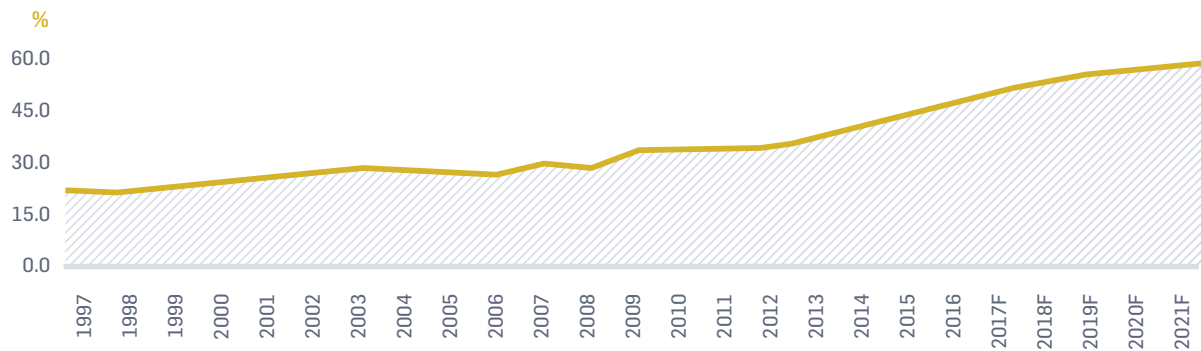
**3.0%**

## General Government Fiscal Deficit (% of GDP) (2000-2016)



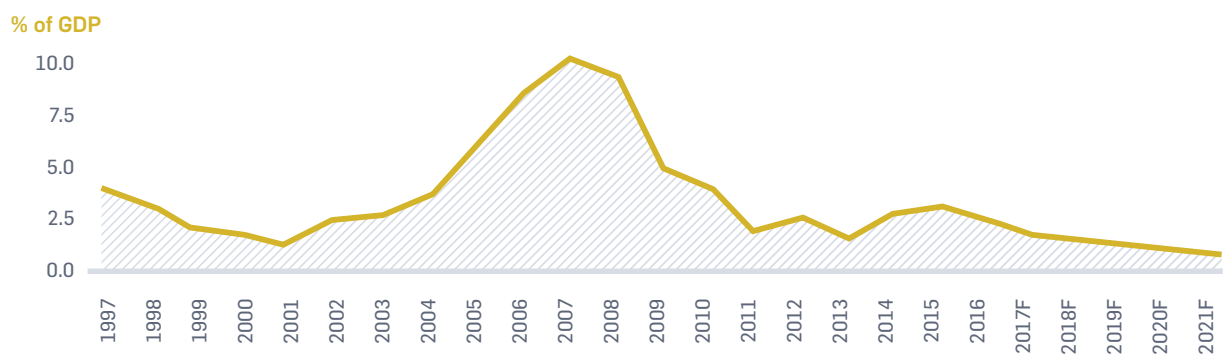
Source: IMF

## General Government Gross Debt (% of GDP) (1997 -2021F)



Source: IMF

## Current Account Balance (% of GDP)



Source: IMF



# China's Trade with OIC Countries



Total OIC exports destined to China (2015)

**9.2%**

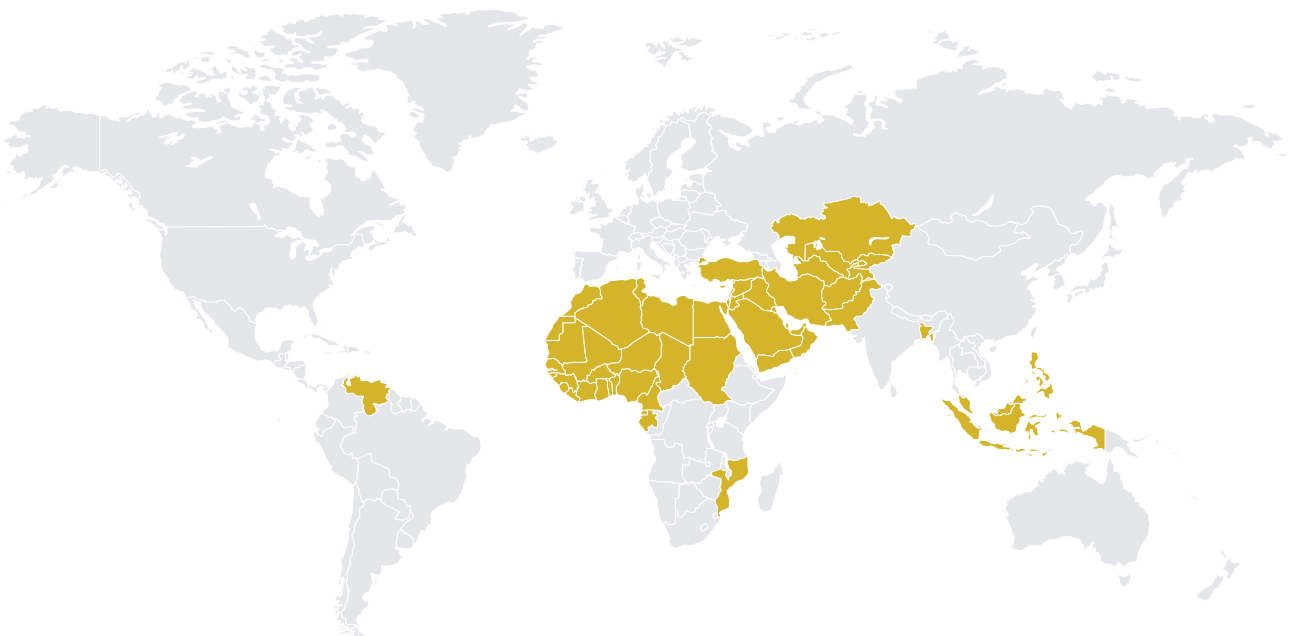
Total OIC imports from China (2015)

**17.4%**

To date, China has signed agreements with 21 Arab countries on economic, trade, and technical cooperation. The country has also entered into international investment treaties with 17 Arab countries, and double tax treaties with 12 Arab

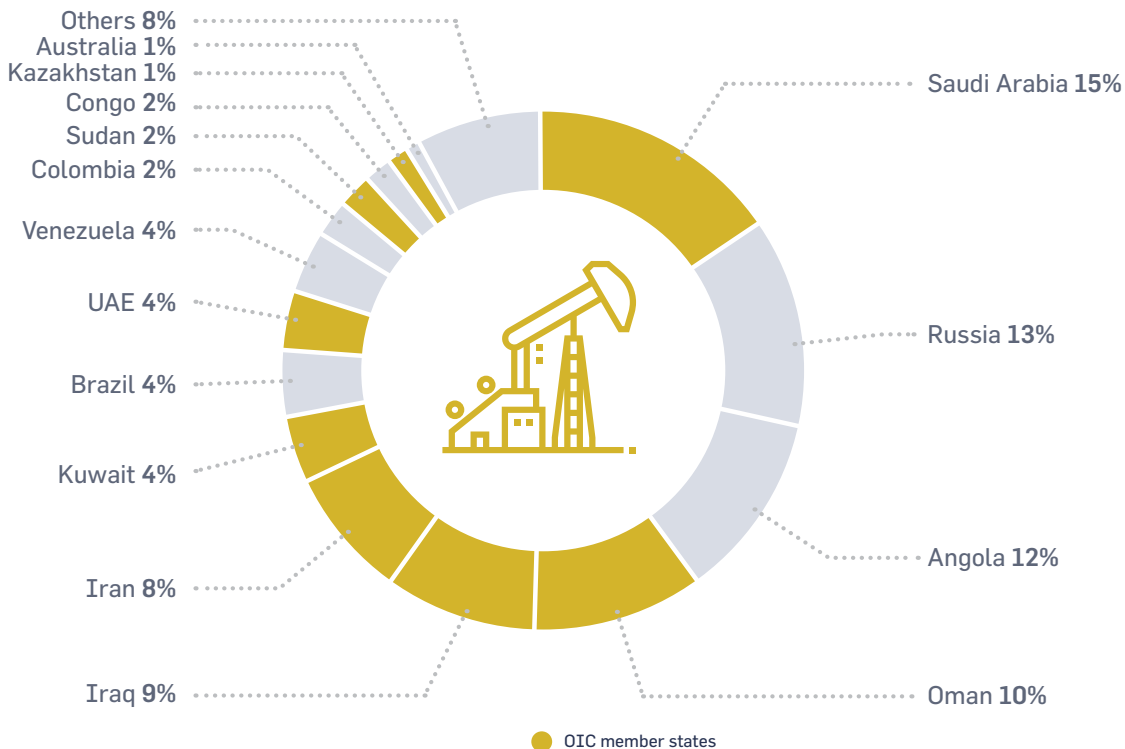
countries. Since 2010, China has offered zero-tariff treatment to six least-developed Arab countries for most products exported to China. Currently, China is the second largest trade partner for Arab countries as a whole.

## OIC Member States



Although the total exports of OIC countries declined from USD2.3tln in 2013 to USD1.6tln in 2015, trade between China and OIC countries have remained dynamic amidst a global economic slowdown.

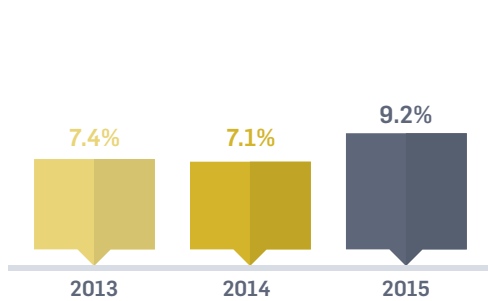
## China: Crude Oil Imports by Country of Origin (2015)



Source: EIA, FACTS Global Energy

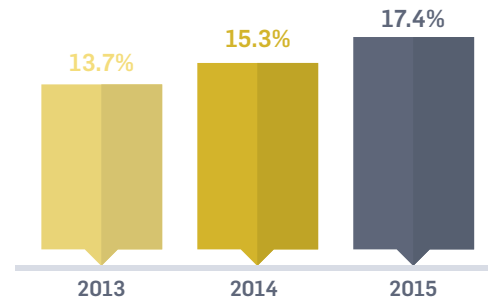
In 2015, 9.2% of total OIC exports were destined to China, representing an increase of 2.1 percentage points compared to 2014. China is the world's largest oil importer, and 8 out of the top 14 origin of Chinese oil imports are from OIC member states. As a result, OIC exports of oil and related products to China accounted for about half of China's total imports. Meanwhile, 17.4% of OIC imports were from China, making the country the largest single trading partner for the bloc.

**OIC countries' exports to China / OIC countries' total exports (%)**



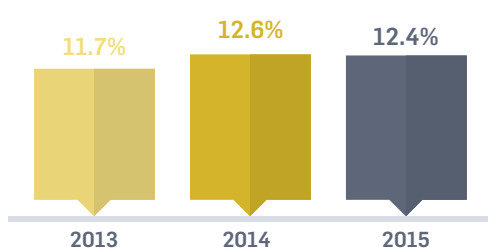
Source: International Trade Center

**OIC countries' imports from China / OIC countries' total imports (%)**



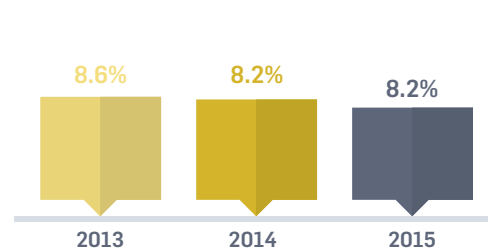
Source: International Trade Center

**China's exports to OIC countries / China's total exports (%)**



Source: International Trade Center

**China's imports from OIC countries / China's total imports (%)**



Source: International Trade Center

In the first three quarters of 2016, China's exports to Middle Eastern countries reached USD163.83bln. In December 2016, the 9th round of negotiations between China and GCC countries on a comprehensive free trade deal (China-GCC FTA) was held, and an agreement is expected to be signed in 2017. The free trade talks started in 2004, and a deal will help China cut costs on energy imports from the region.



# Recent Developments on Chinese Investments in OIC Countries

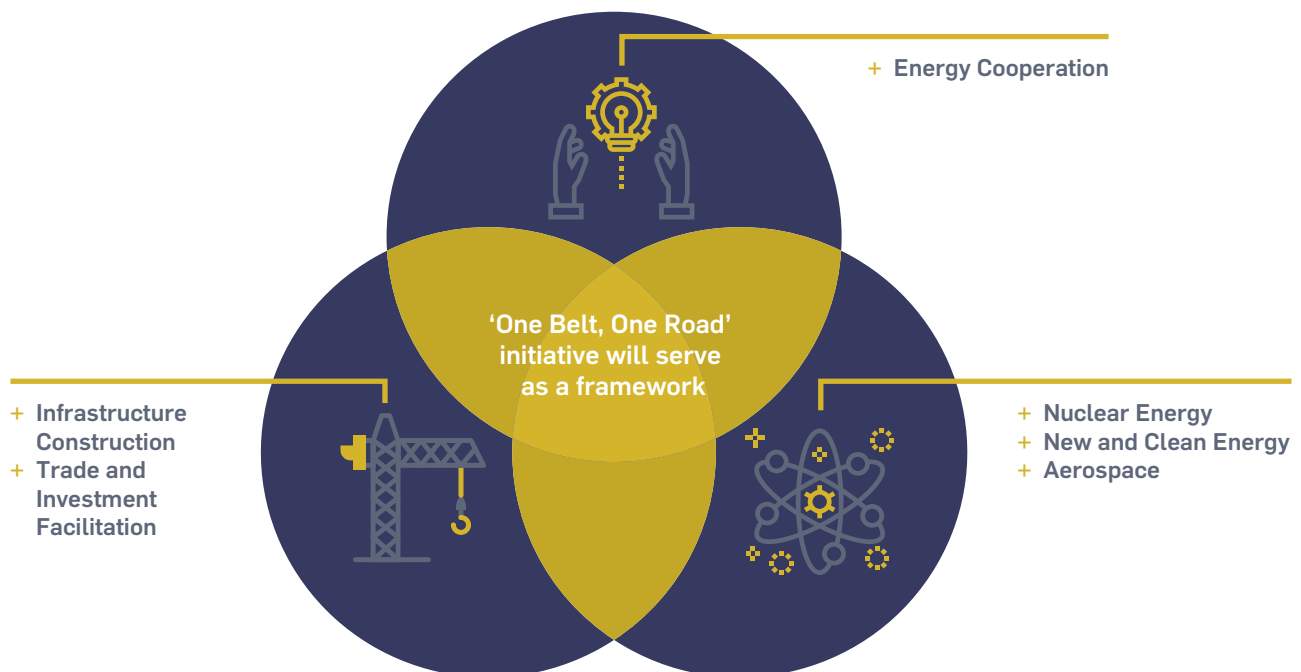
By the end of 2014, Chinese companies' contract projects in Arab countries totalled USD255.1bln.

This includes projects in areas such as housing, telecommunications, transportation, oil, chemistry, power, and construction materials among others. Algeria, Saudi Arabia, and the UAE have been the largest markets. To this end, RMB clearing centers have been established in Dubai and Doha, and a joint investment fund worth USD10bln have been set up between China and the UAE as well as with Qatar as part of the government's drive to forge closer commercial and political ties with the Middle East and build new trade routes.

Moving forward, it is envisaged that China and Arab countries will continue to improve the "1+2+3" cooperation pattern – energy cooperation as the main axis, infrastructure construction and trade

and investment facilitation as two wings, with breakthroughs to be made in the three high-tech areas of nuclear energy, aerospace satellite and new energy. During the 7th Ministerial Meeting of China-Arab Cooperation Forum in May 2016, both sides approved and signed the Doha Declaration and the 2016-2018 Action Plan. Under the agreement, China will offer up to USD15.0bln in loans for the industrial sector in the Middle Eastern countries with emphasis on the oil and gas, renewable energies, auto, and construction industries, while the Arab-Chinese partnership program of action specifies 36 areas of cooperation in the coming two years in the areas of energy, technology, scientific research and infrastructure.

## China's Arab "1+2+3" Approach





To date, more than 25 OIC member countries have joined the OBOR initiative, and over 20 countries are founding members of the Asian Infrastructure Investment Bank (AIIB), an international financial institution founded by China that aims to support the building of infrastructure in the Asia-Pacific region.



In 2016, AIIB issued loans totalling USD1.73bln, of which USD1.11bln were awarded to OIC member countries. In June 2016, the board of AIIB approved four projects worth USD509.0bln. These projects cover energy, transportation and urban development of Bangladesh, Indonesia, Pakistan and Tajikistan. On 29 September 2016, AIIB and the World Bank jointly issued loans totaling USD300.0mln to the expansion project of the hydro-electricity plant of Pakistan. On 9 December 2016, AIIB announced two batches of loans to Oman, totaling USD301.0mln, marking the first time that AIIB invested in port and railway construction.

Indeed, cooperation between China's OBOR initiative and OIC countries gained steam in 2016, with infrastructure development at its core. For example, the China-Pakistan Economic Corridor (CPEC), a collection of infrastructure projects currently under construction throughout Pakistan, is testament to this. As part of the Maritime Silk Road under the OBOR initiative, China has invested more than USD46.0bln in the corridor. The goal is to establish a trade route connecting Gwadar, a port on the Arabian Sea, to northwest China. This enormous project is driven in part by Beijing's desire to build additional routes for its energy imports from the Middle East—to lessen its dependence on sea routes. Other noteworthy OBOR projects and activities include:

### **Karachi- Lahore Motorway and Karakoram Highway Phase-II**

Two projects of the CPEC earmarked for early completion— USD2.6bln Karachi-Lahore Motorway and USD920mln Karakoram Highway Phase-II – will be constructed on a 'build, operate and transfer' basis, and will be undertaken by Pakistan's National Highway Authority. China will facilitate loans for them through its financial institutions led by the China Development Bank.

### **The Orange Line of the Lahore Metro**

The Orange Line is the first of the three proposed rail lines of the proposed Lahore Metro in Pakistan and spans 26.23 km (16.3 mi). The project was initiated with a signed a memorandum of understanding between the governments of Pakistan and China in May 2014, and financing for the project was secured in December 2015 when China's Exim Bank agreed to provide a soft loan of USD1.55bln for the project.

### **China-Kyrgyzstan-Uzbekistan Railway**

Kyrgyzstan's prime minister Temir Sariev has said that the construction of the delayed Kyrgyz leg of the China-Kyrgyzstan-Uzbekistan railway would start in 2016. In September 2015, Uzbekistan said it had finished 104km of the 129km Uzbek stretch of the railway.

### **Khorgos Gateway**

Khorgos Gateway, a dry port on the China-Kazakh border that is seen as a key cargo hub on the new Silk Road, began operations in August 2015. China's Jiangsu province has agreed to invest more than USD600mln over five years to build logistics and industrial zones around Khorgos.

### **Trans-Asian Railways**

Whether transporting frozen poultry or electronic equipment, subsidies from China are making new overland train routes across central Asia an increasingly attractive proposition for logistics businesses. Cheaper than by air, and faster than by sea, increased overland rail networks could help the region capture valuable business and capitalise on increased trade from China to Europe through overland routes across Belarus, Russia and Kazakhstan.

## Rail connection to Tehran

The first freight train from China arrived in Tehran in February 2016 in the wake of China's OBOR project which has seen ongoing investment in overland rail across central Asia. This, plus Iran's landmark nuclear agreement with the west in 2015, has paved the way for deals with France and Germany for a much-needed modernisation of the country's railway network and provided a boost to Chinese-Iranian trade.

## Central Asia-China gas pipeline

The 3,666km Central Asia-China gas pipeline predated the new Silk Road but forms the backbone of infrastructure connections between Turkmenistan and China. Chinese-built, it runs from the Turkmenistan/Uzbekistan border to Jingbian in China and cost USD7.3bln.

## Central Asia-China gas pipeline, line D

China signed agreements with Uzbekistan, Tajikistan and Kyrgyzstan to build a fourth line of the central Asia-China gas pipeline in September 2013. Line D is expected to raise Turkmenistan's gas export capacity to China from 55bn cu m per year to 85bn cu m.

## Khorgos-Aktau railway

In May last year, Kazakhstan's President Nursultan Nazarbayev announced a plan to build — with China — a railway from Khorgos on the Chinese border to the Caspian Sea port of Aktau. The scheme dovetails with a USD2.7bln Kazakh project to modernise its locomotives and freight and passenger cars and repair 450 miles of rail.

