Journal of Islamic Business and Management

https://doi.org/10.26501/jibm/2021.1101-003

THE GLOBAL PERSPECTIVE OF ISLAMIC FINANCE AND THE POTENTIAL FOR CHINA TO TAP INTO THE ISLAMIC FINANCE MARKET

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Abstract

Islamic finance is considered one of the fastest-growing segments of the global financial industry. Over the last four decades, Islamic finance has expanded globally to western and other non-Muslim countries. This paper aims to explore the potential for China to tap into the Islamic finance market and the challenges that may face the implementation of Islamic finance there. The paper adopts a content analysis approach, stressing various aspects of economic sustainability in China and the potential benefits that China may gain from the adoption of Islamic finance. The study reveals that China has a huge opportunity to capitalize on Islamic finance for economic development, particularly in the implementation of China's Belt and Road Initiative (BRI). The paper also highlights the critical success factors for introducing Islamic finance in China, most importantly, political will. Genuine support from the government is needed for the effective introduction of Islamic finance in the country. This support should be subsequently followed by the development of the legal framework, an amendment of the laws, broad publicity to raise public awareness, and effective collaboration with international organizations.

Keywords – Islamic Finance, Development, Challenges, BRI, China.

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INTRODUCTION

Islamic finance has grown considerably over the last four decades and has a global reach. It is considered one of the fastest-growing segments of the global financial industry. Indeed, the rapid growth of Islamic finance is expanding to western and other non-Muslim countries. It is now in the stage of global integration to be adopted as an international financial system (Khalili, 1997; Warde, 2000; Khan & Bhatti, 2008; Y-Sing, 2008; Ahmad, Hanifa, & Hyo, 2019; Novikov, Britikova, Yarushkina, & Kovalenko, 2020). With the rapid growth of Islamic finance, many countries in the west have recently allowed the operation of Islamic banks within their respective jurisdictions. For instance, the UK is considered to be the first leading country in the west to issue Sukuk – an Islamic alternative to bonds – to raise governmental revenue. Moreover, the first full-fledged Islamic bank was launched in Germany in 2017 (Bhavin & Saad, 2017). Similarly, in Japan, the authorities are considering issuing regulations that permit Japanese banks to offer Islamic banking products (Bhavin & Saad, 2017). Yet, despite the increased interest, Islamic finance's penetration in China appears to have lagged behind the rest of the world. This paper aims to explore the potential for China to tap into the Islamic finance market and the amendments necessary to its laws in order to facilitate the development of Islamic finance there. It adopts a content analysis approach, emphasizing various aspects of economic sustainability in China and the potential benefits that may be achieved through the adoption of Islamic finance. To achieve this objective, four dimensions are taken into consideration, namely the development of Islamic finance globally, the potential for China to tap into the Islamic finance market, the role of Islamic finance in the implementation of China's Belt and Road Initiative (BRI), and the issues and challenges that may face the implementation of Islamic finance in China.

THE GLOBAL PERSPECTIVE ON ISLAMIC FINANCE

In the 1980s and 1990s, which are regarded as the early stages of Islamic finance development, the industry was mostly concentrated in predominantly Muslim countries, particularly in the

Middle East and South-East Asia. Ever since, the Islamic finance industry has been enjoying rapid growth worldwide. Islamic financial institutions are now present in over 80 nations around the world (Domat, 2020). After recent years of marginal increases, the Islamic financial services industry (IFSI) returned to strong growth at 14% in 2019. Global assets are expected to surpass USD3.69 trillion by 2024 (ICD-Refinitiv, 2020; Islami Financial Services Board, 2020). Indeed, the rapid growth of Islamic finance is expanding to western and other non-Muslim countries. The reason for this emergence and rapid growth could be due to the underlying principles that Islamic finance stands for (Saiti, Bacha, & Masih, 2014; Al-Jarhi, 2017). According to Chapra (2009), the resilience of Islamic finance during the 2008 global financial crisis was the result of various factors, including the risk-sharing concept, credit being available primarily for the purchase of real goods and services, restriction on the sale of debt for cash at a discount, the requirement of avoiding excessive uncertainty (*gharar*), and the strong emphasis on ethics. These are the main principles that can help inject greater discipline into the financial system and would ultimately contribute to fostering financial stability.

