31 August 2016

CENTRE FOR CHINESE STUDIES
STELLENBOSCH · SOUTH AFRICA

CCS COMMENTARY:

Prospects of Islamic Finance in Africa and China

With only roughly 20 million Muslims in China, it is not surprising that Islamic finance has not taken off in China. Recently, however, some Chinese companies have expressed interest in tapping into offshore pools of Islamic funds. For example, HNA Group, a mainland Chinese firm that owns Hainan airlines, is reportedly considering Islamic financing options for its proposed US$ 150 million acquisition of ships as well as a large offering of offshore *Sukuk* (Islamic bonds). Another example is that of Country Garden, a Guangdong-based property developer, which issued a Malaysian Ringgit 1.5 billion *sukuk* through its Malaysian subsidiary in December 2015. Nonetheless, the use of Islamic financing is far and few amongst Chinese companies given the relative competitive onshore borrowing costs and significant technical hurdles involved. Private companies are at a disadvantage in terms of onshore borrowing as compared to their state-owned enterprise counterparts given the latter's privileged access to the loan markets. Therefore, private companies may welcome the opportunity to diversify their sources of funding and access to credit.

Overview of Islamic finance

Islamic finance refers to *Shari'ah* - compliant finance products and financial arrangements, and contains distinguishing features such as the prohibition on payment and receipt of interest *(riba)*, speculation activities (*maysir*), financial products with excessive uncertainty (*ghahar*), and exploitation of ignorance (*jahl).* While such arrangements have been historically practiced throughout the Islamic world, modern Islamic finance was formalised only in the 1970s with the establishment of the Dubai Islamic Bank and the Islamic Development Bank (IDB) in Saudi Arabia. Further efforts to reduce uncertainty, transaction costs and ensure proper upholding of Islamic values, saw the formation of the Accounting and Auditing Organisation for Islamic Financial Institutions in 1990 that develops and issues *Shari'ah*-based best practices. Parallel to Islamic finance's internationalisation beyond the Middle East, the Islamic Financial Services Board was set up in 2002 in Kuala Lumpur with significant involvement by the International Monetary Fund (IMF) in order to strengthen Islamic banking governance and regulation issues given the growing number of countries with significant levels of Islamic banking. Between 2009 and 2014, Islamic finance grew at an estimated annual growth rate of 17 per cent and had approximately US$ 2.1 trillion worth of assets in 2015. In China, Ningxia Hui Autonomous Region, a majority-Muslim province of Ningxia in Northwestern China has steadily positioned itself as the loci of mainland Chinese Islamic finance activity with encouragement from the China Banking Regulatory Commission. Future plans include ongoing negotiations between Ningxia-based Bank of Shizuishan and Bank Muamalat Malaysia to launch China's first ever Islamic bank.

Islamic finance as a tool of Chinese financial diplomacy

Chinese interest in Islamic finance can be motivated by the diversification of funding sources as much as financial diplomacy purposes. China's growing geo-political clout via the Beijing-backed Asian Infrastructure Investment Bank (AIIB) and the 'One Belt, One Road' initiative affords new incentives to facilitate the use of Islamic finance. To this end, the AIIB has engaged the IDB for mutual exchange of Islamic finance expertise. A successful collaboration between both institutions in Islamic finance immediately differentiates the AIIB from similar institutions such as the Asian Development Bank and the World Bank, while affording more options for AIIB member countries' large demand for infrastructure development. It is also propitious for the AIIB that Islamic finance was successfully deployed in the US$ 1.95 billion flagship Thar Block II coal mining project and associated power plant projects in Pakistan's Thar Region along the China-Pakistan Economic Corridor (CPEC), given the AIIB's recent announcement of a series of co-financed road projects in the CPEC region.

Additionally, the broadening of 'One Belt, One Road' to include Africa under 'One Belt, One Road, One Continent' could lead to greater resonance for Islamic finance via China's existing interests in Africa. After all, both Africa and China have taken concrete steps to invest in the future development of Islamic finance. For example, Kenya has to date two fully-fledged Islamic banks – First Community and Gulf Arab Bank – as well as a *shari'ah*-compliant *takaful* (insurance) company. There are also plans to table a new Islamic Finance Bill to be passed by the end of 2016. African countries with Islamic majorities such as Senegal and Niger issued locally-denominated *sukuk* bonds in 2014 and 2015 respectively, while South Africa issued the continent's first USD denominated *sukuk* bonds in 2014 that targeted Asian and Middle Eastern buyers alongside regional African buyers. Nigeria have signalled their ambitions to develop a thriving Islamic finance hub, as evidenced by the Central Bank of Nigeria being a founding shareholder of Malaysia's International Islamic Liquidity Management Corporation. In response, China has engaged the African Islamic financial sector, for instance, through the signing of a Memorandum of Understanding between the Islamic Corporation for the Development of the Private Sector, the private sector arm of the IDB and the China-Africa Development Fund during the inaugural China-Organisation of the Islamic Conference meeting held in Beijing earlier this year.

Common challenges of establishing Islamic financial markets

Setting aside the enthusiasm for Islamic finance, both China and Africa face considerable challenges in developing strong Islamic financial markets. Domestically, prerequisites for full-service Islamic finance offerings include establishing separate regulatory standards away from conventional finance, and adapting local laws and tax regulations to accommodate the unique configuration of Islamic financial products. Practically, this could involve some modification of best practices from other jurisdictions like the United Kingdom such as the removal of double taxation for Islamic loans, while offering tax reliefs in terms of stamp duties, property or profits taxes to both companies and individuals for usage of Islamic finance products.

At a geopolitical level, China faces competition from other Asian nations such as Japan who has also expressed interest in the potential of Islamic finance for both commercial and diplomatic reasons. For example, Japan's Bank of Tokyo-Mitsubishi UFJ has recently procured a license to provide Islamic financial service through its Dubai branch. At a governmental level, the Japanese International Co-operation Agency in conjunction with the IDB has offered technical assistance to the Kingdom of Jordan for the issuance of sovereign sukuk. Japan's attention in Islamic finance has also pivoted towards South East Asia, as evidenced by Malaysia's Prime Minister Najib Razak's speech at the World Islamic Economic Forum Roundtable held in Tokyo in May 2015 where he addressed the untapped potentials of Islamic finance for Indonesia and Thailand and expressed support for Japan's foray into the Islamic finance market. Nevertheless, Islamic finance is at nascent levels whose full potential would only be realised in years to come, leaving much room for competition and commercial innovation.

Yi Ren Thng
Visiting Scholar
Centre for Chinese Studies
Stellenbosch University