## OIC Member States

			22 Arab countries that are part of the China "1+2+3" policy		Gulf Cooperation Council (GCC) countries
Malaysia	Kyrgyzstan	Benin	Algeria	Morocco	Bahrain
Turkey	Afghanistan	Albania	Comoros Islands	Mauritania	Kuwait
Indonesia	Mali	Guinea	Djibouti	Palestine	Qatar
Iran	Uzbekistan	Guyana	Egypt	Somalia	Saudi Arabia
Nigeria	Turkmenistan	Burkina Faso	Iraq	Sudan	Oman
Kazakhstan	Brunei	Djibouti	Jordan	Syria	UAE
Pakistan	Cameroon	Niger	Lebanon	Tunisia	
Bangladesh	Chad	Sierra Leone	Libya	Yemen	
Ivory Coast	Lebanon	Gambia			
Azerbaijan	Mozambique	Maldives			
Gabon	Senegal	Guinea-Bissau			
Uganda	Tajikistan				
Togo	Suriname				



Section 3:

# Islamic Finance in China



# Overview of Islamic Finance



Over the past few decades, the Islamic finance industry has shown remarkable growth. With a market share of roughly 1.0%<sup>5</sup>, however, it remains a relatively small albeit viable part of the overall financial system currently. At the same time, it is also one of the fastest growing sectors of the global financial services industry. As at end-2015, the overall value of the Islamic finance sector reached a total of approximately USD2.0trln<sup>6</sup>, weathering a series of economic challenges ranging from prolonged low energy prices and downwardly revised economic growth outlook, to geopolitical conflicts, exchange rate depreciations and an assets sell-off spree in emerging markets<sup>7</sup>.

Overall value of the Islamic finance industry (2015)

## USD2.0 trillion

### Sources of Sharia'a

#### Primary Sources

- + **Qur'an** (the word of God)
- + **Sunnah** (the religious actions and quotations of Prophet Muhammad, narrated through his companions and imams. The details about the Sunnah are preserved in the form of Hadiths)

#### Secondary Sources

- + **Ijma'** (Consensus by independent jurists on a particular legal issue)
- + **Qiyas** (the use of deduction by analogy/case law from previously-accepted decisions to provide an opinion)

#### Ijtihad

- + The interpretation of all other sources (both primary and secondary) by individual Sharia'a scholars

<sup>5</sup> Various estimates and research reports indicate that the global Islamic finance sector represents a nascent 1.0% of the total world's financial industry

<sup>6</sup> State of the Global Islamic Economy 2016-2017

<sup>7</sup> IFSB Stability Report 2016

To understand the value proposition of Islamic finance, one must first understand the foundation of Islamic finance. Broadly speaking, Islamic finance is governed by the principles of Sharia'a. By definition, Sharia'a provides a set of ethical principles which is derived from the teachings of the Islamic faith. It also governs every aspect of a Muslim's life and the way one deals with one another. Meanwhile, from a commerce point of view, Sharia'a is the ethical framework that delivers legal, moral, and spiritual guidance aimed at achieving the goals of Islam. These principles and values, many of which are universally applicable, equally apply to Islamic financial services, and are strongly associated with the business ethics often advocated by regulatory bodies. They also focus on generally accepted view of social responsibility and consumer protection encouraged by society as a whole. In summary, Sharia'a provides an ethical business framework and include the following precepts:

### **Honesty and fair trade**

Trades have to be conducted in a fair and honest way and traders should not engage in practices such as manipulative tactics or cheating

### **Disclosure and transparency**

All characteristics including any potential faults, quality, and other relevant specifics need to be disclosed by the seller. All components of the transaction have to be completely transparent to all parties. Although the emphasis here is on the seller, the buyer has some responsibility and needs to ensure that he is aware of what is being sold to him

### **Misrepresentation**

False declarations regarding the goods, the trader's own standing, or ownership of the asset should not occur

### **Selling over and above the sale of another**

Although bargaining is permitted, once a transaction is concluded, another party should not attempt to interfere in the transaction by offering his own goods at a better price

### **Forbidden items are not allowed to be traded**

Only goods and assets that are deemed to have a value in the eyes of Sharia'a are allowed to be traded. Any unlawful (haram) goods such as alcohol, weaponry, and other haram investments are prohibited

### **Hoarding is not allowed**

Notwithstanding that trade is encouraged, hoarding as well as excessive love of wealth is condemned. The emphasis is on balance, reasonableness and fairness

### **Sale of goods and assets in the open market**

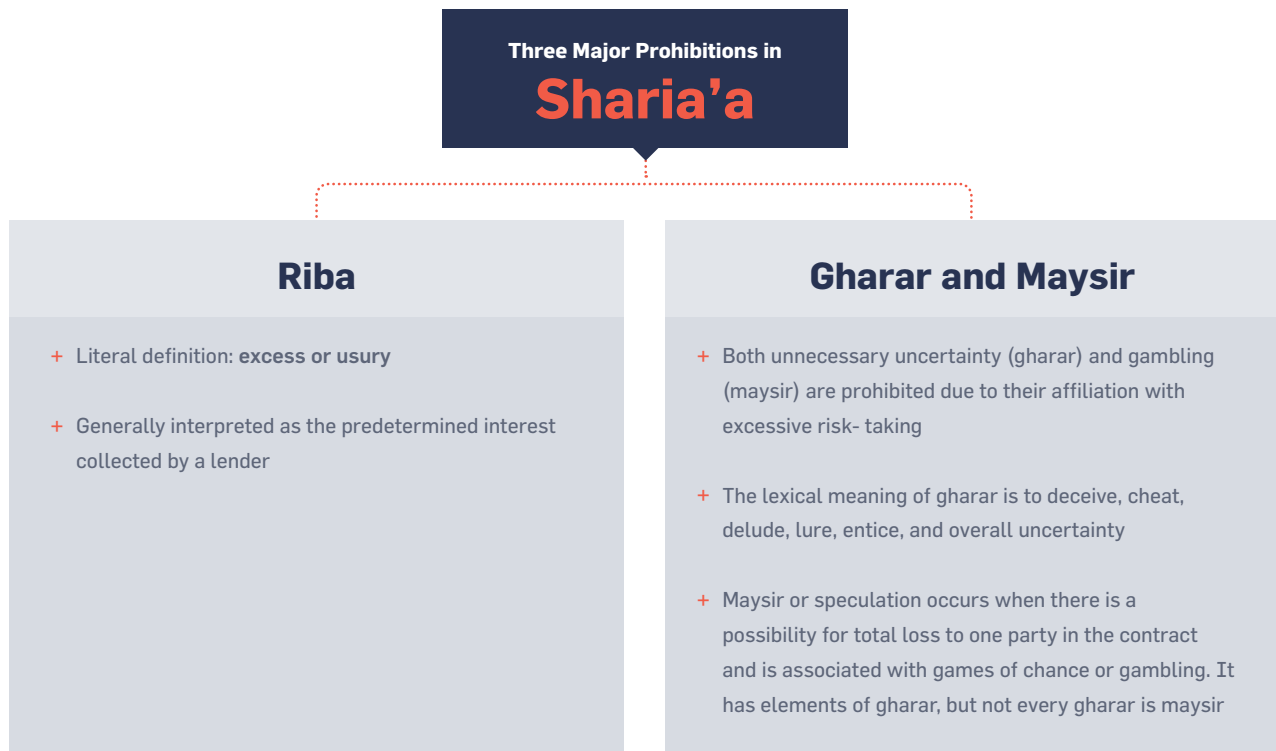
Competition is encouraged and transactions should take place in the open and fair market. All parties have to ensure that they are aware of general market conditions and pricing prior to concluding a transaction. Neither the buyer nor the seller should take advantage of the fact that the other party is unaware of market price and conditions

### **Avoid taking advantage of a seller's vulnerability**

Taking advantage of an individual who, under pressure, is forced to sell an item must at all times be avoided. Instead of taking undue advantage, the buyer should offer assistance to the seller during his plight. Writing off debt, revising repayment structures, or exploring other ways to assist a debtor suffering hardship is encouraged

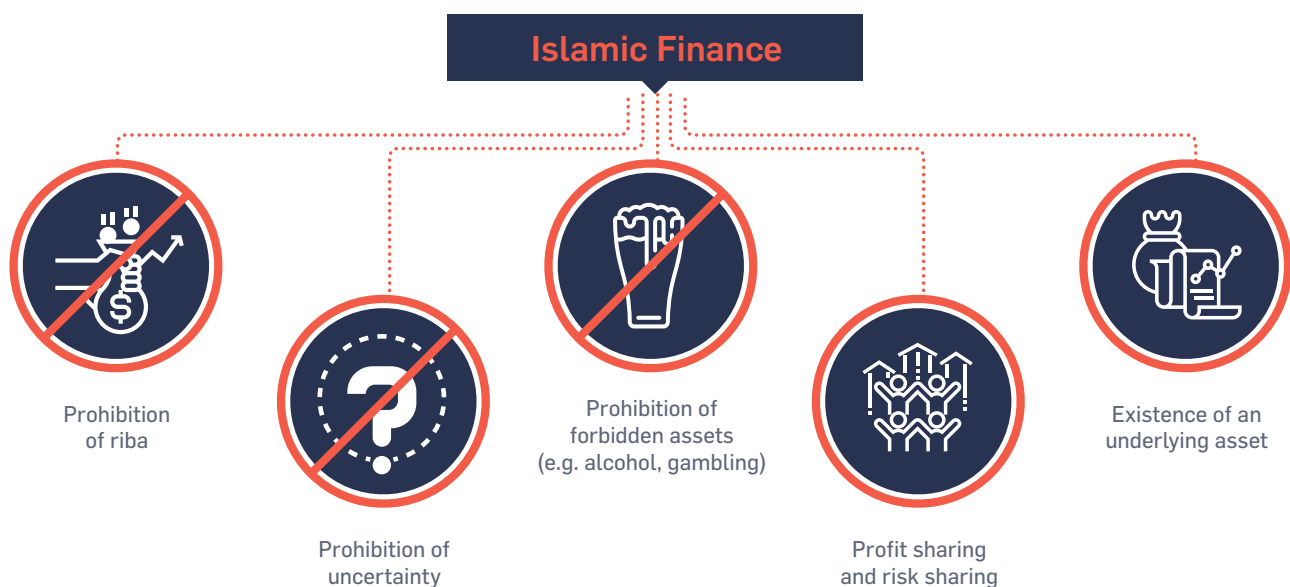


In addition to the guiding principles outlined earlier, Sharia'a defines three major prohibitions: Riba (usury), gharar (unnecessary uncertainty), and maysir (speculation).



Source: Ethica Institute, INCEIF, IFSB

## Key Principles Underlying Islamic Finance





# The Evolution of Islamic Finance



The modern revival of Islamic finance emerged in the 1960s in response to the unmet need for a form of finance that Muslims could trust, and which was in accordance with their ethical and moral principles.

It was marked with the establishment of the first Islamic bank in Egypt by Ahmad El Najjar, followed by the set-up of the Hajj Pilgrims Fund Board, also known as Tabung Haji (TH) in Malaysia.

In the early stages of development of the 1980s and 1990s, the Islamic finance industry was mainly present in the Middle East and South-East Asia in predominantly Muslim-based countries with traditional retail and commercial banking activity (including trade finance) gradually being re-cast in Sharia'a compliant forms. Since then, Islamic financial products have grown in range and sophistication to include capital market, asset

management and takaful (Islamic insurance) products, thus fulfilling the diverse needs of retail and corporate customers. Islamic finance has also evolved in sophistication beyond its traditional boundaries, spanning across more than 85 countries in regions including Asia, Middle East, Europe, the Americas and more recently sub-Saharan Africa. To date, at least 1,291 financial institutions offer some type of Sharia'a compliant financial products. The Islamic finance industry is broadening its ownership base and building a strong value proposition for it to reach wider acceptance and richer value.

## Islamic Finance Innovations and Developments

### 1970/1980s

- + Introduction of Islamic banks offering basic deposit and financing services

### 1990s

- + Improvements in banking services to expand into newer retail and corporate banking segments
- + Introduction of Islamic capital markets with listing of Islamic equity indices, introduction of Islamic funds and the issuance of first corporate sukuk in Malaysia by Shell

### 2000s

- + Introduction of Islamic banks offering basic deposit and financing services including wealth management, trade financing structured products, investment banking, hedging instruments and corporate financial solutions
- + A full-array of Islamic capital market instruments in place including equities, Islamic bonds and asset management
- + Takaful sector increasingly becoming focus of regulators to spur growth and innovation in the segment

### 2010s

- + Islamic finance as an ethical financial system bridging the gap with the real sector and potentially contributing towards global financial stability
- + Islamic finance new growth opportunities in:
  - Environment-friendly projects
  - Sharia'a compliant risk management
  - Addressing liquidity and capitalisation of IFIs
  - Infrastructure projects

Source: "Innovations Drive Expansion of Global Islamic Finance Industry" by MIFC







In the wake of the 2008-2009 financial crisis, there has been a renewed debate on the role that Islamic finance can play in the stabilization of the global financial system, given its strong ethical principles and religious foundations. The conventional banking sector was estimated by the International Monetary Fund (IMF) to have experienced losses in the tune of USD3.0tn to USD4.0tn as a direct consequence of the crisis. In contrast, no Islamic bank required government bail-outs at a magnitude which was witnessed by some of the world's largest banking institutions in advanced economies.

The resilience of Islamic banks during the crisis demonstrates the intrinsic strengths rooted in Islamic finance that are underpinned by the forces of the Sharia'a principles. Islamic finance requires returns to be sourced from ethical investments which avoid highly risky and speculative investments that are deemed to be one of the primary triggers of financial upheavals. Additionally, all financial transactions must undergo proper due diligence and be accompanied by an underlying productive economic activity. In summary, the Islamic finance model can only be extended to activities in the real sector that have economic values, thus establishing the close link between financial transactions and productive flows.

The cohort of institutions offering Islamic finance is not confined to new full-fledged Islamic finance



entities. Major players of the global conventional finance industry are venturing into Islamic finance either through new subsidiary entities or window operations. As Islamic finance continues to reach new heights, recent trends indicate that the industry is evolving into a deeper and more sustainable ecosystem. Currently, many non-traditional markets are working on measures to enable the introduction of Islamic finance in their financial territories. Positively, rigorous efforts have been made to harmonise Islamic financial practices, ranging from the creation of accounting standards for Islamic financial products (through the Accounting and Auditing Organisation for Islamic Financial Institutions, (AAOIFI), to integration of those standards with global corporate and risk management standards (such as Basel Accords I, II and III) through the Islamic Financial Services Board (IFSB).

The remarkable growth rates of the Islamic finance industry are driven by a number of factors namely:

**+ A large, young and rapidly-growing Muslim population.**

The global Muslim is expected to rise from 1.7 billion in 2014 to 2.2 billion by 2030, making up over 26.4% of the world population<sup>9</sup>. Over time, increased savings and investments will need to be met by Sharia'a funds

**+ The budding economies of Muslim-majority countries.**

Mostly growing at a faster rate than the global economy, these countries are driving the demand for Sharia'a compliant services and products. In 2015, the 57 member countries of the OIC had a GDP (PPP based) of USD17tn which represented 15% of the total global GDP (PPP based) of USD113tn in 2015

**+ An increase in affluence which has led to growing economic participation of the Muslim population.**

A report estimates global Muslim spend across sectors at over USD1.9tn in 2015<sup>10</sup>

**+ The search for ethical investments, coupled with greater awareness and increased preference for Sharia'a compliant financial solutions by both Muslim and non-Muslim investors alike.**

Islamic finance is attracting attention in a world of increasing corporate social responsibility. Sharia'a compliant investments can provide investors with products which satisfies their responsible investing needs while not sacrificing returns

**+ Government and regulatory push for the Islamic finance model.**

A rising number of jurisdictions are keen to boost their position as international financial centers, focusing on expanding into the Islamic finance industry and halal market sectors. This has led to a growing number of Islamic and conventional finance institutions entering the industry space

**+ The rise of the Halal/ Islamic economy.**

Top global brands from food, finance, fashion, travel, pharmaceuticals and cosmetic sectors continue to not only engage in the Halal/Islamic economy space but are helping innovate Sharia'a compliant products and services given their global R&D and marketing capabilities<sup>11</sup>

**+ Higher sukuk issuances.**

Higher sukuk issuances, especially by investment grade issuers or countries, has increased the size and depth of the investment universe and is the catalyst for further development and issuance of Sharia'a compliant instruments in the public and corporate sectors

**+ A rise in sophisticated products.**

A rise in sophistication through greater fundamentals in the contracts allowed under Sharia'a law and their appropriate utilization in the development of modern financial instruments

<sup>9</sup> Pew Research Institute

<sup>10</sup> State of the Global Islamic Economy 2016-2017

<sup>11</sup> State of the Global Islamic Economy 2016-2017



## Factors Contributing to the Robust Growth of Global Islamic Financial Assets



### Value Propositions

The breadth of contractual modes in Islamic finance are able to cater for the wide spectrum of risk profiles, ranging from the low risk sales and lease-based modes to the higher risk equity-based modes of financing



### Increasing Demand

Growing demand from Muslim population for Sharia'a compliant financial solutions amid increasing acceptance by non-Muslims due to ethical reasons and availability of a wide range of products



### Regulatory Support

Governments and regulatory bodies have taken steps to ensure that the regulatory framework is supportive. Incentives are also introduced to jumpstart the growth of the Islamic finance industry



### Financing Gap

Sharia'a compliant financial instruments can act as potential tools to reduce the financing gaps and act as alternative fund raising mechanisms to boost economic activity



### Tap Wider Wealth Base

Abundant liquidity flows from the recycling of petrodollars generated by high oil prices over the years

The future outlook of the Islamic finance industry remains promising. Several significant new players from diverse regions such as Africa, East Asia and the Americas have entered the market in recent years, and the trend is expected to continue. In view of the buoyant prospects for the industry in these new markets, it is likely that Islamic finance

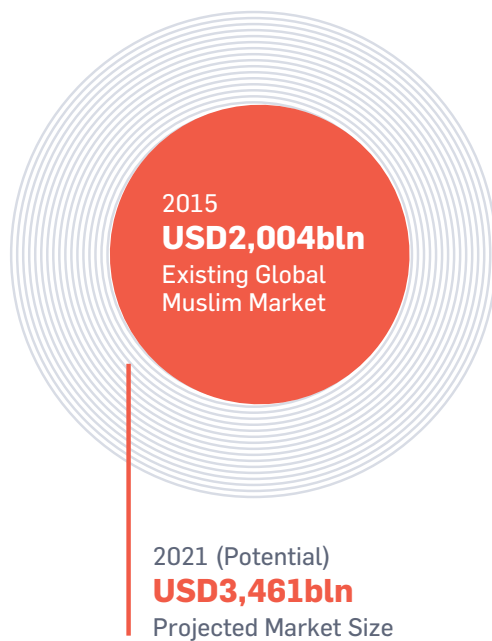
will continue its positive growth trajectory, and the pool of investors interested in Sharia'a compliant securities is expected to rise along with it. This is evidenced by the fact that many major international conventional players continue to develop their Islamic finance capabilities.