From just providing basic banking services in the 1990s, the Islamic finance industry has grown and expanded to develop other financial market segments such as the Islamic capital market, asset management, and Islamic insurance known as *takaful*. Since then, the Islamic finance industry has developed in providing a range of ethics-based products to corporate and retail customers, responding to the market's varying needs. Not only that, Islamic finance has proven its development through its growing interest in improving the community and preserving the environment by introducing a range of targeted financial products such as SRI Sukuk, green Sukuk and the like (Kuwait Finance House, 2013; Ahmed, Mohieldin, Verbeek, & Aboulmagd, 2015; Deloitte & ISRA, 2018; Gundogdu, 2018; Osman, 2019). It is worth noting that the issuance of green Sukuk exceeded USD 3 billion in 2019, and this is expected to accelerate in the coming years as part of efforts to combat climate change and meet sustainable development goals in national and international agendas.

According to recent reports, the Islamic banking industry is still dominating the global portfolio of Islamic financial assets, accounting for a 69% share in 2019. The Sukuk industry comes next and is rapidly growing in popularity, accounting for a 19% share in 2019, as evidenced by large and more frequent issuances flowing to the market. According RAM's Sukuk Snapshot, global Sukuk issuance has grown exponentially over the last three decades, recording a total issuance of USD 152.6 billion in 2020. Malaysia continued to be the top Sukuk issuer with a market share of 39.2%. Saudi Arabia was in second place with a share of 20.4% (USD 6.7 billion), followed by Indonesia with 17.5% (USD 6.1 billion). The Islamic funds' sector is also growing fast with assets under management worth USD 140 billion at the end of 2019. The sector has grown by a remarkable 30% since 2018 (USD 108 billion) (ICD-Refinitiv, 2020). On the other hand, *takaful* remains a nascent industry, constituting only a 2% share of global Islamic financial assets as at the end of 2019. It is worth mentioning that the Islamic banking industry and the Sukuk sector are the main players dominating and shaping the Asian Islamic financial landscape. These two sectors have driven the trajectory of robust growth in Asia during recent years, amounting for a combined value of over USD 543.8 billion, equivalent to 22.3% of total Islamic financial assets (Islamic Financial Services Board, 2020).

THE POTENTIAL FOR CHINA TO TAP INTO THE ISLAMIC FINANCE MARKET: OPPORTUNITIES

Islamic finance is now in the stage of global integration to be adopted as an international financial system. The literature on Islamic finance has postulated that the system would stimulate economic growth and development of practicing countries (Hassan & Aldayel, 1998; Ahmed et al., 2015; World Bank Group, 2016; Halim, How, & Verhoeven, 2017; Gundogdu, 2018; Al-Roubaie & Sarea, 2019; Hassan, Aliyu, Saiti, & Halim, 2020). Emerging markets such as China, whose appetite is evolving on a daily basis, would certainly benefit from huge investment opportunities in the Islamic finance industry. China's active market will also provide significant opportunities for the development of Islamic finance (Malik, 2010; Sarker et al., 2019).

To elaborate, the Chinese economy is poised to reach new levels, which will require huge investments in every sector to boost economic growth. In other words, China remains the most attractive market in the world because of its sheer size and the amount of infrastructure that needs to be built and financed (Kamel, 2018). According to the OECD (2015), the urbanization pace in China is significant as millions of people are moving to cities. There are currently 15 megacities in China, and urbanization there is expected to reach 70% by 2050 (OECD, 2015). This indicates the massive need for power, housing, food, transportation, and modern infrastructure. As such, China's hunger for investments and capital is insatiable as the economy continues evolving (Malik, 2010; Sarker et al., 2019). Islamic finance presents one of the great opportunities that could be used to finance projects and infrastructure, which are the main driving forces of the Chinese economy.

Not only is China moving towards huge development in all sectors within its jurisdiction, it is involved in development globally (Kamel, 2018; Selmier, 2018). Most Chinese projects and government initiatives are related either directly or indirectly to infrastructure development, which necessitates huge fund inflows and sources of financing. Sukuk have a long and good reputation in financing infrastructure and contributing to the growth of countries where Islamic finance exists (Deloitte & ISRA, 2018). This is reflected in the rapidly increasing demand for Sukuk globally. The issuance of Sukuk globally has grown sharply since 2008 from a low base, soaring from USD 24 billion to USD 135 billion by end of 2013 (International Islamic Financial Market, 2020). In addition, China is concerned with the implementation and development of the Belt and Road Initiative (BRI), which is considered perhaps the most massive intercontinental project in history (Sarker et al., 2019). The BRI project focuses on infrastructural investments, which Sukuk could perfectly assist to finance. Issuing Sukuk would make China more approachable to new segments of investors as well as strengthening financial interconnectivity with Muslim countries along the BRI routes. Moreover, promoting Sukuk in China would extend the influence of the Asian Infrastructure Investment Bank (AIIB) globally, as the Islamic Development Bank is exploring the potential of issuing Sukuk through AIIB (Bo et al, 2016).