# The Global Islamic Finance Industry

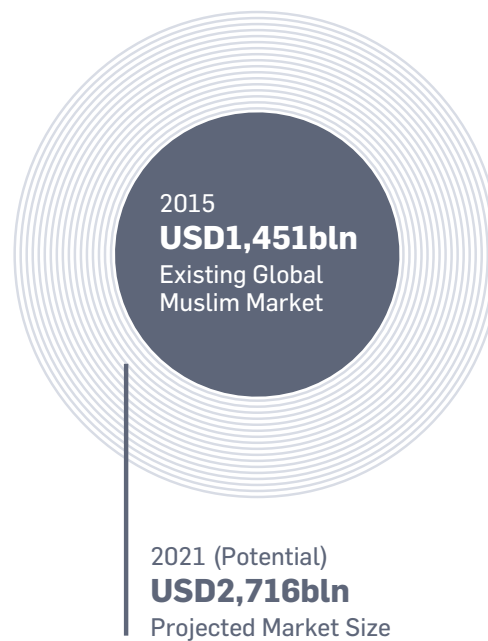
In the past decade, Islamic finance has gained much acceptance in the global arena as rising awareness of Sharia'a compliant propositions has encouraged more countries and entities to connect with the global cohort of Islamic finance stakeholders. Today, there are at least 1,291

Islamic financial institutions operating across the globe. Currently, total global financial assets of the Islamic financial industry are estimated at USD2tn and are expected to surpass USD3.4tn by 2021.<sup>12</sup>

## Global Islamic Finance Assets (2015 vs. 2021)



## Global Islamic Banking Assets (2015 vs. 2021)



State of the Global Islamic Economy 2016-2017

## Islamic Finance Sectors (2015)

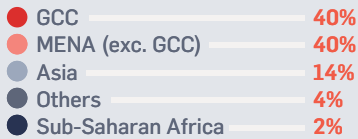
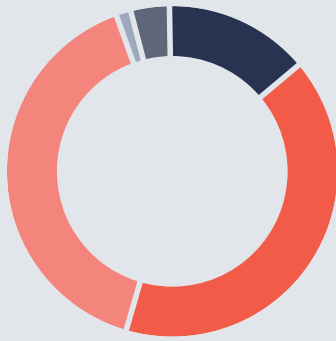


Source: State of the Global Islamic Economy 2016-2017

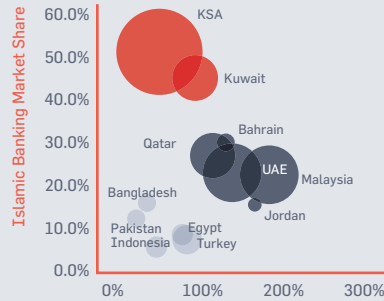
<sup>12</sup> State of the Global Islamic Economy 2016-2017

## Islamic Banking Sector

Islamic Banking Assets by Region (2015)



Shares of Global Islamic Banking Assets vs. Banking Penetration (2015)



+ The Islamic banking sector continues to be the dominant segment, accounting for almost 80% of the global Islamic finance industry; assets in full-fledged Islamic banks, subsidiaries and windows amount to approximately USD1.5tn as at 2015.

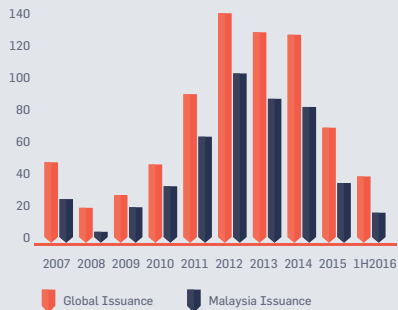
+ The aggregated average industry growth in US dollar terms has been very moderate at 1.4% y-o-y, particularly on account of exchange rate depreciations in several key Islamic banking markets, including Malaysia, Indonesia and Turkey.

+ There remains substantial asset concentration in a few Middle Eastern and Asian countries. The top nine Islamic banking jurisdictions by assets account for 92.1% of the global Islamic banking industry.

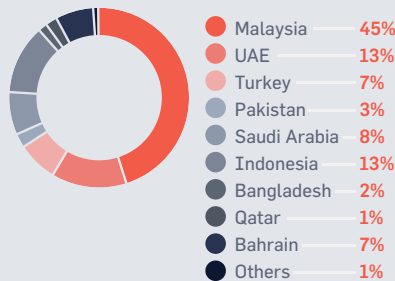
+ Hence, the stability of the global Islamic banking system critically hinges upon the smooth functioning and viability of the Islamic banks in these jurisdictions alone.

## Sukuk Sector

Global Sukuk Issuance (1H16)



Global Sukuk Issuance (1H16)



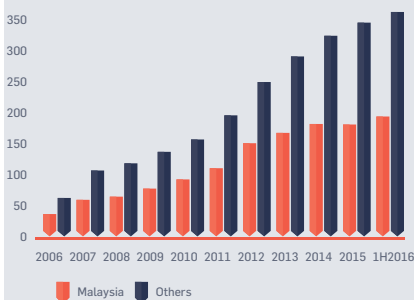
+ The sukuk market is still dominated by sovereign and multilateral issuers (70% of all issuances in 2015). Sukuk issuance in 1H16 witnessed a slight decrease of 3.3% compared to the corresponding period last year, mainly due to market uncertainty and overall sluggish global growth.

+ Excluding its historical biggest issuer, the global market for sukuk will remain at below-peak levels in 2016.

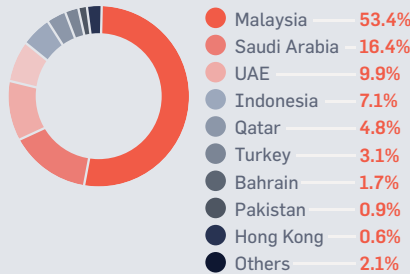
+ The correction started last year, mainly because the central bank of Malaysia (Bank Negara Malaysia), the largest issuers of sukuk worldwide, stopped issuing. Excluding the BNM effect, sukuk issuance dropped by around 5% in 2015 from 2014.

+ According to Standard & Poor's, sukuk issuance is estimated to reach USD50-USD55bn in 2016, compared with USD63.5bn in 2015. The sovereign sukuk sector may expand on the back of increased budget deficits, particularly in the energy-exporting countries.

Global Sukuk Issuance (1H16)

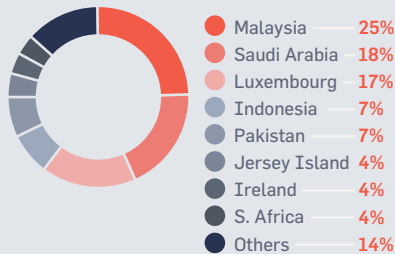


Global Sukuk Issuance (1H16)

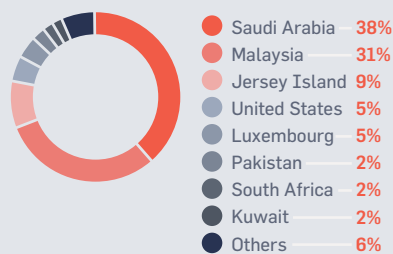


## Islamic Funds Sector

Number of Islamic Funds by Country (4Q15)



Global Islamic Assets under Management by Domicile (USDbln) (4Q15)



+ Although relatively a small sector, the Islamic funds industry continues to grow, underpinned by the large number of Sharia'a compliant capital market instruments such as fixed income instruments, money market instruments, Islamic equities and other structured products.

+ In 4Q15, total of global Islamic assets under management (AuM) was USD58bln. The number of Islamic funds stood at 1,053.

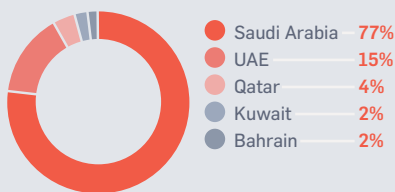
+ Saudi Arabia remains a key player (38% of global Islamic AuM) supported by demand and supply factors (increased awareness towards Sharia'a compliant investment products and strong governmental support).

+ In Asia, Malaysia (market share of 25%, with more than one third of new Islamic funds being launched yearly since 2000), Indonesia (7%, supported by an aggressive effort to deepen the Islamic finance industry across all sectors) and Pakistan (7%, owing to increased awareness) are key jurisdictions.

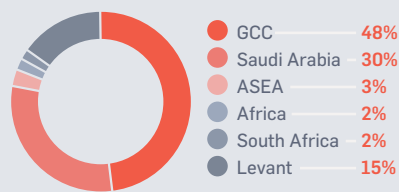
+ Together, the largest domiciles for Islamic funds are Saudi Arabia and Malaysia, which together hold 69% of Sharia'a compliant AuM.

## Takaful (Islamic Insurance) Sector

Share of Gross Takaful Contribution in GCC (2014)



Share of Global Gross Takaful Contribution (2014)



+ GCC and ASEAN regions continue to be key takaful markets (78% and 3% of global market share, respectively).

+ In 2014, Saudi Arabia dominated the takaful industry in the GCC region (77%) and globally (30%), underpinned by strong regulatory support and initiative from Saudi Arabian Monetary Agency (SAMA).

+ In ASEAN region, Malaysia (71%) and Indonesia (23%) contributes more than 90% of the takaful market share (as of 2014).

+ Regions offering huge untapped potential include emerging takaful markets such as Africa (Sudan, Kenya, Nigeria, Tunisia) and Europe (Luxembourg, UK, France and Germany, home of the highest concentration of Muslims in the region).



# Islamic Finance Developments in China

Being the world's second largest economy, the market potential for Islamic finance in China is thus enormous. Neighboring Hong Kong, as one of the world's fastest-growing major economies over the last 30 years have made significant strides in establishing Islamic finance in its own backyard. Moving forward, in view of its unique role as the vital gateway to mainland China and a leading hub for offshore renminbi business, the opportunities

are plentiful. As the renminbi becomes more internationalized in the future, Hong Kong can offer an ideal platform to link Islamic and renminbi financing together by developing financial products that are Sharia'a compliant and denominated in renminbi. Many investors in the Islamic world today are actively looking for investment opportunities in Asia, particularly in mainland China, in order to diversify their portfolios.



## Hong Kong Sets its Sight on Islamic Finance

Given the strategic importance and influence of investors from the Middle East, Islamic finance is increasingly in demand by investors seeking investment and financing products compliant with Islamic law.

In response to the growing investment links between Asia and the Middle East, the Hong Kong government is focusing its efforts on tapping into the global demand for Sharia'a compliant investments by developing an encouraging and conducive environment for Islamic finance to thrive.

Due to Hong Kong's role as a global financial center, the development of the sukuk market has been identified by the Hong Kong government as a key initiative to support economic growth. Significantly, in March 2014, the 'AAA'-rated Hong Kong government passed a legislation which made the issuance of sukuk by the Hong Kong Monetary Authority (HKMA) possible. The Loans (Amendment) Bill 2014 followed the introduction of the Inland Revenue and Stamp Duty Legislation

(Alternative Bond Schemes) (Amendment) Ordinance 2013 in July 2013, with both pieces of legislation together providing a taxation framework for sukuk, comparable to that provided by Hong Kong for conventional bonds.

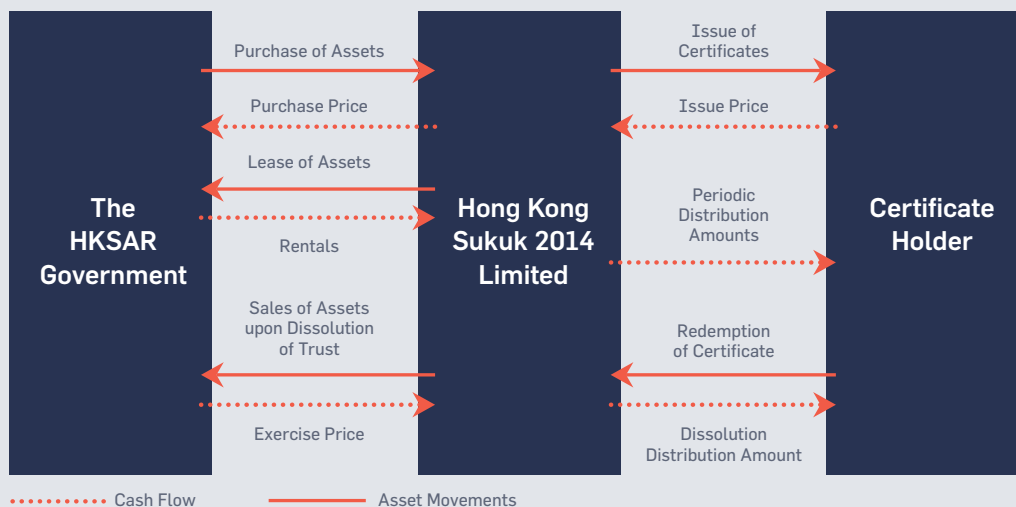
Consequently, on 11 September 2014, Hong Kong became the first 'AAA'-rated government in the world to issue a dollar-denominated sukuk and follows London in seeking to boost its Islamic finance credentials and attract business from cash-rich investors in the Gulf and Southeast Asia. The Ijarah sukuk—a sale and leaseback structure that is typically wholly-backed by hard assets such as real estate—was listed on the Hong Kong, Malaysia and Dubai bourses, and created an important international benchmark.

### Hong Kong Sukuk 2014 Limited

Item	Description
Type	Ijarah
Issue Size	USD 1 billion
Currency	USD
Maturity	11 September 2019
Country of Issue	Hong Kong
Tenor	5 years
Issue Date	11 September 2014
Sukuk Rating	S&P: AAA, Moody's: Aa1
Exchanges	Bursa Malaysia, Hong Kong Stock Exchange, Nasdaq Dubai/DFM
Notes	The sukuk used an ijarah structure, a Sharia'a compliant sale and lease-back contract, underpinned by selected units in two government-owned commercial properties

Source: Zawya

## Hong Kong Sukuk 2014 Limited: Structure Diagram and Cash Flows



Source: Hong Kong Sukuk 2014 Limited Prospectus

Following the successful issuance of the inaugural sukuk in 2014, the Hong Kong government issued its second sukuk on 3 June 2015. The sukuk uses a Wakalah structure, where one-third of assets is underpinned by selected units in an office building in Hong Kong, while two-third of the assets is backed by Sharia'a compliant commodities, making Hong Kong the first 'AAA'-government sukuk issuer to adopt this structure. The sukuk was issued by a special-purpose vehicle wholly owned by the Hong Kong government, and was listed in Hong Kong,

Malaysia and Dubai. The sukuk received warm welcome from global investors, attracting orders of USD2bln from a diverse group of international investors. Priced at 1.894%, it gave the government a cheaper funding cost than that for the inaugural sukuk issue in 2014 (2.005%). The use of the "asset light" structure in the latest issuance set a benchmark for potential issuers in the private sector and demonstrated the flexibility of Hong Kong's Islamic finance platform.

## Hong Kong Sukuk 2015 Limited

Item	Description
Type	Wakalah
Issue Size	USD 1 billion
Currency	USD
Maturity	3 June 2020
Country of Issue	Hong Kong
Tenor	5 years
Issue Date	3 June 2015
Sukuk Rating	S&P: AAA, Moody's: Aa1
Exchanges	Bursa Malaysia, Hong Kong Stock Exchange, Nasdaq Dubai/DFM
Notes	The sukuk uses a Wakalah structure, where one-third of assets is underpinned by selected units in an office building in Hong Kong, while two-third of the assets is underpinned by Sharia'a compliant commodities

Source: Zawya





## Hong Kong Sukuk 2015 Limited: Structure Diagram and Cash Flows



Source: Hong Kong Sukuk 2015 Limited Prospectus



## Summary of the Key Parameters of the Two Series of Sukuk under the Government Bond Programme

Item	Sukuk 1	Sukuk 2
<b>Issue date</b>	September 2014	June 2015
<b>Size</b>	USD1 billion	USD1 billion
<b>Tenor</b>	5 years	5 years
<b>Format</b>	Rule 144A/Reg S	Reg S
<b>Price</b>	+ 2.005% + 5Y UST + 23bps	+ 1.894% + 5Y UST + 35bps
<b>Investor orders</b>	+ USD4.7 billion + Over 120 investors	+ USD2 billion + 49 investors
<b>Investors by location</b>	+ 47% Asia + 36% Middle East + 11% US + 6% Europe	+ 43% Asia + 42% Middle East + 15% Europe
<b>Investors by type</b>	+ 56% banks and private banks + 30% sovereign wealth funds + 11% fund managers + 3% insurance companies	+ 77% banks, private banks and fund managers + 23% sovereign wealth funds, central banks and supranationals
<b>Islamic structure</b>	Ijarah	Wakalah
<b>Underlying assets</b>	100% government properties	+ 34% government properties + 66% exchange-traded commodities

Source: Hong Kong Monetary Authority

In March 2016, the Hong Kong government announced that its third sukuk issuance would commence in the second half of the year. Although there has been no updates since then, Hong Kong remains steadfast in raising its rank in the Islamic finance space and capitalize on the opportunities at hand, especially as it seeks to be a comprehensive financial center. Hong Kong's interest in Islamic finance is also tied to broader China's One Belt One Road initiative, which is an effort to strengthen Hong Kong and China's economic ties with his historical 'silk road' partners across Eurasia.

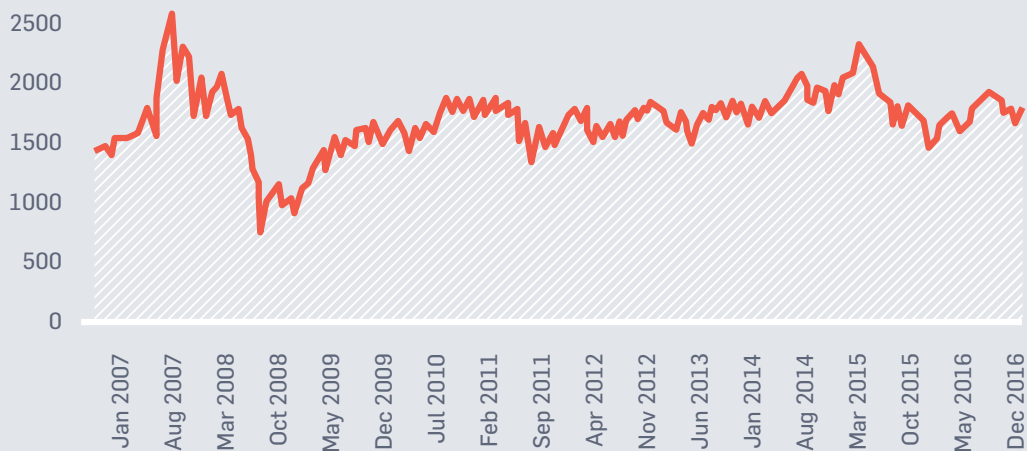
On the equity capital markets front, Hong Kong remains a global force. Many Chinese businesses continue to seek initial public offerings in Hong Kong's stock exchange. The introduction of Islamic indexes will continue to assist Sharia'a compliant investors looking at Hong Kong stocks. For example, the Dow Jones Islamic Market China/Hong Kong Titans 30 Index covers the 30 largest Hong Kong-listed companies whose primary operations are in mainland China and Hong Kong. Meanwhile, the 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.

## Annual Performance (%): MSCI Golden Dragon Islamic vs. MSCI Golden Dragon 2008- 2016

Year	MSCI Golden Dragon Islamic	MSCI Golden Dragon
2016	8.29	5.75
2015	-10.56	-7.12
2014	5.99	8.06
2013	-3.11	7.25
2012	12.31	22.65
2011	-11.12	-18.35
2010	16.38	13.60
2009	64.01	67.12
2008	-49.84	-49.37

Source: MSCI

## Dow Jones Islamic Market China/Hong Kong Titans 30 Index Performance (USD) January 2007- 15 January 2017



Source: Dow Jones

Other equity indexes include the MSCI Zhong Hua Islamic Index, which tracks the performance of the large and mid-cap representation across all China securities available to non-domestic investors that are listed in Hong Kong and China as well as Hong Kong securities listed on the Hong Kong stock

exchange which are relevant for Islamic investors. Meanwhile, the FTSE Shariah Hong Kong and China Indices are designed to represent the performance of the largest and most liquid Sharia'a compliant companies in Hong Kong and China.

## Annual Performance (%): MSCI Zhong Hua Islamic vs. MSCI Zhong Hua (2008- 2016)

Year	MSCI Zhong Hua Islamic	MSCI Zhong Hua
2016	5.13	1.52
2015	-12.65	-5.58
2014	1.09	7.27
2013	-9.28	6.26
2012	19.22	24.72
2011	-13.18	-17.54
2010	13.63	10.03
2009	52.69	62.05
2008	-51.52	-50.86

Source: MSCI

## Annual Performance (%): FTSE Shariah Hong Kong vs. FTSE Shariah China 2008- 2016

Year	FTSE Shariah Hong Kong	FTSE Shariah China
2016	4.0	5.2
2015	-5.6	-12.2
2014	17	-0.1
2013	-0.6	-3.0
2012	31.0	18.6
2011	-22.9	-16.0
2010	12.5	13.8
2009	63.0	74.4
2008	-49.8	-58.1

Source: FTSE

Despite the significant developments in neighboring Hong Kong, mainland China remains a major market where Islamic finance has not yet flourished. At present, the supply of Islamic financial products and services to the Chinese mainland is mostly in the form of capital market instruments traded through the Hong Kong financial market. The first attempt to provide Sharia'a compliant financing

services to Chinese Muslims was made by Muslim businessmen in Linxia, Gansu Province in the 1980s. Linxia, formerly known as Hezhou, is the capital of the Linxia Hui Autonomous Prefecture. The small city is also known by its nickname—"the little Mecca of China". This is so because it has been a religious, cultural and commercial center for Chinese Muslims for centuries.<sup>13</sup>

<sup>13</sup> "Islam in China: Accommodation or Separatism?", The China Quarterly, Vol.174. Gladney D.C. (2003)

Since China adopted the reform and open-door policies in the 1970s, the Chinese Muslim business community started to grow. Although there were established conventional banks to finance the operation of their businesses, their demand for banking services could not be satisfied on two fronts: firstly, conventional banks were primarily serving large businesses at the time, and secondly, the services were against their religious beliefs. This is evident by a survey conducted by the Industrial and Commercial Bank of China (ICBC) which found that only 13% of the 200 self-employed Chinese Muslims surveyed had owned a formal account at a formal institution.<sup>14</sup>

Recognizing the demand for Sharia'a compliant financial services, local Muslim businessmen proposed Islamic banking in the late 1980s. With the support from the local government and the central bank of China, the first Sharia'a compliant Chinese financial institution named the Hezhou Islamic Financing Company was established in February 1987, providing both deposit and lending services. As it focused on small businesses' finance needs and remained consistent with the beliefs of the Chinese Muslims, the Hezhou Islamic Financing Company served the local Muslim community successfully. However, as China's economy and banking industry continued to develop, small financial institutions such as the Hezhou Islamic Financing Company faced many challenges. With limited services and weak control mechanisms over uncollectible loans, they could not compete with large financial institutions. After 20 years of operations, the Hezhou Islamic Financing Company (later known as Ningxia

Jiefang Road Rural Credit Cooperative) went out of business in 2007.

Perceived by many in China as being for Muslims only, Islamic finance has struggled to develop its full potential, although recent advances have shown encouraging progress and there is growing awareness. To date, on the regulatory front, the Chinese government has not implemented any specific laws promoting the development of Islamic finance or a sukuk market, which is a necessary prerequisite for the industry to grow. However, there have been a number of Sharia'a compliant investment products that seek to invest in the Chinese market.

For instance, in 2006, a series of Islamic funds were launched to offer Islamic investors' exposure to the Chinese market. Specifically, Shamil Bank, a leading Bahrain-based Islamic commercial and investment bank and a wholly-owned subsidiary of Ithmaar Bank, launched its USD100mln Shamil China Realty Mudarabah, representing the first-ever Islamic property fund for investment in the Chinese real estate market. The four-year Mudarabah invested in the Xuan Huang China Realty Investment Fund Limited, a joint venture between Shamil Bank and CITIC Group, which are among the largest state-owned entities in China. The fund undertook Sharia'a compliant investments in China's real estate sector, including land development projects, residential, commercial and industrial properties, while institutional investors and high net worth individuals (HNWI) in the GCC were the target.

## Xuan Huang China Realty Investment Fund

An offshore real estate fund setup in 2005 in partnership with Shamil Bank of Bahrain B.S.C. and CITIC United Asia. The fund invested in China's residential and retail property investments in second tier cities such as Anhui, Chongqing, Xian and Tianjin. The fund was successfully closed in 2011.

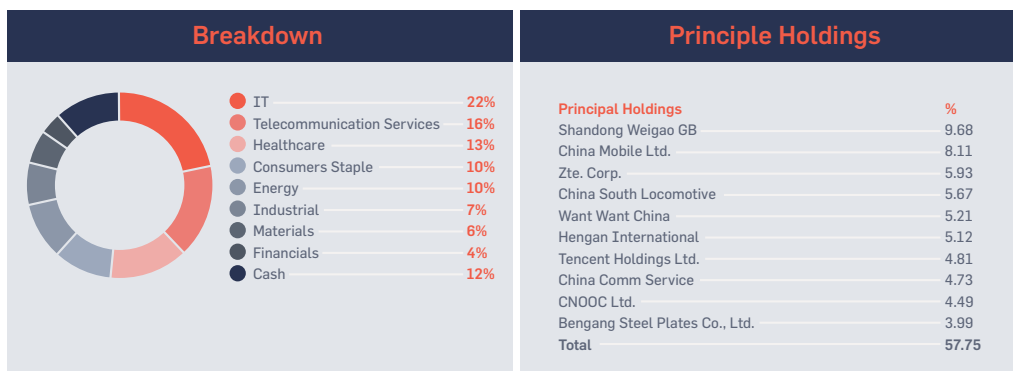
Source: CITIC International Assets Management Limited

<sup>14</sup> "Financial Institutions Accommodating Ethnic Minority Groups' Customs: Hezhou Muslim Financing Company", Almanac of China's Finance and Banking. Zhang Z. & Zao H. (1987)



Meanwhile, in the same year, Deutsche Bank, through its global mutual fund arm DWS Investments, launched its first Sharia'a compliant mutual fund capability, which was marketed as DWS Noor Islamic Funds PLC and included the DWS Noor China Equity Fund, targeting Sharia'a compliant Chinese equity investments.

### DWS Noor China Equity Fund: Portfolio Analysis



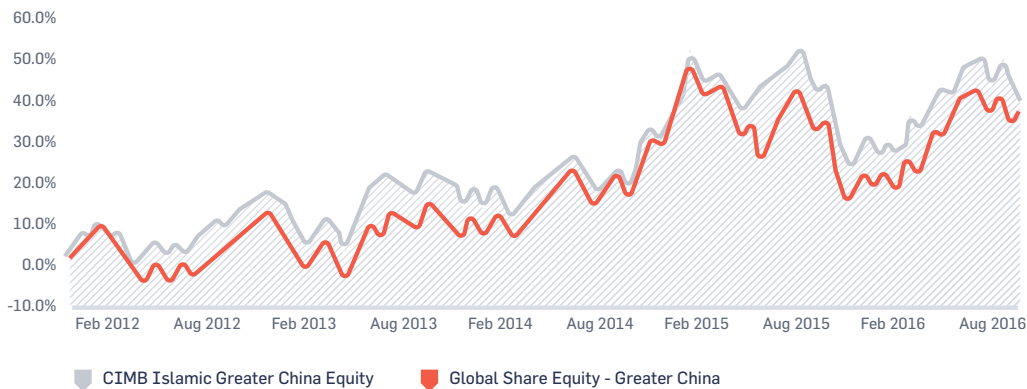
Source: DWS Investments As at 31 March 2009

\*The DWS Noor Global Equity Select Fund, DWS Noor China Equity Fund, DWS Noor Japan Equity Fund and DWS Noor Asia Pacific Equity Fund under the umbrella DWS Noor Islamic Funds was terminated in 2009 and shares were redeemed.

The CIMB Group also launched a CIMB Islamic Greater China Equity Fund in 2009, which aims to provide investors with medium to long term capital appreciation. The fund invests primarily in Sharia'a compliant equities and Sharia'a compliant equity related securities of companies based in the Greater China region. The year also marked Saudi Arabia's Al-Rajhi's foray into China. Al Rajhi Investments (ARI) introduced Sharia'a compliant investments in the Chinese market through its Shariah Asia Investment Fund (SAIF), in partnership with China Resources (CRC). The latter

is a central government-owned conglomerate and, through its holdings in China Vanke and CR Land, is recognised as a dominant investor and developer in the country's property market. SAIF focused on development and asset repositioning projects in the Chinese real estate market, with a total equity capitalisation target of USD500mln. Both CRC and ARI have committed to invest USD100mln in the Islamic fund, thus creating a window of opportunity for Islamic investors to access investment opportunities in the Chinese market.

## CIMB Islamic Greater China Equity Fund Performance



## Cumulative Performance (%)

	3 months	6 months	1 year	3 years	5 years
<b>Fund</b>	-2.72	5.65	6.06	20.07	44.30

Source: CIMB

## Calendar Year Performance (%)

	2016	2015	2014	2013	2012
<b>Fund</b>	-0.37	17.63	0.44	6.55	18.14

Source: CIMB

In more encouraging news, in 2009, China became an associate member of the Islamic Financial Services Board (IFSB), one of the main standard-setting bodies for Islamic finance, and a proposal was made to study the amendments to legislation that would be required to facilitate the development of Islamic finance in China. However, there has been little subsequent movement from the Chinese government to start on any necessary amendments.

Back in 2006, financial sector reforms brought about the liberalization of the Chinese banking sector, heralding a significant departure from the country's conservative stance by allowing

increased foreign participation in the sector. Efforts by well-established Islamic banks soon followed-- in 2012, Affin Holdings and the Bank of East Asia announced the submission of a proposal to the China Banking Regulatory Commission (CRBC) to establish the first Islamic bank in the country. In the same year, Sharia'a compliant Bank Muamalat Malaysia and Bank of Shi Zui Shan of China announced plans to establish an Islamic bank in the Ningxia Province, with the aim of working together to establish a comprehensive Islamic finance framework for China and offer Islamic banking products to the province's Muslim population, which makes up a large proportion of the total for China.

## With the encouragement of the CRBC, the Ningxia Hui Autonomous Region, home to the Muslim Hui ethnic group, is positioned to take the lead in pioneering Islamic financial services in China.

It has, in the past, increasingly sought to boost trade and financial ties with the Muslim world. An autonomous region in the northwest of China, where 35.0% of the population is Muslim (roughly 2.2 million), Ningxia has plans to establish an Islamic financial center in its capital Yinchuan in the next five to seven years. The goal is to facilitate financial co-operation between China and the Middle East, establish Islamic banks and banking products in China and develop a wholesale Islamic capital market, including Islamic bonds, equities and funds. However, this is only viable if the Islamic capital market is developed as an extension of the existing conventional market. Islamic capital market must be seen as an alternative to the existing conventional market so that Sharia'a compliant financial products are adopted not just by Muslims in China. This will add the depth and breadth of the financial market of Ningxia by widening the spectrum of financial products and services available.

Additionally, Ningxia is actively spearheading the development of the halal market in China while positioning itself as the core region. In September 2014, the Ningxia Halal Food International Trade Certification Centre, established in January 2008, became the first halal certification body in China with the government's stamp of approval by the Certification and Accreditation Administration of People's Republic of China (CNCA), signaling the government's commitment with Sharia'a compliance. Since 2008, more than 100 domestic halal food enterprises have passed the halal authentication and China has signed halal food standards with seven countries, including Saudi Arabia, Egypt, Qatar and Malaysia, supporting an increasing number of Chinese halal products accepted by other countries.<sup>15</sup>



It was reported in March 2015 that the city of Wuzhong in Ningxia is planning to build China's biggest domestic and international industrial zone for buying, processing and selling halal products, underpinned by the fact that the city's halal industry grew by over 21.0% in 2014, with the output of 191 companies reaching more than USD2.9bln.<sup>16</sup> Well-established companies such as Ningxia Hongshanhe Food Co Ltd., Yili (Ningxia) and Baodi Halal Food Company have played great roles in the development of halal food industry in this province. To date, numerous halal food festivals have taken place in order to promote the industry.

<sup>15</sup> "China Focus: Halal food helps Ningxia explore international market", 14 September 2013 from news.xinhuanet.com

<sup>16</sup> "Wuzhong to build halal industry cluster", 27 March 2015 from news.xinhuanet.com

## Location of Ningxia



Besides Wuzhong, Yinchuan is also striving to develop the halal industry. By the end of 2012, Yinchuan had more than 4,800 halal food enterprises and other processing or selling enterprises. Some have showcased their products outside China and at exhibitions in Cairo, Dubai and Istanbul.

In February 2014, China-based Dagong Global Credit Rating Company, in collaboration with Russia-based RusRating and US-based Egan-Jones Ratings, launched the Universal Credit Rating Group with the aim of encouraging global Islamic institutions to join and have a greater influence on the international rating sector through participation in the rating governance process. In December 2013, Dagong Global Credit Rating also signed a Memorandum of Understanding (MoU) with the Islamic International Rating Agency (IIRA) agreeing to the joint management of ratings of Islamic financial institutions, economic research and to improve the level of ratings coverage in Islamic countries, as well as more investment from Chinese companies in Islamic countries.

China is also drawing a lot of expertise from Gulf Cooperation Council (GCC) countries, namely Qatar. Qatar International Islamic Bank QSC and QNB Capital LLC in April 2015 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. The partnership is further intended to help the Qatari lenders access the Chinese market in a more direct way. Seven months after Hong Kong sold its debut sukuk, China is exploring Islamic finance for projects from hospitals to metro stations, according to London-based Dome Advisory Ltd., which is working with a government-owned fund in Shanghai to finance five projects.

In April 2015, Arman Muslim Foods Industrial Group of Xinjiang, Ltd, a leading Chinese producer and retailer of Muslim food products, signed an agreement with Malaysian company TPM Biotech, a wholly-owned subsidiary of Technology Park Malaysia, for the Malaysian company to provide a feasibility study and training on Halal certification to Arman. Subsequently if things progress well, both companies would enter into a joint venture. Established in 1995, Arman Muslim Foods Industrial Group has supermarkets in Urumqi, the capital of Xinjiang, and also distributes its products to over 2,700 Arman franchise chain stores and over 10,000 other stores throughout the Xinjiang province.





In another development, in May 2015, Jeddah-based Islamic Corporation for the Development of the Private Sector (ICD), the Islamic Development Bank's (IDB) private sector arm reported that it was teaming up with an arm of Industrial and Commercial Bank of China (ICBC) to look for business opportunities, in a sign of growing Chinese interest in Islamic finance. ICD will cooperate with ICBC Financial Leasing, a wholly-owned subsidiary of ICBC, China's biggest lender by assets. The two companies aim to develop Islamic business in the ICD's 52 member countries, including the Ijarah type of Sharia'a compliant banking and liquidity management. Both parties will seek to do syndicated financing for private sector projects. The ICD followed on with an MoU with China International Contractors Association (CHINCA), a contractor trade organization that acts as a link

between the Chinese government and CHINCA's 1,300 members who operate in over 180 countries.

Meanwhile, a first-of-its-kind bank following Islamic principles was opened in Xining, capital of China's northwestern Qinghai provide customized services to Muslims. The Jianguo Road Branch of Xining Rural Commercial Bank began operations in late September 2015, in time for Eid-ul-Adha. The bank offers small-sum loans to Muslim customers and also provide guarantee and mortgage services for Mecca pilgrims. The new bank joins the Islamic banking unit (established in 2009) of Bank of Ningxia in providing Sharia'a compliant financial products.





In the same month, the Bahrain Economic Development Board signed an MoU with the China Council for the Promotion of International Trade as the countries seek to enhance bilateral relations. This partnership will also strengthen ties between the Ningxia region and Bahrain as the former seeks to develop an Islamic finance center for China and the latter being a leader of the industry.

In October 2015, Country Garden, a Guangdong-based property developer announced their intention to issue Islamic medium-term notes and subsequently in December 2015, it issued a RM1.5bln sukuk through its Malaysian subsidiary.

Efforts to foster the development of Islamic finance in China continued in 2016, with numerous events and conferences being held in the country in order to promote the industry and raise awareness.

**Growing partnerships between corporations, banks and multilateral agencies who are encouraged by business opportunities that Islamic finance can offer were also witnessed in the year.**

# Islamic Finance Milestones in China

1980s  
& 1990s

- + The first Chinese financial institution providing Sharia'a-compliant services named the Hezhou Islamic Financing Company was established in February 1987
- + In 1989, the Industrial and Commercial Bank of China (ICBC) and the China Construction Bank (CCB), two "big four" state-owned commercial banks, opened several Muslim savings banks in Qinghai province
- + In 1997, Lanzhou Bank in Gansu province established its first Muslim branch

2006

- + USD100mIn Shamil China Realty Mudarabah, the first Islamic property fund was launched by Shamil Bank and CITIC Group targeting the Chinese real estate market
- + Deutsche Bank, through its global mutual fund arm DWS Investments, launched its first Sharia'a compliant mutual fund capability targeting Sharia'a compliant Chinese equity investments

2009

- + CIMB Group launched a CIMB Islamic Greater China Equity Fund
- + Al-Rajhi Investments partnered with China Resources to launch the Shariah Asia Investment Fund (SAIF), which seeks to invest directly in certain types of real estate projects in China
- + People's Bank of China became an associate member of Islamic Financial Services Board (IFSB)
- + A commercial bank in Ningxia Hui Autonomous Region-Ningxia Bank established an Islamic division to offer Sharia'a compliant products/services to the Muslim community. Ningxia Bank also set up a supervisory board which including religious figures to supervise the activities of its Islamic division

2012

- + Affin Holdings and the Bank of East Asia announced the submission of a proposal to the China Banking Regulatory Commission (CRBC) to establish the first Islamic bank in the country
- + Bank Muamalat Malaysia and Bank of Shi Zui Shan of China announced plans to establish an Islamic bank in the Ningxia Province, with the aim of working together to establish an Islamic finance framework for China and offer Islamic banking products to the province's Muslim population

2013

- + China's State Council approved Ningxia as an economic experimental zone for inland development, which has been considered a tacit approval to the introduction of Islamic finance in the zone

2014

- + Ningxia Halal Food International Trade Certification Center, established in 2008, became the first halal certification body in China with government's stamp of approval, by the Certification and Accreditation Administration of People's Republic of China (CNCA)
- + A halal industrial park to integrate research, design, manufacture, processing and trade for the halal industry was built in Wuzhong, Ningxia
- + China-based Dagong Global Credit Rating Company in collaboration with Russia-based RusRating and US-based Egan-Jones Ratings, launched the Universal Credit Rating Group with the aim of encouraging global Islamic institutions to join and have a greater influence on the international rating sector
- + Dagong Global Credit Rating Company signed an agreement with Islamic International Rating Agency (IIRA) for joint management of IFI ratings, economic research and more investment from PRC companies in Islamic countries

2015

- + Qatar International Islamic Bank and QNB Capital LLC signed an agreement with Southwest Securities Co. to develop Sharia'a compliant finance products
- + ICD signed an agreement with ICBC Financial Leasing to develop Islamic business
- + ICD signed an agreement with China International Contractors Association (CHINCA), a contractor trade organization that acts as a link between the Chinese government and CHINCA's 1,300 members who operate in over 180 countries
- + IDB is in talks with China's Asian Infrastructure Investment Bank (AIIB) to explore the potential of utilizing Sharia'a compliant financing facilities to fund Asia's infrastructure needs
- + Arman Muslim Foods Industrial Group of Xinjiang, Ltd, a leading Chinese producer and retailer of Muslim food products, signed an agreement with Malaysian company TPM Biotech, a wholly-owned subsidiary of Technology Park Malaysia, for the Malaysian company to provide a feasibility study and training on Halal certification to Arman
- + Brunei and China plans to set up three industrial parks in the Southern Guangxi province, one of which will be for Halal food production
- + The Jianguo Road Branch of Xining Rural Commercial Bank opened a first-of-its-kind bank in Xining following Islamic principles to provide customized services to Muslims
- + The Bahrain Economic Development Board signed an agreement with the China Council for the promotion of international trade as the countries seek to enhance bilateral relations. This partnership will also strengthen ties between the Ningxia region and Bahrain as the former seeks to develop an Islamic finance center for China and the latter being a leader of the industry
- + In October, Chinese property developer Country Garden Holdings Company Ltd plans a debut sukuk sale, from a RM1.5bln (USD343.3mln) programme set up by its Malaysian subsidiary. It has appointed CIMB Investment Bank as the lead arranger and manager for the medium-term notes
- + Subsequently, Country Garden, issued a RM1.5bln sukuk through its Malaysian subsidiary in December

2016

- + In March, ICD hosted the first ever China-OIC Forum in Beijing
- + ICD signed an agreement with China-Africa Development Fund to boost investment and growth in selected African countries
- + ICD signed an agreement with CNBM International Engineering Co. to launch a global public-private partnership (PPP) scheme for social infrastructure projects in ICD member countries
- + Beijing hosted first ever China-UAE Conference on Islamic banking and finance in May. The event was organized by Hamdan Bin Mohammed Smart University's (HBMSU) Dubai Centre for Islamic Banking and Finance and Dubai Islamic Economy Development Centre (DIEDC) in cooperation with China Islamic Finance Club and ZhiShang Intercultural Communication and in partnership with Thomson Reuters
- + In May, Fullgoal Asset Management (Hong Kong) partnered with Dubai-based Mawarid Finance to launch an Islamic fund underpinned by Chinese equities
- + Chinese Business Hub, an outfit assisting Chinese companies to build a presence in the UAE, in August secured a Sharia'a compliance certification for one of its investment products
- + In December, Meezan Bank, Pakistan's first and largest Islamic bank, signed an agreement with Al-Sadiq Consulting Ltd, China's first Islamic Finance consulting company to explore opportunities for Islamic finance in China-Pakistan Economic Corridor (CPEC). The agreement focuses on the ever-increasing economic participation between Pakistan and China and the opportunities that may be derived from improved Islamic banking channels between the two countries

# Islamic Finance Opportunities in China

Although the most significant industry players remain in the GCC and parts of Southeast Asia, the growth of non-traditional markets for Islamic finance is promising. Given China's influential role in the overall health of the global economy and especially in the aftermath of the global financial crisis, the main takeaway is to foster financial

systems that are resilient to shocks, and will best cater to the real economy and promote sustainable growth through productive and responsible innovation. In this respect, there is immense potential to draw on the economic value that Islamic finance has to offer. Outlined below are the factors that will support Islamic finance in China:

**Factors that support Islamic finance in China**

- + Encouraging demographic trends
- + An alternative source of liquidity and means of investment for Chinese SMEs and retail clients
- + China's commitment to a "green economy" can be powered by Islamic finance
- + Islamic finance as a means to stimulate growth in key economic sectors as part of China's greater economic restructuring plan
- + Under the 'One Belt, One Road', Islamic finance can build stronger ties with Muslim-denominated countries
- + Islamic finance as a gateway for China to tap into the booming global halal economy

## 1. Encouraging demographic trends in China support the expansion of Islamic finance in the country. Islamic finance can also provide an alternative source of liquidity and/or means of investment to all consumers and investors, regardless of religious background

Typically, countries with strong Islamic finance potential have a large and growing share of Muslim population. A 2009 study conducted by the Pew Research Center concluded that there are 21,667,000 Muslims in China, accounting for 1.6% of the total population, while China's 2010 Population Census found that there are 23,142,104 Muslims in China in 2010. Because the country is so

populous, its Muslim population is expected to be the 19th largest in the world in 2030<sup>17</sup>. The Muslim population in China is projected to increase from 23.3 million in 2010 to nearly 30 million in 2030. Of all the countries in the world where Muslims live as religious minorities, only three other countries – India, Nigeria and Ethiopia – have more than 20 million Muslims.