Another opportunity that China can benefit from in embarking on Islamic finance is by promoting ethical investments and social activities (Saiti et al., 2014; Al-Jarhi, 2017; Al-Roubaie & Sarea, 2019; Sarker et al., 2019). To illustrate, it is undoubtedly true that the world is facing many challenges such as climate change and financial crises that are hitting many economies. These sudden but long-anticipated crises have promoted the notion of ethical and sustainable investments in the minds of many investors. This has led to the rising popularity of the concept of ethical investment and related concepts such as corporate social responsibility (CSR), socially responsible investment (SRI) and sustainable development goals (SDGs), which can all play a major role in addressing the threats faced by the environment and society (Bukhari et al. 2019 and Osman, 2019). In the same vein, Malaysia has initiated Value-Based Intermediation (VBI), which aims to play an important role in the preservation of the environment and several socio-economic development issues.

One of the recent developments and innovations in this area pertains to socially responsible investment (SRI) Sukuk, which seek to finance renewable energy and other environmentally sustainable projects. Several countries have recently witnessed remarkable development in renewable energy investments using SRI Sukuk that have been introduced to facilitate and promote sustainable and responsible investing. Malaysia and Indonesia are among the first countries to issue this type of Sukuk. In Malaysia, the first green SRI Sukuk, valued at RM 250 million, was issued to partly finance large-scale solar construction in Kudat, Sabah. Following that, Quantum Solar Park Malaysia Sdn Bhd launched the world's largest green SRI Sukuk, valued at RM1 billion, to fund the construction of Southeast Asia's largest solar photovoltaic plant project in three regions: Kedah, Melaka, and Terengganu. Indonesia has also recently issued USD 1.25 billion of green sovereign Sukuk, whose revenues will be partly used to finance renewable energy projects. The increase in the adoption of green Sukuk to finance renewable energy projects is attributable to the following factors: the increase in renewable energy projects, particularly solar energy projects, the low capital costs, and the fact that it is a Shariah-compliant instrument (Laldin, 2019). Besides that, Islamic finance has a lot in common with impact investment and can play a major role in addressing the problems faced by the society. It has the potential to increase the effectiveness of efforts to mobilize resources for the sake of realizing the instruments of sustainable development. Therefore, the Chinese government may provide an enabling environment for Islamic financial institutions, which should emphasize ethical and value-based intermediation as the world is moving towards promoting ethical and sustainable investments.

Moreover, recently the Chinese government has been striving to diversify its reserves in commodities and other investments to avoid any side effects of the devaluation of the dollar, which accounts for 70% of total reserves. China prefers safe or low-risk investments to maintain its reserves in order to reduce its dependence on US treasury bills, particularly after the financial crisis that devastated the US economy in 2008 and then affected the rest of the world (Sorenson, 2007). Sukuk and other instruments of the Islamic capital market would be among the best alternatives for attracting Chinese attention towards asset-backed instruments (Podpiera, 2006; Bo et al., 2016).

In addition, the Chinese government is involved in ongoing massive infrastructural projects that require macroeconomic and financial stability. For instance, the accomplishment of the BRI project requires financial stability and funds inflow, which could potentially be offered by Islamic finance instruments (Bo et al., 2016; Selmier, 2018; Chu & Muneeza, 2019). The principles of Islamic finance represented in asset-based financing and risk-sharing could help in promoting better risk management by financial institutions and their clients and discourage credit booms (Chapra, 2009; Saiti et al., 2014; Al-Jarhi, 2017). The Islamic financial system matches to some extent the proposal of the 1930s Chicago plan that called for full backing of bank loans. Likewise, recent studies claim that the full backing of bank loans would decrease macroeconomic instability and minimize the risk of bank runs (Kumhof & Benes, 2014; Wolf, 2014; Al-Jarhi, 2017).