### Muslim Population of China

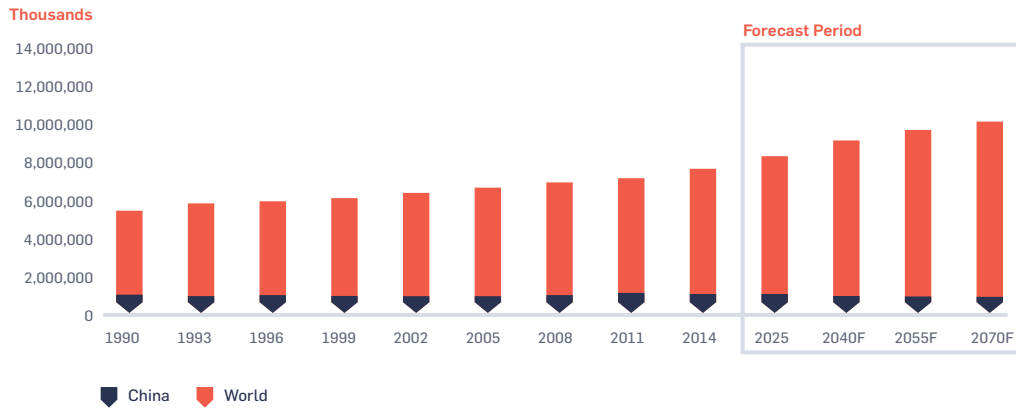
Year	Projected Muslim Population	Percentage of Population that is Muslim
2010	23,308,000	1.7%
2030	29,949,000	2.1%

Source: Pew Research Center

<sup>17</sup> The Future of the Global Muslim Population" January 2011, Pew Research Center

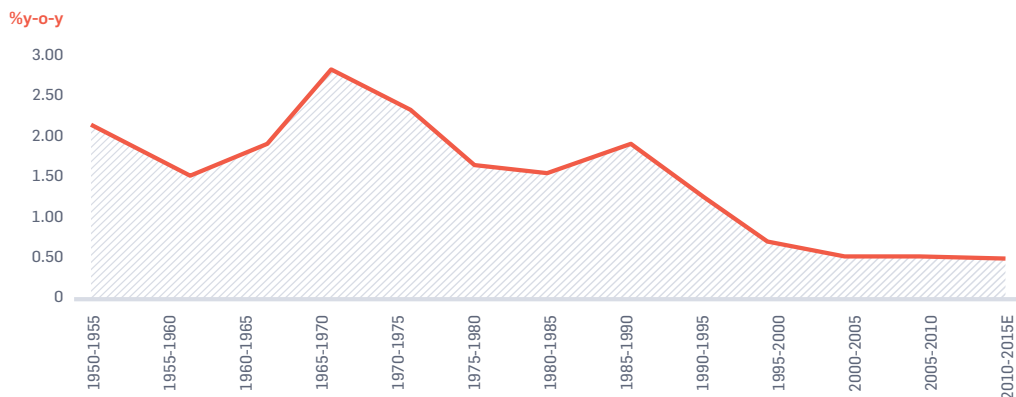


## China: Total Population Trend (1990-2080F)



Source: UN

## China: Population Growth Trend (1950-2015)



Source: UN

Muslims are not a new presence in China. Most of China's Muslim communities have lived in China for more than 1,000 years. According to China's 2010 Population Census, there are 56 officially recognized ethnic groups in China. Of the 56 ethnic groups, Han is the largest ethnic group (91.6% of the total Chinese population). The ethnic groups

excluding Han are known as minority ethnic groups and they comprise 8.4% of total Chinese population. Of the 55 ethnic minority groups in China, ten groups are predominantly Muslim. These groups include Hui, Uyghur, Kazakh, Dongxiang, Kyrgyz, Uzbeks, Salar, Tajik, Bonan, and Tatar.

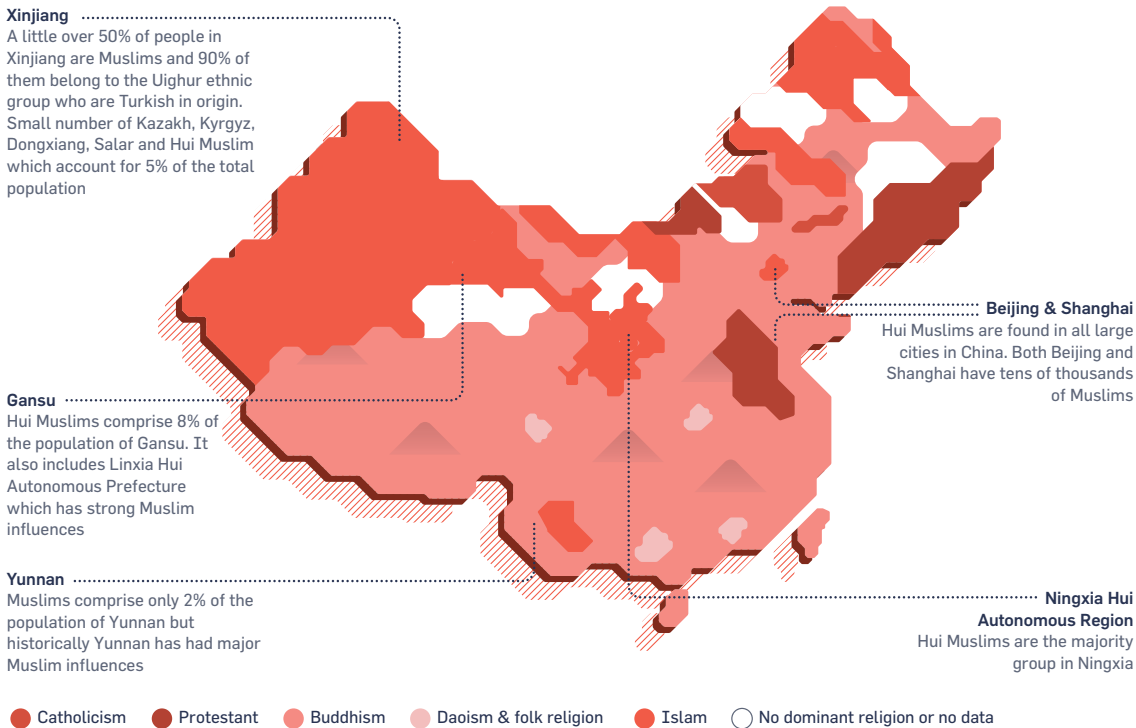
## Chinese Ethnic Groups that are Predominantly Muslim

Ethnic Groups	Groups Populations	% of Total Tabulated Muslims	% of Total Populations <sup>18</sup>
Hui	10,586,087	45.74%	0.79%
Uighur	10,069,346	43.51%	0.76%
Kazakh	1,462,588	6.32%	0.11%
Dongxiang	621,500	2.69%	0.05%
Kyrgyz	186,708	0.81%	0.01%
Salar	130,607	0.56%	0.01%
Tajik	51,069	0.22%	<0.01%
Bonan	20,074	0.09%	<0.01%
Uzbeks	10,569	0.05%	<0.01%
Tatar	3,556	0.02%	<0.01%
<b>Total</b>	<b>23,142,104</b>	<b>100%</b>	<b>1.74%</b>

Source: China's 2010 Population Census

While Muslims live in every region in China, the largest concentration of Muslims today are in the Western provinces of Xinjiang, Ningxia, Qinghai and Gansu. A substantial number of Muslims live in the cities of Beijing, Tianjin and Shanghai.

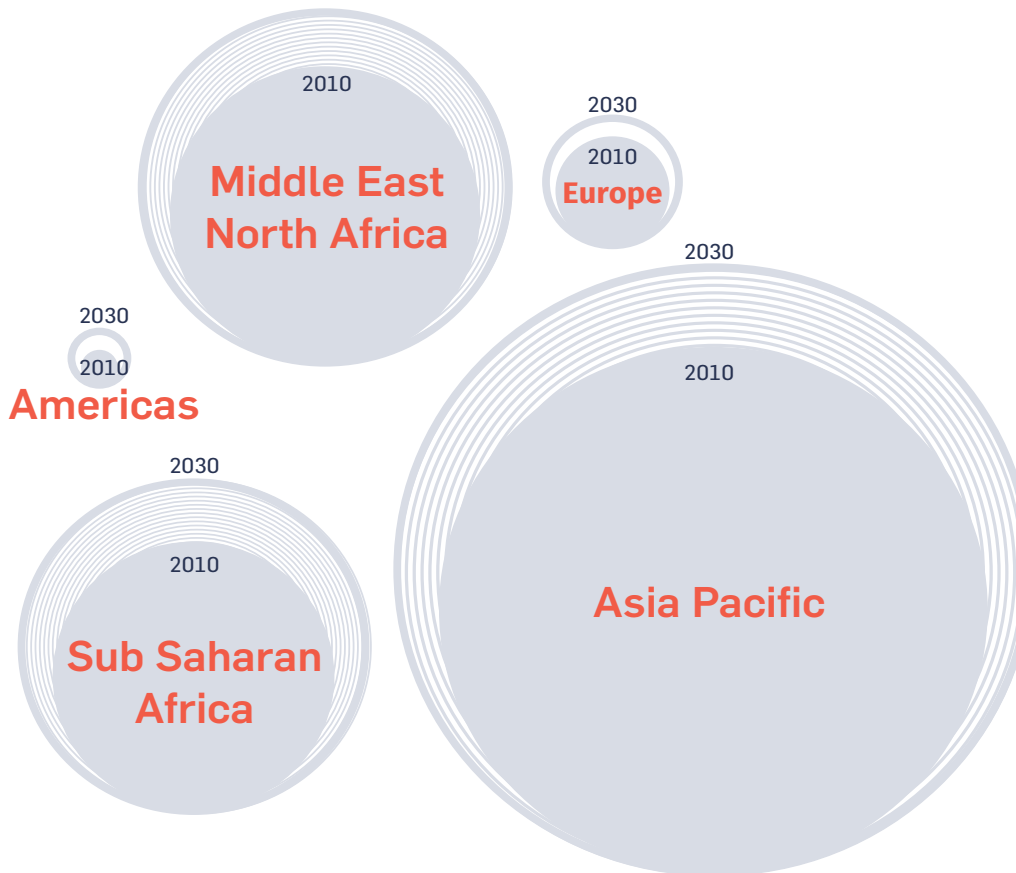
## Major Religions in China



Source: Professor Fenggang Yang, Center on Religion and Chinese Society, Purdue University

<sup>18</sup> According to China's 2010 Population Census, the total population of China was 1,332,810,869 in 2010

## The Future of the Global Muslim Population



Source: Pew Research Center

Overall, if current trends continue, a majority of the world's Muslims (about 60.0%) will continue to live in the Asia-Pacific region<sup>19</sup>. Therefore, basing it on statistics alone, there is an untapped demand for faith-based finance in the country and the region, and the low penetration level presents considerable opportunities for further growth and development of the Islamic finance industry. According to a 2013 survey of 5,000 Muslims in the Ningxia Hui

Autonomous Region, 24% of the respondents stated that they wished to subscribe to banking services that conform to Sharia'a. Specifically, 86% of the respondents from the rural areas stated that they wished to get the Sharia'a compliant financial products and services<sup>20</sup>, underlining the prospects of transforming this region as an emerging center for Islamic finance.

**It is of utmost importance to highlight that Islamic finance is no longer a niche market catering to Muslims only. Islamic finance may be based on Islamic principles, but its application is not limited to Muslims alone.**

<sup>19</sup> Pew Research

<sup>20</sup> "On the Financial Structure and Financial Development: A Case Study of Islamic Finance in Ningxia", Journal of Northwest University for Nationalities, Vol. 2, Sun G. (2013)

With almost 1.4 billion inhabitants, China constitutes the largest single market for financial services. The country's growing population calls for the need for basic financial services. In 2002, 40% of urban middle income consumers lived in Beijing, Shanghai, Guangzhou or Shenzhen, but this will fall to 15% by 2022. 85% of them lived in the eastern coastal regions in 2002, but this will decrease to

60% by 2022. China's income distribution is slowly rebalancing towards the West and North, away from East and South China, and away from the first-tier and second-tier mega-cities to the medium and smaller sized cities. China's rural areas have traditionally lacked basic financial services, with banks balking at the cost of building branches in less developed parts of the countries.

## China City Tier System



Source: Luxury China, Marketing Opportunities & Potential, Chevalier & Lu

Although banking and financial markets have undergone significant reforms in the last two decades, its rural banking market remains relatively underdeveloped. To address this issue, the Chinese government has focused considerable attention on enhancing access to financial services in rural areas via policy initiatives such as easing market-entry requirements and creating new incentive mechanisms. While these policies have widely increased banking service coverage and sustainable bank lending to rural households and SMEs<sup>21</sup>, experts agree that basic banking services are not yet accessible to all, and there is still a sizeable gap between demand for and supply of loans to rural households and SMEs. The cumulative effect of a sizeable share of a country's population being

effectively excluded from access to formal financial services carries both private and social costs, and ultimately undermines economic growth and development. Given the various benefits, furthering financial inclusion is of utmost importance and Islamic finance can provide access and usage of quality financial services which enable broader social and economic development goals. Opening up to Sharia'a compliant products and services will not only allow poor households and small entrepreneurs in rural areas in particular to be able to invest in education, build their businesses, save for retirement, and confront unforeseen risks and more, but it will also have a positive impact on equitable growth, job creation, and innovation.

<sup>21</sup> "Financial Inclusion in the People's Republic of China", CGAP and the Working Group on Inclusive Finance in China, Pete Sparreboom and Eric Duflos

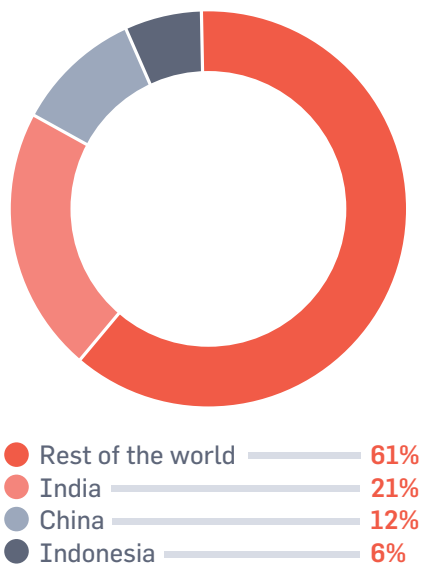


## China vs. Selected Asia: Banking Account Penetration

Country	Adults with account at formal financial institutions (% , 15+ years)	
	2011	2014
China	63.81	78.92
India	35.23	52.75
Indonesia	19.58	35.94
Malaysia	66.17	80.67
Pakistan	10.30	8.71
Thailand	72.66	78.13

Source: World Bank Global Findex

## Share of the World's Unbanked Adults in China, India and Indonesia (2014)



Source: Global Findex Database

In addition, Islamic finance may attract consumers who are interested in ethical/socially responsible investing, as Islamic finance prohibits unethical practices such as any involvement with products and industries that is considered harmful to society and a threat to social responsibility. Some examples include alcohol, tobacco, and any products based on uncertainty or gambling. A key challenge, however, is to emphasize the ethical value propositions offered by Islamic finance – to improve its appeal to the mass market beyond religiously observant Muslims. Additionally, lack of government support, education and product awareness remain some of the factors that may hinder Islamic finance from taking off in China.

## A Strong Philosophical Convergence between Ethical Investing and Islamic Finance

### Socially Responsible Investing

- + Explicitly acknowledges the relevance of environmental, social and governance factors
- + Double bottom line: social good and economic profit approach to investing
- Avoids excessive debt

### Islamic Finance

- + Economic development and growth along with social justice to all
- + Avoids usury and excessive debt

Source: Ameriprise Financial

## 2. — China's commitment to a "green economy" can be powered by Islamic finance

The rapid economic growth achieved in the last three decades has primarily relied on coal-based energy consumption, road-based transportation and a carbon-intensive industrial structure.

As a result of prioritizing economic growth at all costs, China has paid a heavy environmental price with the country now facing numerous environmental issues such as air, water, and soil pollution and climate change, coupled with a growing reliance on energy imports. The World Bank estimates that the cost of environmental damages will continue to rise, and will reach between 3%-6% of China's GDP.

Therefore, transforming from a resource- and pollution-intensive economy to a green economy is now a strategic priority for China. While the 13th Five Year Plan, approved at the March 2016 meeting of the country's Nation People's Congress (NPC) has reaffirmed China's commitment to a low carbon future, vision alone is not enough. Efforts must be streamlined and focused on the actual steps being taken to achieve the goals and spur real progress. One of the greatest lessons to be learned from the early days of China's green development is that fostering a sustainable future requires using approaches and processes that are sustainable in practice as well.

To significantly move from commitment to action, the Chinese government must not only enhance its administrative efficiency but more importantly adopt new market-based approaches to create a supportive yet stable environment for nourishing the green economy. The notion is simple-- when financial markets fail to deliver, economies falter and may eventually crash as witnessed in recent years. Against this new economic climate, Islamic finance and its key principles can be part of the solution in fast-tracking China's transition to green development.

## Islamic finance as the most genuine form of green finance

Financial systems can play a catalysing role in the development of green initiatives, and Islamic finance can contribute immensely. In this regard, the role of Islamic banks extends beyond being a component of a financial system, but as part of a total value-based social system that is driven by the principle of public interest. This system seeks to enhance the general welfare of society, where environmental protection and sustainability is inherently part of the Islamic finance agenda<sup>22</sup>.

After Chinese President Xi Jinping announced a comprehensive set of guidelines for putting in place a green finance system for China (more on this under Quick View: China's Green Finance Drive ), the entire country is now making it top priority to "green" every facet of the financial system, both on China's domestic front and in its international undertakings. It is also partly driven by the scale and urgency of the challenge of financing sustainable development.

To this end, Islamic finance can develop Sharia'a compliant instruments that can support China's green transformation of the economy. Utilizing ethical finance such as Islamic finance to effectively fund China's green initiatives ensure that it meets the broader purpose of aligning the country's financial system with the financing needs of an inclusive, sustainable economy. It will also accelerate the development of new growth drivers and enhance the potential for economic growth.

### What is green finance?

Green finance refers to financial services provided for economic activities that are supportive of environment improvement, climate change mitigation and more efficient resource utilization. These economic activities include the financing, operation and risk management for projects in areas such as environmental protection, energy savings, clean energy, green transportation, and green buildings.

### Fast Facts

While some progress has been made in green finance, only a small fraction of bank lending is explicitly classified as green according to national definitions. Less than 1% of global bonds are labelled green and less than 1% of the holdings by global institutional investors are green infrastructure assets. The potential for scaling up green finance is substantial.

Source: UNEP Inquiry



<sup>22</sup> MIFC "Islamic Finance: Ready to Finance a Greener World", September 2014

## Islamic finance and its emphasis on a moral economy may just be what China needs in its green drive

The Islamic law of Sharia'a which governs the Islamic financial system has ample injunctions which emphasise the need to care for the environment and forms of life on earth while ensuring the proper usage of natural resources

Islamic finance endeavours to promote an ethical financing and economic concept that extends beyond being a component of a financial system, but as part of a total value-based social system that is driven by the principle of public interest

Source: MIFC

As enlightened investors become more aware that the over-arching principles of Islamic finance share many common values with the global model of sustainable development, the Islamic finance industry has been responding by developing Sharia'a compliant green financing products designed to meet the growing demand for environment-friendly investments.

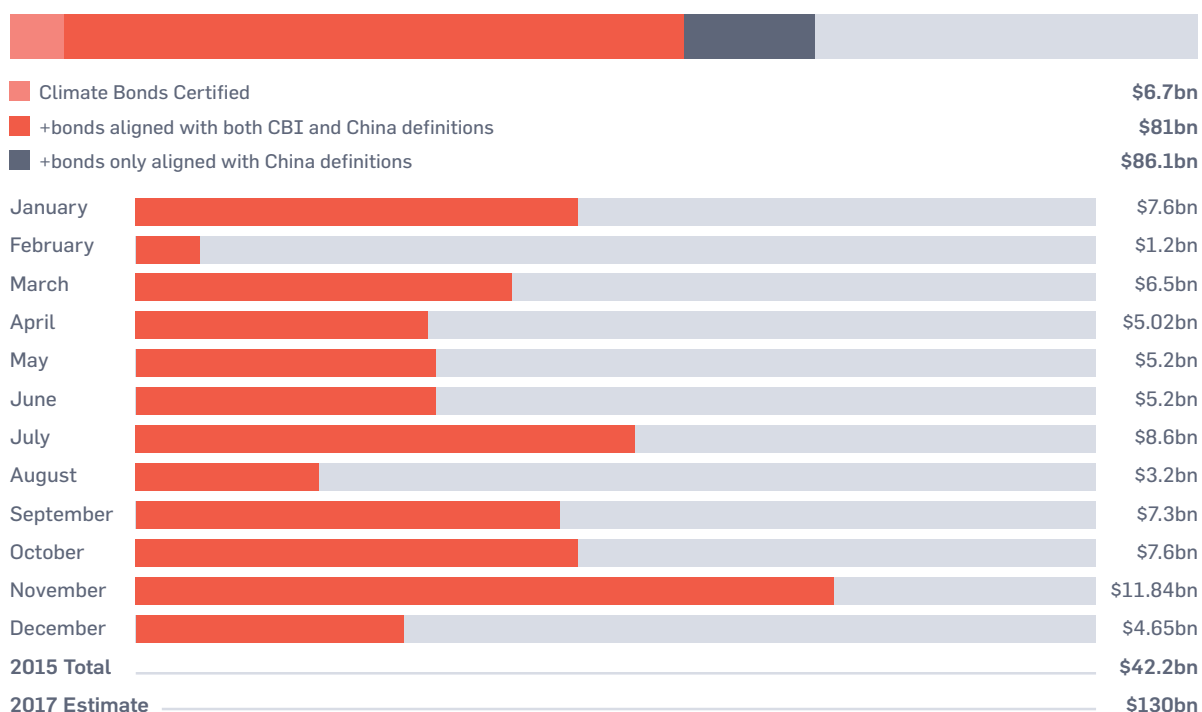
For example, the most commonly used tradable Islamic finance instrument is the sukuk. Following a surge of sovereign sukuk issuances from countries beyond the Islamic world in countries

such as the UK, Luxembourg and Hong Kong, regional based sukuk instruments have provided access to a wider pool of investors, many of whom are seeking to diversify their holdings beyond traditional asset classes. This increased appetite for sukuk products combined with the financing needs of green initiatives mean that green sukuk (or socially responsible investment (SRI) sukuk) have the potential to bridge the gap between conventional and Islamic investors. Due to its asset-based structure, the sukuk promises to be an appropriate financial instrument for investment in green projects.

### Overview of the Green Bond Market

2016 Issuance (Aligned with CBI definitions)

\$81billion



Source: Ameriprise Financial



In brief, a green sukuk is the Sharia'a compliant version of a green bond and represents Sharia'a compliant investments in renewable energy and other environmental assets. Green sukuk notably address the Sharia'a concerns for protecting the environment. They are structured in the same

manner as a traditional sukuk, whilst typically enjoying the beneficial tax treatment of a green bond. The market for green sukuk is being driven by the following advantages over other capital markets instruments:

1. — Holding green sukuk would allow investors to gain exposure to the renewable energy sector, particularly in the Middle East. With a rising global population and dwindling fossil fuel reserves, renewable energy is poised to become an increasingly significant and profitable sector
2. — Green sukuk will allow investors to hedge against climate change in their investment portfolio
3. — Issuers (particularly in the Middle East) may also wish to diversify their energy mix. Green sukuk should allow sovereigns to encourage investment in renewable energy sources. This is particularly relevant in light of the recent collapse in oil prices
4. — In the context of investment funds divesting funds from certain industries, such as tobacco and firearms; many large institutional investors have recognised the need to invest a proportion of funds into socially responsible and ethical investments. Green sukuk offer the potential to combine profitable investing with the desire for an ethical portfolio

Source: Green Bonds & Islamic Finance, White & Case

The first green sukuk would be the Orasis Green Sukuk<sup>23</sup>, issued in France in August 2012 by Legendre Patrimoine (an investment company specializing in solar energy and real estate investments) and Anouar Hassoune Conseil (an Islamic finance consultancy firm offering financial, brokerage, project management and training advisory services). The sukuk is backed by renewable energy assets and is the first structure

in France where Islamic certificates are open for investment to private individuals as well as institutional investors<sup>24</sup>.

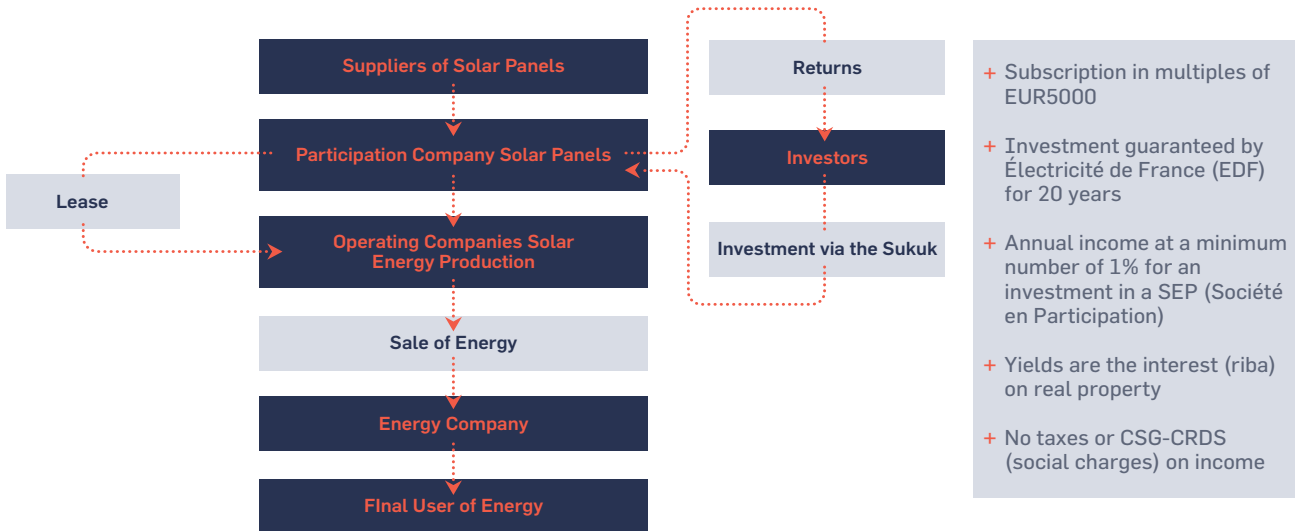
Other examples include the SRI sukuk by Khazanah Nasional Berhad (KNB) (Malaysia's state-owned sovereign wealth fund), and two successful sukuk issuances by UK-based International Finance Facility for Immunisation Company (IFFIm).

**KNB used the proceeds from the issuance to fund schools to improve the accessibility of quality education in Malaysia, while the proceeds from the IFFIm issuances were donated to the Gavi Vaccine Alliance for children immunisation programmes in the world's poorest countries with the aim to strengthen health systems.**

<sup>23</sup> [http://cenf.univ-paris1.fr/fileadmin/Chaire\\_CENF/HC\\_-\\_Orasis\\_Sukuk\\_presentation\\_10-2012.pdf](http://cenf.univ-paris1.fr/fileadmin/Chaire_CENF/HC_-_Orasis_Sukuk_presentation_10-2012.pdf)

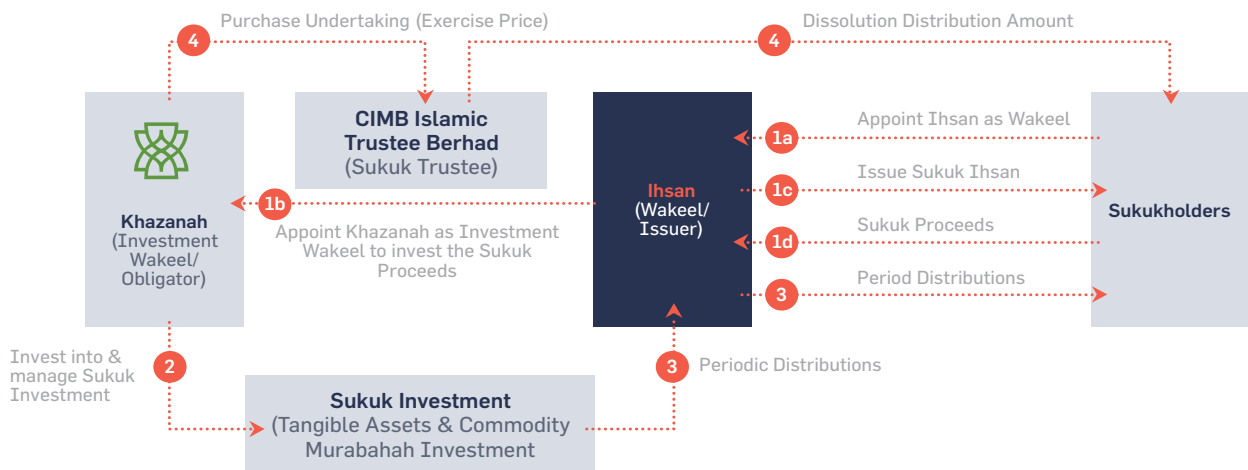
<sup>24</sup> "Orasis" is a Greek word for "vision", and the Orasis sukuk literally translates to visionary green sukuk

## The Structure Chart for the Orasis Green Sukuk



Source: [http://cenf.univ-paris1.fr/fileadmin/Chaire\\_CENF/HC\\_-\\_Orasis\\_Sukuk\\_presentation\\_10-2012.pdf](http://cenf.univ-paris1.fr/fileadmin/Chaire_CENF/HC_-_Orasis_Sukuk_presentation_10-2012.pdf)

## Khazanah SRI Sukuk



Source: CIMB

## Khazanah SRI Sukuk

<b>Issuer</b>	Ihsan Sukuk Berhad, a special purpose vehicle initiated by Khazanah
<b>Obligor</b>	Khazanah Nasional Berhad
<b>Principal Adviser/ Lead Arranger</b>	CIMB Investment Bank Berhad
<b>Joint Shariah Advisers</b>	CIMB Islamic Bank Berhad and Amanie Advisors Sdn. Bhd.
<b>Facility</b>	RM1 billion in nominal value Sukuk programme established under the "Sustainable and Responsible Investment Sukuk" framework
<b>Facility Tenure</b>	25 years from the date of the first issuance
<b>Offering Tenure</b>	7 years
<b>Issue Price</b>	100%
<b>Periodic Distribution</b>	Annual basis
<b>Payment Frequency</b>	
<b>Rating</b>	Initial rating of AAA(s) by RAM Rating Services Berhad
<b>Islamic Principle</b>	Wakalah Bi Al-Istithmar
<b>Use of Proceeds</b>	Ihsan: To purchase the sukuk investments Khazanah: To fund Yayasan AMIR's Trust Schools Programme for 2015

Source: CIMB

Although Islamic finance has yet to play a larger role in green financing, the Islamic Declaration on Climate Change launched at the International Climate Change Symposium in August 2015 signalled the Islamic finance market's commitment to develop a market to finance climate-related initiatives.

Back in 2012, in order to spearhead the development of best practices and promote the idea of green sukuk for climate change investment projects, the Climate Bonds Initiative (CBI) in cooperation with the Clean Energy Business Council of the Middle East and North Africa (MENA) and Dubai-based Gulf Bond & Association established the Green Sukuk Working Group.

In China's case, it is clear that substantial further efforts are needed to divert the capital allocation towards green investments across the economy. A key driver for this capital re-allocation is for banks

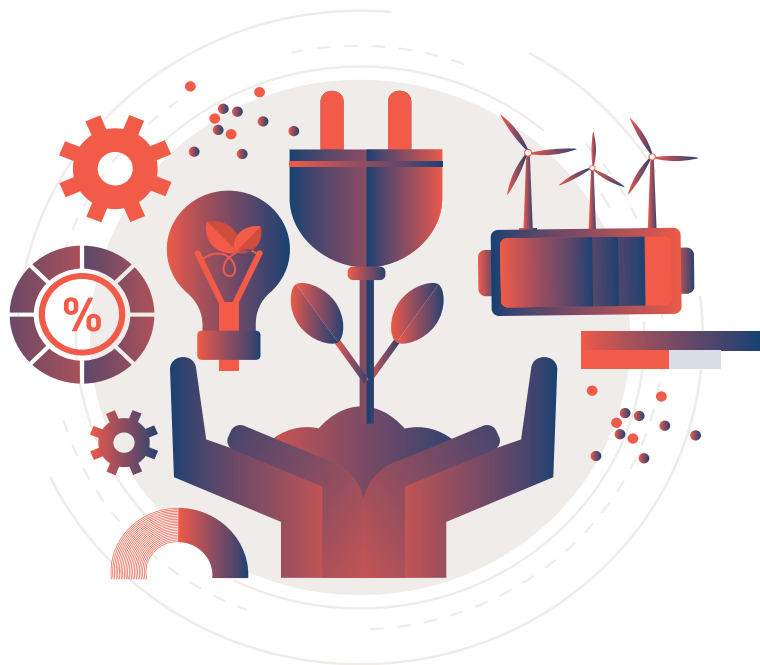
and institutional investors to be more responsible and take fuller account of environmental risks and environmentally driven returns in their decision-making process, as the fate of China's environment and its financial sector are intrinsically linked. Ethical, environmental and socially responsible values within finance and business are features that are deeply entrenched within Islamic theology and jurisprudence. Therefore, the use of Islamic finance in China's green drive is a promising business proposition given the synergies between two concepts.

## Quick View: China's Green Finance Drive "Green is Gold"

The increasing scientific evidence supporting climate change and the role of human activities in greenhouse gas emissions has led to the issue becoming a key item on the international agenda.

With the high-profile signing ceremony of the Paris Agreement by 174 countries at the United Nations in May 2016, the complex process of tackling the historic commitments on climate change has been formally launched. As the largest emitter of greenhouse gases and the largest consumer of various commodities in the world, China has been responding to this challenge by becoming increasingly active in leading ambitious actions to protect the environment.

Positively, seven of China's government ministries adopted a set of principles to ensure future investments in the country are environmentally friendly, thus turning it into a national strategy. In a joint statement released on 1 September 2016, the People's Bank of China declared that the "Guidelines on Establishing the Green Financial System" laid out a series of policy incentives to reshape China's domestic financial system in order to serve the needs of green, inclusive development. Some of these incentives include re-lending operations by the People's Bank of China, specialized green guarantee programs, interest subsidies for green loan-supported projects, the support for introduction of the PPP model in the green industry, and the launch of a national-level green development fund.



## Overview of the Guidelines on Establishing the Green Financial System

- + Underline the importance of establishing the green financial system
- + Establish a policy framework to support green lending
- + Enhance the role of the securities market in supporting green investing
- + Launch green development funds and mobilize social capital through public
- + Develop green insurance
- + Improve environmental rights trading market and develop related financing instruments
- + Support local government initiatives to develop green finance
- + Promote international cooperation in green finance
- + Prevent financial risks and strengthen implementation

Following the G20 Summit in the Chinese city of Hangzhou in September 2016, leaders of the bloc released a final communiqué which, for the first time, highlighted the importance of green finance as an effective means to support global sustainable growth. The communiqué builds on the work of the G20 Green Finance Study Group (GFSG), a Chinese initiative co-chaired by China and the UK with support from the United Nations Environment Programme Inquiry into the Design of a Sustainable Financial System (UNEP Inquiry) which released its findings in the "G20 Green Finance Synthesis Report" at the Summit.

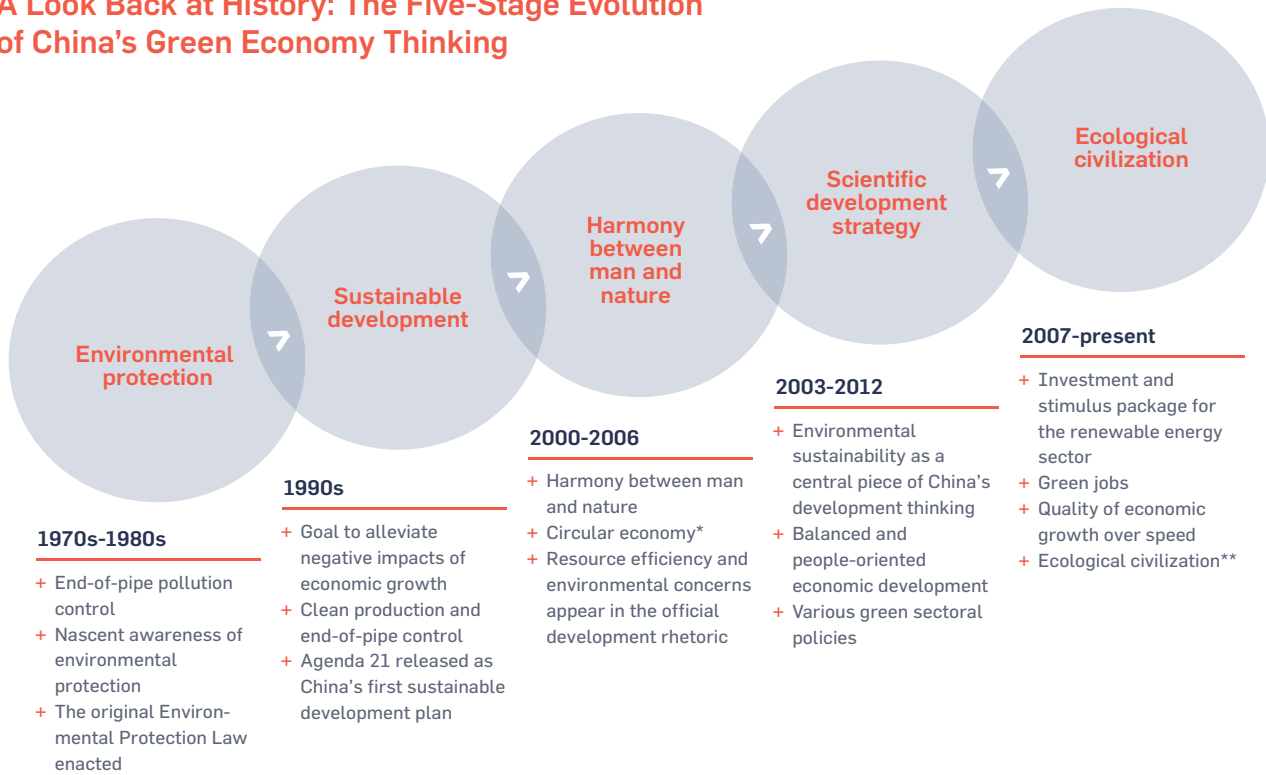
Back in 2014, the Research Bureau of the People's Bank of China (PBoC) convened a Green Finance Task Force made up of 40 experts from ministries, financial regulators, academics, banks and other financial institutions, complemented by international experts brought together by the UNEP Inquiry to consider the steps that China could take to establish a green financial system. The outcome was a report entitled "Establishing China's Green Financial System: Report of the Green Finance Task Force", which presents an ambitious framework of recommendations.