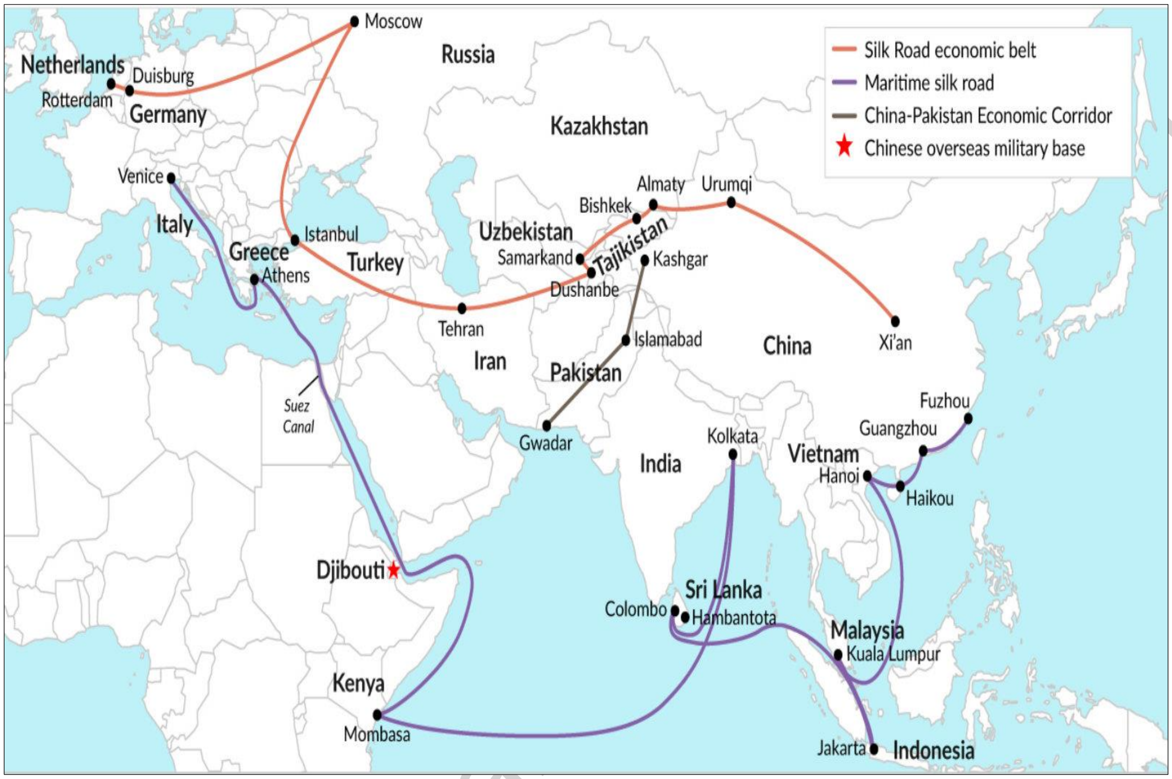
Another opportunity that China can benefit from in embarking on Islamic finance is by offering different modes of financing to small and medium-sized Chinese enterprises (SMEs), microfinance and micro-insurance. Islamic finance is suitable to finance start-ups and SMEs as it stands upon the risk-sharing principle and linking credit to collateral (Chapra, 2009; Al-Jarhi, 2017; Ezeh & Nkamnebe, 2019; Islamic Research and Training Institute, 2020). Therefore, the Chinese government can capitalize on Islamic finance in contributing more towards inclusive growth (Kammer et al., 2015). China has the largest population in the world, currently 1.38 billion. Of these, 1.5% are Muslims, around 20 million of the total population. The introduction of Islamic finance and Islamic insurance (*takaful*) might also offer a huge opportunity for Muslims in China to participate in Islamic finance and Islamic insurance (*takaful*) (Husin & Rahman, 2013, 2016).

Based on the above-mentioned facts, it is observed that China has huge opportunities to develop and expand the Islamic finance industry for the sake of supporting its fast-growing economy. Doing so would be of enormous potential benefit to China. Islamic finance has the potential to support many strategic sectors such as attracting funds inflow, infrastructure investment, financial inclusion, and so on.

THE ROLE OF ISLAMIC FINANCE IN THE IMPLEMENTATION OF CHINA'S BELT AND ROAD INITIATIVE (BRI)

The Belt and Road Initiative (BRI) is a global strategy of development initiated by the Chinese government. The BRI strategy considers infrastructure investments and development across 152 different countries and international organizations located in Asia, the Middle East, Europe and

Africa (World Bank Group, 2018). It was originally announced by the People's Republic of China leader Xi Jinping during official visits to Kazakhstan and Indonesia in 2013. The word "Belt" refers to the overland routes of both rail and road transportation, or the so-called "The Silk Road



Economic Belt"; while the word "Road" refers to the sea routes, also called "The Maritime Silk Road of the 21st Century" (Kuo & Kommenda, 2018). The Chinese government considers BRI as "an attempt to enhance China's regional connectivity for the sake of embracing a brighter future" (Xinhua, 2015; Chu & Muneeza, 2019). Some argue that BRI is a global strategy aimed at making China the center of a trade network by extending its influence and interests over many countries, which account for more than 60 percent of the world's population (Chohan, 2018). The following figure illustrates China's Belt and Road Initiative.

Figure 1: China's Belt and Road Initiative
Source: https://www.gisreportsonline.com

The total estimated cost for all the projects that have been proposed, built or are under construction has ranged from USD 4 to 8 trillion. The vast majority of the BRI projects focus on new construction or redevelopment of trade infrastructure such as roads, ports, airports and railroads, as well as systems for generating and transmitting energy and information (Shaikh et al., 2016; Amighini, 2017; Higgins, 2018). Certainly, the flow of funds and finance play a key role in such huge projects (Yu, 2017; Li & Jin, 2018; Chu & Muneeza, 2019). Islamic finance could play a crucial role in China's BRI financing strategy, considering the large Muslim population along the BRI routes, particularly in Kazakhstan, Pakistan and Iran (Bo et al., 2016; Kamel, 2018). These three countries occupy a strategic position representing a significant part of the Silk Road's nodes during the trade route's existence in the medieval era (Waugh, 2007; Green, 2015; Kamel, 2018). With the unique position of Iran and Pakistan in modern Islamic economics, China should consider Islamic finance products for financing BRI-linked infrastructure projects (Bo et al., 2016; Selmier, 2018).

Furthermore, Islamic finance could play a significant role in the implementation and development of BRI, particularly through the issuance of Sukuk. Sukuk can provide an ideal and practical financing platform for corporations and individuals seeking new business opportunities as well as diversifying sources of funds for construction companies. Besides that, issuing Sukuk would make China more approachable to new segments of investors as well as strengthening its financial interconnectivity with Muslim countries along the BRI routes. Promoting Sukuk in China would extend the influence of the Asian Infrastructure Investment Bank (AIIB) globally, as the Islamic Development Bank is exploring the potential of issuing Sukuk through AIIB (Bo et al., 2016). In other words, Chinese investors' involvement with Sukuk would strengthen communication with Muslim countries, which might promote the interest of corporations and investors to expand their business along the BRI planned routes (Bo et al., 2016; Kamel, 2018).

POTENTIAL ISSUES AND CHALLENGES FACING THE INTRODUCTION AND IMPLEMENTATION OF ISLAMIC FINANCE IN CHINA

There are a number of challenges that may confront the introduction of Islamic finance in China. The first challenge is political will. The willingness and support of the government are key to the successful introduction of Islamic finance into China's financial market (Warde, 2000; Maryam, Mehmood, & Khaliq, 2019; Asutay & Mohd Sidek, 2020). The central bank of China and the regulator should understand that the Islamic finance system is a financial system that operates according to Islamic principles. Many countries in the west have recently allowed the operation of Islamic banks within their respective jurisdictions (Ahmad et al., 2019; Novikov et al., 2020). The previously cited examples of the UK, Japan and Germany are relevant in this regard. Therefore, the willingness and the support of the government are considered the most important factors for the successful introduction of Islamic finance in China.

The second challenge is related to the regulatory and legal framework for accommodating the Islamic finance system (Warde, 2000; Karbhari, Naser, & Shahin, 2004; Noordin & Fares, 2016; Muneeza, 2018, 2020; Asutay, Ayturk, & Aksak, 2020; Oseni, Hassanb, & Ali, 2020). Countries that intend to launch Shariah-compliant banking products should first create the legal framework that governs the work of Islamic financial institutions. For instance, in Malaysia, the first codifying regulatory act that facilitated the infrastructure of Islamic banking was the Islamic Banking Act (IBA) 1983. This was followed by Takaful Act 1984 to allow the licensing and operation of *takaful* companies in Malaysia. Then, the Banking and Financial Institutions Act 1989 (BAFIA) authorized any licensed institution (conventional banks and financial institutions) to carry out Islamic banking business or any Islamic banking financial business in Malaysia. The climax of this effort was the issuance of the Islamic Financial Services Act (IFSA) in 2013, which provides a comprehensive legal framework for the Islamic finance industry. Therefore, in order to introduce Islamic finance in China, a comprehensive legal framework should be developed including the amendment of laws to suit the implementation of Islamic finance in the country.