Indeed, these documents call for finance from banks, corporations and investors to be directed at "economic activities that are supportive of environment improvement, climate change mitigation and more efficient resource utilization," including the "financing, operation and risk management for projects in areas such as environmental protection, energy savings, clean energy, green transportation and green buildings".

According to recent estimates, at least USD320bln-USD640bln a year is required to develop China's renewable energy, clean transport and energy efficiency sectors and to address environmental issues and climate change. The People's Bank of China (PBoC) has made it clear that less than 15% of this total will come from public or government sources, highlighting China's senior leadership's motivation to approve guidelines capable of re-tooling the country's financial system to provide the necessary investment. Subsidies will be provided for loans classed as "green", and over time companies will be required to take part in a mandatory environmental disclosure scheme.



## A Look Back at History: The Five-Stage Evolution of China's Green Economy Thinking



Source: China's Path to a Green Economy: Decoding China's Green Economy Concepts and Policies

\* A concept to decouple growth from resource constraints. Widely adopted by the Chinese government, as illustrated by the 2009 'Circular Economy Promotion Law. It involves three levels in China: eco-cities (macro), eco-industrial parks (meso) and clean production and designs (micro)

\*\*A political vision emphasising the ecological quality and sustainability of China's economic development. First introduced in 2007 by former president Hu Jintao, it gained political traction at the 18th National Congress in 2013



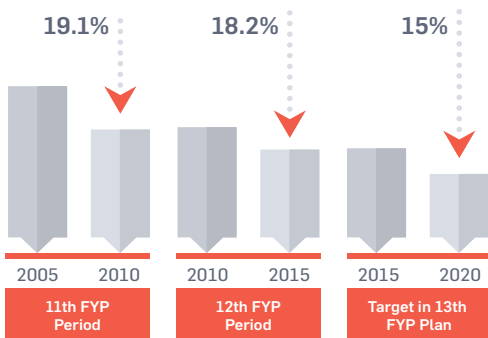
## China's New Leaner and Greener 13th Five-Year Plan



Under the 'Environment' section, the 13th Five-Year Plan emphasises a cleaner and greener economy, with a strong commitment to environmental management and protection, clean energy and emission controls, ecological protection and security and the development industries. Meanwhile, under 'Financial Services', the plan envisages establishing a green financial system consisting of green loans, green bonds, a green development fund and other innovative green financial products amongst further financial reforms.

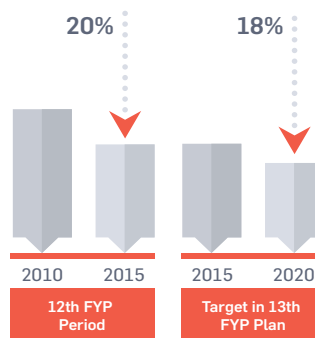
## The Climate and Energy Targets in China's 13th Five Year Plan

### Energy Consumption per Unit of GDP



Note: The data for the 11th and 12th FYP period refers to the actual energy intensity reduction

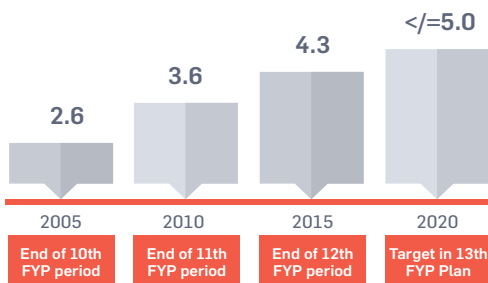
### Carbon Dioxide Emission per Unit of GDP



Note: The data for the 12th FYP period refers to the actual carbon intensity reduction

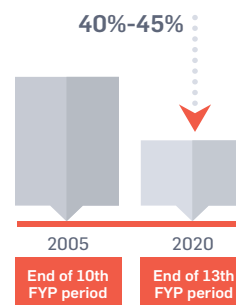
### Total Energy Consumption

Billion tons of coal equivalent



Source: China Energy Statistical Yearbook 2015

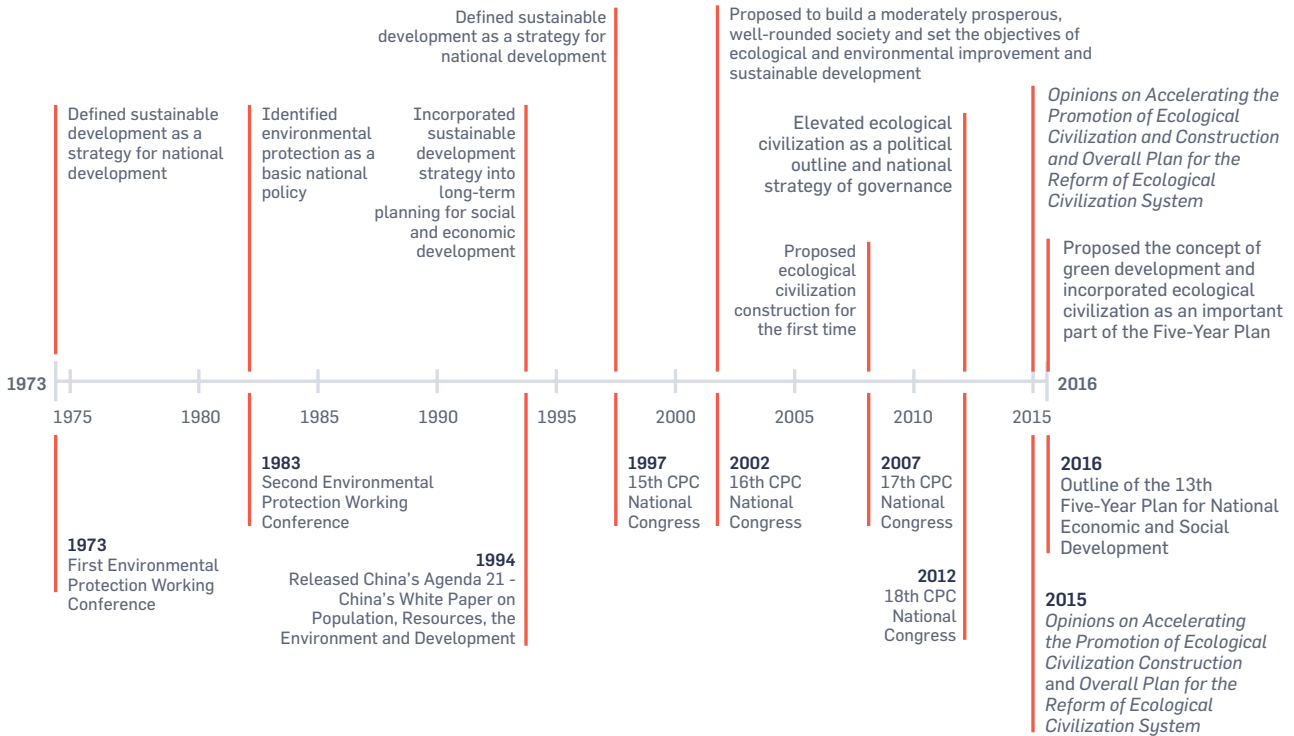
### Climate Target/Carbon Intensity



The Chinese government has long regarded 'ecological civilization'-- defined as a stable and prosperous country that operates within the limits imposed by natural resources, ecosystems and planetary boundaries-- and environmental protection as a long-term strategy vital to the

country's modernization and its people's well-being. China began outlining environmental protection as a fundamental national policy in the 1980s and established sustainable development as a national strategy in the 1990s.

## Evolution of China's Eco-Civilization Development



Source: UNEP



**3. — Islamic financing can be made available to calibrate and stimulate growth in key economic sectors as part of China's greater economic restructuring plan, given its close link to the real economy**

Since the global financial crisis of 2008-2009, China has relied on an unsustainable growth model of excessive credit and investment, which has given birth to a large pool of vulnerabilities in the fiscal, real estate, financial, and corporate sectors.

The huge rise in debt-fuelled investment to offset the weakening in external demand has largely proven the weakening of the link between financial intermediation and productive economic activity. It provides a concrete example of how exponential growth in financial activities that are detached from the growth trajectory of the real economy can develop into a source of instability.

In its efforts to transition to a slower, yet safer and sustainable growth path, structural reforms are required to reverse past trends, and this partly points to the fact that China should refrain from over-reliance of debt-financed investment to boost growth. In this context, Islamic finance has a major role to play. While conventional intermediation is largely debt-based and allows for risk transfer, Islamic intermediation, in contrast, is asset-based, and centers on risk sharing. In addition to providing Islamic banks with additional buffers, these features make their activities more closely related to the real economy and tend to reduce their contribution to excesses and bubbles.

The inherent strengths of Islamic finance, including the close link between financial transactions and productive flows, in addition to the built-in dimensions of governance and risk management, has contributed greatly to the viability and resilience of the industry, especially during the 2008-2009 financial crisis. There is also strong discouragement against excessive risk



undertakings and a prohibition against speculative elements. These rulings also serve to insulate the Islamic financial system from excessive leverage, which in turn contributes towards promoting financial stability and its long-term sustainability.

Thus, Islamic finance can be made available to calibrate and stimulate growth in key economic sectors as part of China's greater economic restructuring plan, given its close link to the real economy.



## Selected Sharia'a Compliant Financing Concepts

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### Ijarah Leasing

Refers to an arrangement under which the lessor leases equipment, building or other facilities to a client at an agreed rental fees or charges, as agreed by both parties. The ownership of the asset remains in the hands of the lessor. However, after the end of the rental period, the ownership of the asset is generally transferred to the lessee

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### Istisna' Commissioned manufacture

A contract under which one party buys the goods and the other party undertakes to manufacture the goods, according to agreed specifications, price and within a certain time. It is used to finance construction and manufacturing projects, and also enables banks to finance working capital

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### Mudharabah Profit and loss sharing

Refers to an agreement made between a capital provider and another party, known as the Mudharib (manager) who acts as the entrepreneur. This arrangement will enable the entrepreneur to carry out business projects and profits are distributed based on a pre-agreed profit sharing ratio. In the case of losses, the losses are borne by the provider of the funds, unless it is due to negligence, misconduct or violation of the conditions agreed upon by the entrepreneur

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### Murabahah Cost-plus financing

A form of contract under which the bank agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then resell the assets or goods to its client with a mark-up profit and generally with a deferred payment. Such sales contract is valid on the condition that the price, other costs and the profit margin of the seller are stated at the time of the agreement of sale

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### Musharakah Joint venture

Refers to a partnership or joint venture for a specific business, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation

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### Bai'Salam Future delivery

Refers to an agreement whereby payment is made in advance for delivery of specified quantity and quality of a commodity or goods, to be delivered on a specific date and at an agreed price

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#### 4. — China wants to build stronger ties with countries under its “One Belt, One Road” strategy to rebuild Silk Road trade links with Asia and Europe, and Islamic finance can be the solution

Islamic finance is gaining prominence as a channel for China to expand its economic influence abroad as banks strengthen ties with Muslim-majority countries and Chinese companies start to tap offshore pools of Islamic funds. With ‘One Belt, One Road’, Chinese state-owned enterprises and

private companies are now more willing to explore Islamic finance, as networking now will include the world’s main centers of Islamic finance, the Middle East and South-east Asia, where Sharia’a compliant assets account for as much as a quarter of total banking assets.

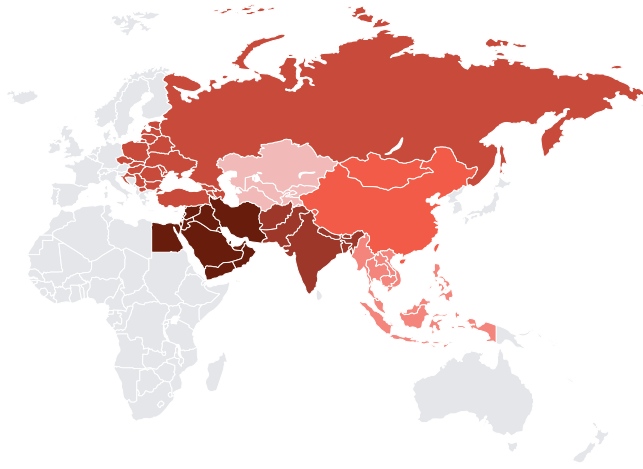
#### About 40% of OBOR countries are Muslims

Regions	Total Population	Muslim Population	Proportion of Muslims (%)
Middle East & Africa	332,456,535	310,610,117	93.43
Central and Western Asia	99,857,512	84,382,978	84.50
South East Asia	599,138,114	234,691,259	39.17
South Asia	1,385,180,121	431,021,087	31.12
Central Europe	291,708,982	20,625,157	7.07
OBOR Nations (ex China)	2,708,341,264	1,081,330,598	39.93
OBOR Nations (plus China)	4,084,390,207	1,103,330,598	27.01
Total	7,286,270,042	1,703,146,000	23.37

Source: Pew Forum study on Global Muslim Population, CIA World Factbook

Therefore, given the strong proliferation of Islamic finance in Muslim-dominated markets, it can be a tool of commercial diplomacy for countries seeking to enhance trade and cross-border investment links and advance their interests in the Middle East and Southeast Asia. This dynamic also enables Islamic finance to grow by engaging participants outside of its traditional geographic markets.

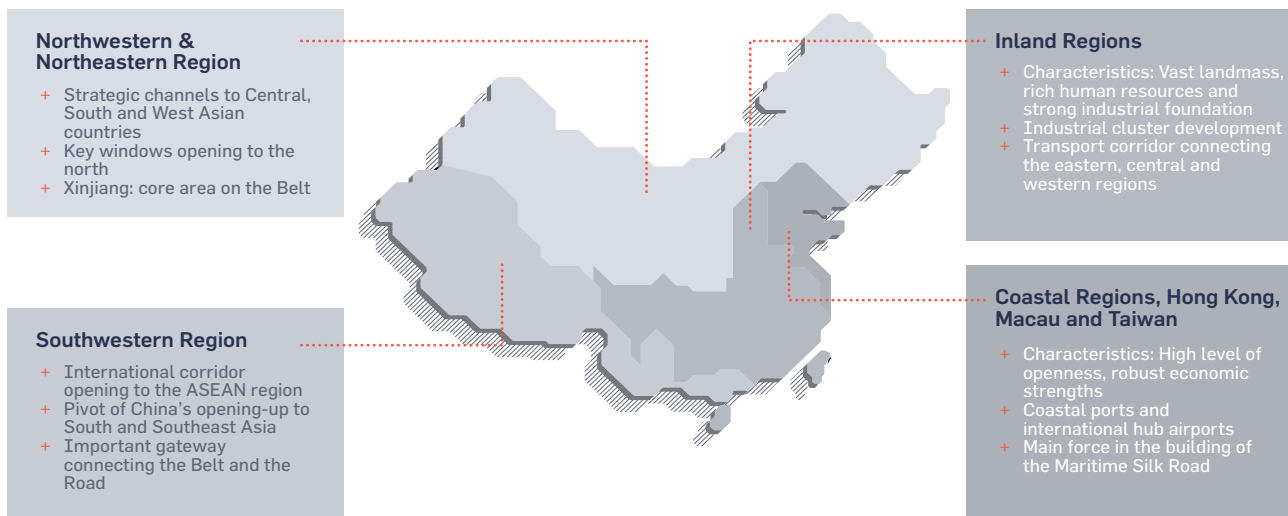
## 'One Belt, One Road' Initiative



Region	Country
● East Asia	China, Mongolia
● Southeast Asia	Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste, Vietnam
● Central Asia	Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan
● Middle East & North Africa	Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Palestine, Syria, United Arab Emirates, Yemen
● South Asia	Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
● Europe	Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey, Ukraine

Source: Industrial Cooperation between Countries along the Belt and Road, China International Trade Institute, August 2015. The countries are grouped based on World Bank's classification by region

## Regions & Provinces in China: Positioning in the OBOR Initiative



Source: Vision and Actions on Jointly Building Silk Road Economic Belt and 21st Century Maritime Silk Road, compiled by the Fung Business Intelligence Center

## The Role of Islamic Finance in 'One Belt, One Road'

### — An alternative means of financing: Sukuk and Sharia'a-compliant financial instruments as viable financing tools to meet the infrastructure needs of 'One Belt, One Road'

The success of the 'One Belt, One Road' initiative hinges on the construction of vast infrastructure, engineering and energy projects. To date, it is clear that the 'One Belt, One Road' initiative is backed by substantial financial firepower via the USD50.0bln Silk Road Fund, which will directly support infrastructure projects in developing countries along the routes, as well as the newly-established Asian Infrastructure Investment Bank (AIIB) and to some extent, the New Development Bank (NDB), a BRICS multilateral development bank. However, even China's deep pockets have limits, with the country's total debt to GDP continuing its steady upward march at more than 240%.<sup>25</sup> The way the 'One Belt, One Road' initiative is financed therefore could be the most important factor in terms of the sustainability of the bold project.

For that reason, it is crucial to explore alternative and complementary innovative financing mechanisms such as Islamic finance. The burden of financing projects under the 'One Belt, One Road' initiative can shift away from banks towards bond markets, or in Islamic finance it is called sukuk markets. Globally, sukuk has emerged as a competent alternative to conventional debt financing for large infrastructure and energy projects. This is so because Islamic finance requires a clear link with real economic activity and transactions have to relate to a tangible, identifiable asset, which comes in handy in the case of infrastructure financing. Furthermore, sukuk investors typically have an appetite for longer periods and prefer stable and predictable cash flow, traits associated with infrastructure or energy projects. Thus, it is clear that the infrastructure sector linked to the 'One Belt, One Road' initiative holds tremendous potential for both sukuk issuers and investors.

Evidenced by the latest statistics available, sukuk has become a viable financing tool to meet the infrastructure needs of various countries. In the recent decade, a total of USD95.0bln of infrastructure sukuk has been issued by more than 10 countries, whereby market for infrastructure sukuk has generally been dominated by issuances from Malaysia, followed by Saudi Arabia and the UAE. In Asia alone, Asian Development Bank (ADB) estimates that a funding of USD8.3tln is required until 2020 for infrastructure projects, while the funding requirements in the Middle East are estimated to be USD2.0tln over the same period. Developing economies in Africa have also already begun its entry into the sukuk market for such infrastructure financing with some having put in place the legal groundwork for sukuk issuances.

Islamic financing is not just confined to sukuk. To date, numerous governments and business entities have applied various forms of Islamic financial instruments to fund projects and mobilize resources for infrastructure, energy, health, education, water, sanitation, trade, housing and other sectors. They can also meet the needs of governments and private sector to finance mega projects as well as micro-level operations. This bodes well as the efficient mobilization of all available resources will ensure the 'One Belt, One Road' success.

### — Islamic trade facilities can strengthen China's trade ties

A direct consequence of the "One Belt, One Road" initiative would be a further increase in trade volume with over 65 countries. Islamic finance can provide new opportunities in unimpeded trade and become the preferred mode of finance for emerging Muslim-majority markets such as Turkey, Indonesia, Malaysia, Qatar, Saudi Arabia and the UAE. Some of these markets are evolving into hot spots for global business and they promise to permanently alter the global trade scene over the next 10 years. They also already have strong trade links with other core Islamic finance markets, which offer new opportunities for growth for Islamic trade finance. Overall, Islamic finance can help promote greater financial integration for China and connect trade relations between China and the rest of the world. Ranging from Islamic banker's acceptances to Islamic factoring services, Sharia'a compliant trade instruments are fast becoming preferable modes of financing for a growing number of trading companies across Southeast Asia and the Middle East. Having Islamic banking and finance facilities in China would surely assist trade and commerce between China and these countries. In many cases, Islamic finance is driven by the needs of stakeholders and regulatory rules. For example, in Malaysia, it is a requirement for listed entities to have at least two-thirds of their financial transactions conducted through the Islamic system.