The third challenge that may face the introduction of Islamic finance is related to tax and regulatory impediments. Despite its enormous potential and its emergence as an alternative system to conventional banking, Islamic banks have had a limited impact so far on access to finance, as they are not dealing with most financial instruments offered on money markets (Al-Jarhi, 2017; Muneeza, 2018). As a result, regulators will have to offer a range of concessions and assistance to unlock this potential. It will be important to reduce taxes and alleviate regulatory barriers to financing Islamic banks, and to also strengthen the financial infrastructure (Kammer et al., 2015).

The fourth challenge is related to the Sukuk market. Sukuk are considered among the best-suited instruments for financing infrastructure due to their risk-sharing feature, which could also assist in bridging financial gaps. However, the supply of Sukuk might also be challenging, in particular when they fall short of demand. Therefore, national regulators and authorities should concentrate on supporting true securitization, enhancing the clarity of investors' rights, and improving the issuance of regular sovereign Sukuk for the sake of providing a benchmark and guidelines for the private sector. This is in consideration of the expectation that the increased sovereign issuance would be regulated and backed by sound public financial management (IFSB, IRTI & IsDB, 2010; Kammer et al., 2015; Muneeza, 2018, 2020).

Another challenge that might confront the introduction of Islamic finance in China is the lack of awareness. Awareness is defined as individuals' passive participation and raised interest about particular issues (Muneeza, 2018; Bickford & Reynolds, 2002). Many studies assert the importance of awareness in affecting customers' perceptions about participating in new products and services (Mohammed & Ortmann, 2005; Ayinde & Echchabi, 2012; Rammal & Zurbruegg, 2016; Kaakeh, Hassan, & van Hemmen Almazor, 2018; Muneeza, 2018; Ahmad et al., 2019; Ezeh & Nkamnebe, 2019; Alam & Seifzadeh, 2020). As Islamic finance is a new potential entrant to the Chinese market, the Chinese government should play a significant role in promoting Islamic finance and spread that through news, conferences, seminars and so on for the sake of reaching the masses to meet the expected results (ICD Thomson Reuters, 2017). Also, the introduction of Islamic finance in China would require joint efforts and collaboration with countries and international organizations such as IFSB and AAOIFI. These efforts would facilitate the implementation process at an effective cost and enable China to capitalize on the best practices of the industry.

Finally, the establishment of a Shariah committee within each Islamic financial institution (IFI) in China would be vital for overseeing the implementation of Islamic financial operations (Muneeza, 2018). The appointment of Shariah committee members is intended to provide objective and sound advice to an IFI to ensure that its aims and operations, business, affairs and activities are in accordance with Shariah (Bank Negara Malaysia, 2017). Failure to establish a Shariah committee would result in catastrophic challenges and issues such as Shariah non-compliance risk that leads towards a chain of other financial and non-financial negative implications including reputational risk (Bank Negara Malaysia, 2017; Alhammadi, Archer, & Asutay, 2020).

CONCLUSION

From the above discussion, the critical success factors for introducing Islamic finance in China vary. One of the key factors is political will. The willingness and the support of the government are key to the successful introduction of Islamic finance into China's financial market. This support should be followed by establishing the legal framework including the amendment of laws to suit the implementation of Islamic finance in China. A broad publicity campaign should be enacted to raise public awareness, and there should be collaboration with international organizations in the areas of executive training and education to facilitate the introduction of Islamic finance in the country. Further, an audit system and Shariah committee should be established within each Islamic financial institution to oversee the implementation of Islamic financial operations and to regulate fatwas.

On the other hand, the introduction of Islamic finance in China would undoubtedly be one of the main driving forces of the country's economic growth through financing infrastructure projects. For instance, the implementation and development of the Belt and Road Initiative (BRI) through the issuance of Sukuk will provide an ideal and real financing platform for corporations and individuals who seek new business opportunities. Besides, issuing Sukuk would make China more approachable to new segments of investors regardless of strengthening financial interconnectivity with Muslim countries along the BRI routes. In other words, promoting Sukuk in China would extend the influence of the Asian Infrastructure Investment Bank (AIIB) globally, as the Islamic Development Bank is exploring the potential of issuing Sukuk through AIIB. Another opportunity for China to benefit from in embarking on Islamic finance is offering different modes of financing to small and medium-sized Chinese enterprises (SMEs), microfinance and micro-insurance.

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