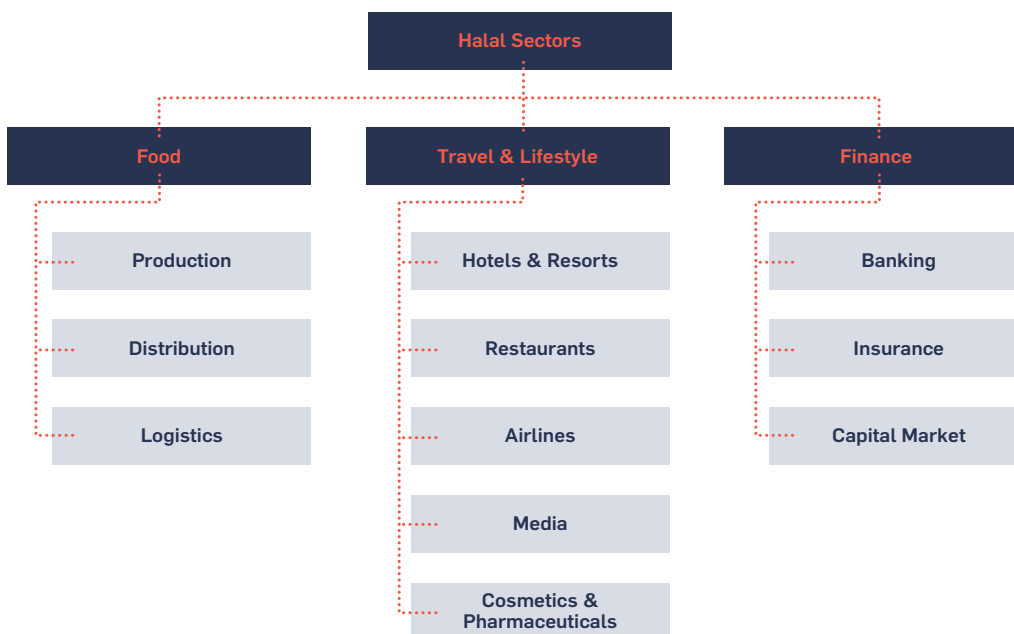
<sup>25</sup> The Economist, "Deleveraging Delayed", 24 October 2015.

## 5. — Islamic finance as a gateway for China to tap into the booming global halal economy

By definition, halal (which means permitted or lawful in Arabic) is a term designating any object or an action which is permissible to use, or engage in, according to the principles of Sharia'a. Therefore, the global halal economy include businesses whose operations comply with the principles of Sharia'a, in which halal is a value proposition that exists within

key elements of the supply chain of the intersecting industry sectors. Based on current assessments, the global halal economy is poised to grow over the next few years. In 2015, halal sectors worldwide were valued cumulatively at USD3.9tn and are forecasted to reach USD6.5tn by 2021<sup>25</sup>.

### Overview of the Global Halal Industry



Source: State of the Global Islamic Economy 2015-2016

The founding principles of the halal economy share much in common with recognized values of ethics and sustainability—which makes halal products and services equally attractive to non-Muslim consumers, especially in view of an emerging global sentiment around the ethical and socially-conscious businesses post-crisis. Indeed, it is being recognized as a new benchmark for safety and quality assurance.

Promoting halal industry has gone beyond being driven by religious obligation but also by its lucrative commercial potential. As a result, halal

firms are heavily involved in international trade, particularly those operating out of non-OIC countries and whose exports cater to the markets which are home to a large Muslim population. In this process, halal firms are in critical need of three financing lines:

- + Trade financing to support international trading activities
- + Risk management products to hedge international exposures
- + Working capital to help with the raw materials and other processing expenditures



This represents significant opportunities for Islamic finance, a natural economic partner. Underpinning this is the increased awareness on the need for utilizing Sharia'a compliant financial services by the suppliers of halal products and services in order to achieve full halal status<sup>26</sup>. This ensures an end-to-end Sharia'a compliance not only in the delivery of end-products to consumers,

but suppliers are also provided with alternative and ethical funding options. For example, many companies in the halal food market are fragmented. Financing vertical integration of the supply chain, from slaughterhouses to distributors is an investment opportunity that should provide favorable returns for the investors as well as develop strong, fully halal companies.

## The Relationship between Islamic Finance and Halal Industries



Source: MIFC

In China's context, while connecting Islamic liquidity with halal opportunity, Islamic finance will thus allow China to capitalize on growing global demand for halal products. Latest statistics continue to support this argument-- in 2015, the 57 mostly-Muslim majority countries of the world represent 15% of the total global GDP, a 1.7 billion population growing at a faster pace than the global population and some of the fastest-growing economies in the world<sup>27</sup>. Their influence stretches beyond Muslim-majority countries as more than 350 million Muslims reside as minorities in many nations, with largely affluent ones living in the West and large populations residing in the emerging nations of India, Russia as well as China.

Across the globe, this fast-growing and relatively young population of Muslims is increasingly asserting its faith-based sensitivities in the marketplace to products as varied as food, banking, and finance extending all the way to fashion, cosmetics, travel and healthcare. At a time where the IMF describes the global economy entering 'secular stagnation' due to a decline in investments

and an ageing population, the Islamic economy stands in stark contrast offering the most viable solution to global economic growth.

Apart from tapping into the global halal economy via funding, China can also contribute to the growing halal industry as a supplier. Estimates show that the halal food expenditure is expected to grow to USD1.9tn by 2021 and will account for 18.3% of global expenditure. With a consumer market that large, especially originating from OBOR countries such as Indonesia, Turkey, Pakistan, Egypt, Bangladesh, Iran and Saudi Arabia (these countries are the top 7 Muslim countries with the highest spend on food and beverage in 2015), the halal food sector represents a great opportunity for developing Chinese brands interested in expansion. Known as the world's factory, China has a huge production capacity, a comprehensive logistics system, as well as existing infrastructure to support business activity. These attributes will provide a solid foundation for China to participate in the global halal food supply chain, in addition to other halal sectors.

<sup>26</sup> 'The Halal Economy: Huge Potential for Islamic Finance', MIFC 2014

<sup>27</sup> State of the Global Islamic Economy 2016-2017

## China's Halal Food Manufacturers

### Arman Muslim Foods Industrial Group

- + One of the leading manufacturers of halal food in the region, with 14 supermarkets in Urumqi, the capital of Xinjiang
- + Arman also distributes to over 2,700 Arman franchise chain stores and over 10,000 other stores throughout Xinjiang province
- + Through its recent partnership with TPM Biotech of Malaysia, the company is aiming to raise its adherence to halal and the quality of its manufacturing processes to access the broader global halal markets

### Jingyitai Halal Food Co. Ltd.

- + A major player in the Ningxia Hui Autonomous Region, with plans to build a halal food factory in the UAE
- + If Jingyitai's plans materialize it will be the first Chinese halal food manufacturer to invest directly in the MENA region
- + The company spent five years with China Agricultural University and Ningxia University to develop technology to freeze convenience foods, and says it is the first company in Yinchuan to provide Haj meals in Mecca
- + It has established export markets in the UAE, Qatar and Kuwait

### Yinchuan Laheqiao Halal Food Co. Ltd

- + One of the largest halal meat producers in China's northwest region
- + It processes over one million sheep, 80,000 cattle and 10,000 camels per year, with an annual turnover of CNY600mIn and a growth rate of 10% a year
- + It has established export markets in Jordan and the UAE

### Henang Dayong Bangjie Food Co.

- + It was reported in August 2016 that it has signed a deal with the local government of Xincheng county in Guangxi province for a CNY250mIn investment in feedlots, processing plants and cold chain facilities
- + The firm is targeting the domestic market for packaged halal meat as well as the international halal market
- + With an ambition to be the leading halal brand in China, Bangjie has branched out in China's north with a large subsidiary producing sheep and cattle for the halal market, with export markets in the Middle East and Russia

### Bogong Halal Food Co. Ltd.

- + A subsidiary of Bofeng Beef Group
- + Has the capacity to process 100,000 cows per annum into halal beef products

Other domestic conventional players tapping into the halal food industry

### Shineway Group

- + One of China's largest processed meat companies, it entered the market in 2009 through a USD310mIn investment in a halal meat production base

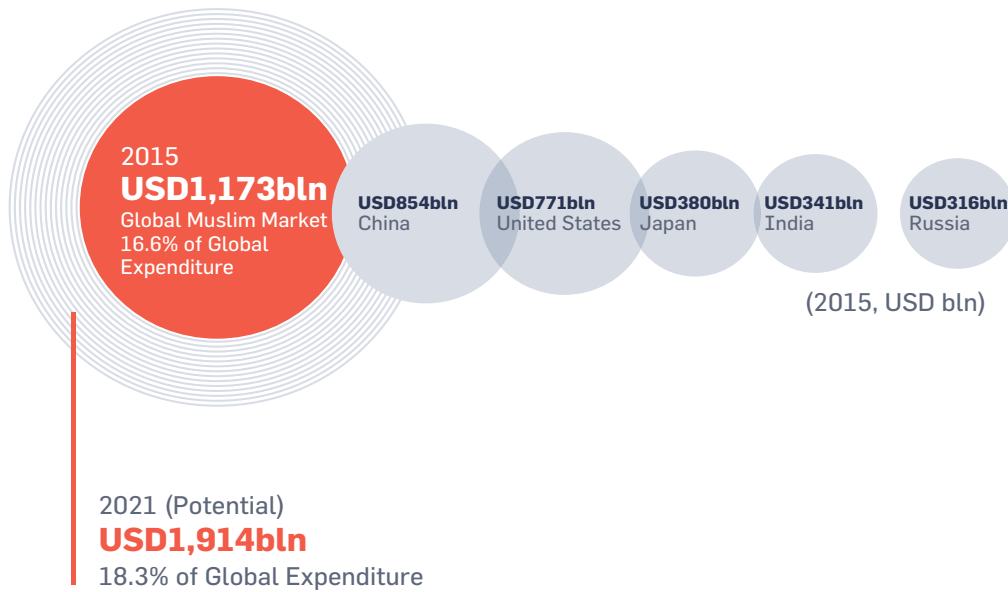
### Beijing Shunxin Agriculture Co. Ltd

- + A national diversified food products manufacturer with revenues of RMB6.8bIn in 2014 (USD1.8bIn) acquired Linxia Qingheyuan Halal Food Co. Ltd. for USD220mIn in 2015
- + Linxia is a vertically integrated meat processor, with in-house husbandry and slaughtering and is a key player in Gansu province, which has a sizeable Muslim population

### Xinhua Agriculture

- + Acquired Kinxia Qinheyuan Halal Food Company for USD267mIn in 2015

## Global Muslim Consumer Spending on Food & Beverage vs. Other Countries (2015)



Source: State of the Global Islamic Economy 2016-2017

## Some of China's Halal Certification Bodies and Authorities

Name of Organization	Location
Shandong Islamic Association	Jinan, Shandong Province
China Islamic Association	Beijing
ARA Halal Development Services Center Inc. (ARAZ)	Zhengzhou, Henan Province
Linxia Halal Food Certification Center (Gansu)	Linxia, Gansu Province

Source: Department of Islamic Development Malaysia (JAKIM)



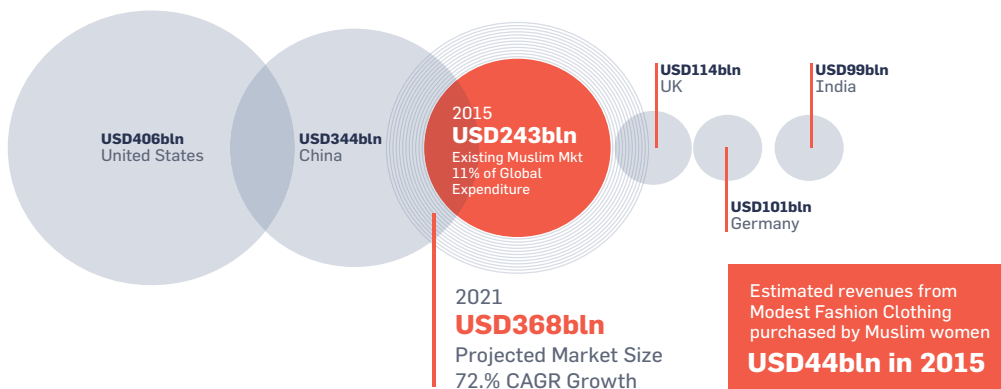
China has long created the infrastructure required to support the halal trade, including the 2008 construction of halal food and Muslim supplies manufacturing hubs such as the Wuzhong Halal industrial park in the Muslim stronghold of Ningxia, which to date houses over 200 companies. In 2014, China established its first halal food certification center, the Ningxia Halal Foods International Trading Certification Center, where it is permitted to certify halal food in several provinces in the country.

It is important to note that China remains the largest exporter of clothing to OIC countries at USD21.9bln in 2015, leading by a wide margin from the second largest exporter, India (USD5.6bln). Estimated global Muslim consumer spending on conservative clothing is USD243bln in 2015 (11% of the global market spend) and is set to increase to USD358bln in 2021, representing a 7.2% CAGR growth between 2015 and 2021. Once more, the

sheer size of the market present an opportunity to develop the segment, mainly largely untapped verticals such as sports apparel, menswear, and the likes. Additionally, cross-selling can also be made to other faith-based, modest-conscious consumers.



## Modest Fashion: Muslim Spend vs. Global Market Spend (2015)



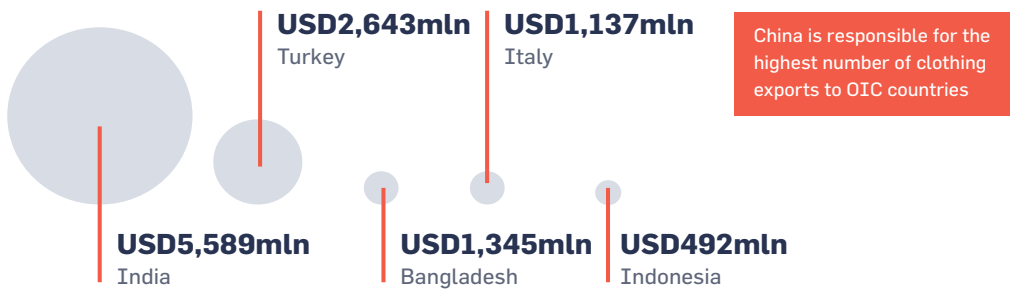
Source: State of the Global Islamic Economy 2016-2017

## Countries that Export Most Clothing to OIC Countries

**USD21,926mln**

**China**

(2015, USD mln)

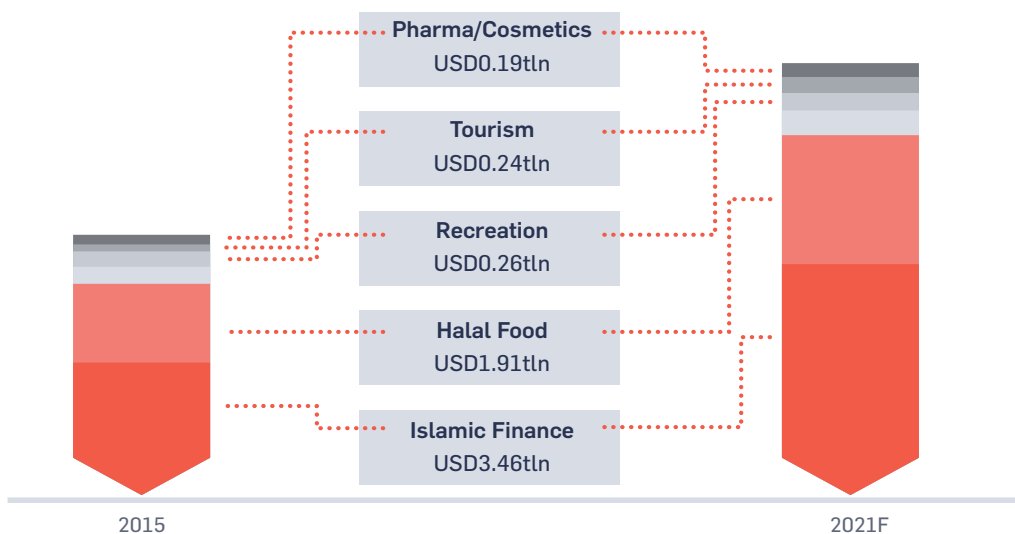


China is responsible for the highest number of clothing exports to OIC countries

Source: State of the Global Islamic Economy 2016-2017

In summary, as the world’s largest manufacturing hub and supplier of raw materials, not only can China contribute greatly to the burgeoning halal industry, but the country can also offer industry support from the funding side via Islamic finance.

## Global Halal Economy by Sectors (2015 vs. 2021F)



Source: State of the Global Islamic Economy 2016-2017

\*Based on totals of expenditure of Muslim consumers & Islamic finance assets



# Key Takeaways

Islamic finance is still a nascent industry in China, however the opportunities for the industry to flourish in China are manifold. While structural demographic and economic prospects for China are bright, several key enablers need to be in place to support sustainable growth moving forward, and Islamic finance can provide the solution.

Currently, the global Islamic finance industry faces several multi-dimensional challenges in its bid to unlock its huge potential, and it is no exception in China's case. These challenges include:

— Circumstances where the scope of the Islamic finance and service offerings exceed limitations of the existing financial services laws, regulations and accounting regimes, therefore necessitating the introduction of amendments or special exemptions to be enacted. It will be important, among other measures, that the Chinese government adapts its regulatory and supervisory framework to support the development of the industry. Chinese regulators will have to produce general and specific rules and guidelines in order for this to take place. An approach that can be adopted by Chinese regulators would be to retain the existing conventional financial framework and take incremental steps to accommodate the specificities of Islamic finance, which leads to gradual extension and differentiation of the legal and regulatory system over time.

— Varying interpretations of Sharia'a, often fuelled by different Sharia'a regulatory frameworks. The nature of Islamic law allows for different interpretations, which results in different practices and use of concepts across jurisdictions. If Islamic finance is to move deeper into mainstream global finance, the industry needs to further prove its credibility by harmonizing Sharia'a standards and practices across the board. The progressive harmonization of Sharia'a, in this respect, needs to be viewed as a driver towards greater financial integration.

— The recurring issue of tax treatment of Islamic finance products and the need to create an enabling tax environment which does not discriminatorily penalize these products for the structure and techniques utilized. Moreover, Sharia'a compliant structures and techniques are proven to offer enhanced downside protection and be more conducive to the development of a fiscally-sound economy on the back of its intrinsic links. Accordingly, changes are required to stamp duty, property and other tax regimes in order to enable Islamic finance products to compete with conventional ones.

— The limited public awareness about Islamic finance in China. The low penetration levels of Islamic finance can be attributed to the lack of public awareness regarding Islamic finance products and services and the perception that Islamic finance is for Muslims only. When consumers lack knowledge about Islamic finance products and services, Islamic finance institutions often need to work harder than their conventional counterparts to educate people.

— Meanwhile, the Islamic finance industry cannot develop without the professional human capital for Islamic finance. Currently, there are shortages in skills and capabilities in the Islamic finance business, including among regulatory authorities. Often referred to as the industry's gatekeepers, the lack of qualified scholars is squeezing further growth in the industry. However, institutions such as International Center for Education in Islamic Finance (INCEIF) and Bahrain Institute of Banking and Finance (BIBF) are attempting to correct the problem with a variety of new courses and degrees. To move forward, it is necessary for China to create large pools of experts and highly-qualified professionals with in-depth expertise in Sharia'a and conventional financial practices to bridge the gap. The Chinese government can introduce professional degree programs, Islamic finance talent development programs and courses for Islamic finance in collaborations with Islamic finance thought leaders such as Malaysia. Indeed, collaborations between mature and emerging regional centers in Islamic finance can serve as a catalyst for the development of talent and knowledge in the industry.

As a result of the factors outlined above and the industry's relative youth, at this point in its development the modern Islamic finance industry is somewhat fragmented. All of the above represent obstacles to success, but not complete barriers. To date, growing number of players have started addressing these challenges systematically and to varying degrees of success. Together, if all the above challenges are met and appropriate measures are undertaken, the Islamic finance industry will reach a new dimension in China.

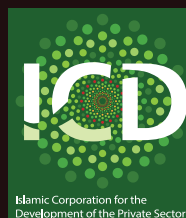
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