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A Study of the Banking Services for Muslims in China

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Abstract: Islamic law (i.e., *Sharia*) has significant influence on Muslims attitudes toward financial service. Recognizing the needs for finance services in a modern economy and Muslims' preferences over Sharia-compliant financial services, Muslim economists proposed the Islamic banking-a banking system that provides financial services that conform to Islamic law and moral code. China is the country with the third largest number of Muslims living as minorities and survey results indicate that there are demands for Sharia-compliant financial products and services among Chinese Muslims. However, as of today, there are just few financial institutions in China offering Sharia-compliant financial products and services on a pilot basis. This paper reviews the history and current status of the Sharia-compliant financial products and services provided by the financial institutions in China. It also investigates the reasons why Islamic banking is not yet an established part of the banking services in China. Since providing banking services to the entire population is important for developing countries like China, the paper makes recommendations on removing barriers for financial institutions to expand their outreach to Chinese Muslims.

Key words: banking services; Muslims; China
JEL codes: G20, P20, Z12

1. Muslims' Financing Preferences and Islamic Banking

1.1 Muslims' Financing Preferences

Islam's law (or *Sharia*) impacts Muslims attitudes toward financial service. Studies have shown that the interest prohibitions and the profit/loss sharing principles, derived from the Quran's stipulation, impact Muslims' financing preferences and behaviors. For example, in a sample of over 65,000 Muslims from 64 economies, Demirguc-Kunt, Klapper and Randall (2013) find that the relative propensity of Muslims to use formal financial services and their attitudes towards conventional financial products are significantly different from those of non-Muslims. Specifically, after controlling for other individual- and country-level characteristics, Demirguc-Kunt et al. (2013) find that: (1) Muslims are significantly less likely than non-Muslims to own a formal account or save at a formal financial institution; (2) While cost, distance, and documentation are cited by both Muslims and non-Muslims as barriers to account ownership, Muslims are more likely than non-Muslims to report religion as a barrier to account ownership[1]; and (3) Muslims prefer for a hypothetical more expensive Sharia-compliant loan over an equivalent conventional loan.

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1 However, this result appears to be mainly driven by respondents in Sub-Saharan Africa.

1.2 The Origin and Development of Islamic Banking

Recognizing the need for finance services in a modern economy and Muslims' preferences over the financial products/services that are consistent with their religious beliefs, Muslim economists proposed Islamic banking—a banking system that provides financial services that conform to Islamic law and moral code. With the institutional and governmental involvement, the Islamic Development Bank, the first inter-governmental and interest-free bank, was formally founded in Jeddah, Saudi Arabia in 1975. In the same year, the first private interest-free bank, the Dubai Islamic Bank, was established in Dubai, the United Arab Emirates (Abdul Gafoor, 1995).

Islamic banking has become increasingly attractive to Muslims worldwide since its inception and it has become a dynamic, fast-growing global phenomenon today. During the past decade, the assets of Islamic banks have grown at an average rate of 15% (www.imf.org). Despite a slowdown caused by the economic and political setbacks in some of the Islamic finance markets, Islamic banking assets with commercial banks globally has an annual growth of 17.6% from 2010 to 2013 and reaches US$1.7 trillion in 2013 and they are forecasted to remain growing in the future (Ernst & Young, 2013). It is not surprising that Islamic banks were originated in the Middle East and are concentrated in the Middle East and Southeast Asia where Muslim populations dominate. But Islamic banks are present in non-Muslim regions like Europe, the United States as well and they have become popular in both Muslim and non-Muslim communities. Today, there are more than 500 Islamic financial institutions in 75 countries (KPMG Sweden, 2013).

1.3 The Key Concepts in Islamic Banking

Islamic banks provide financial products/services that conform to Sharia (Islamic law) and moral code. The key difference between Sharia-compliant financial products/services and conventional financial products/services is that Sharia-compliant financial products/services avoid a predetermined fixed interest (or *riba* in Arabic term), derived from the Quran's stipulation. In addition, Sharia-compliant financial products/services prefer profit/loss sharing (or *Mudarabha* in Arabic term) in financial transactions, but they avoid transactions involving excessive uncertainty (or *gharar* in Arabic term). Islamic Banks offer a variety of Sharia-compliant finance products/services. The following are among the most common ones.

(1) Mudaraba

Mudaraba is an Islamic deposit account wherein the owner of the account does not explicitly receive interest, but rather shares in the overall profits of the financial institution or the profits of a specific investment account the financial institution holds.

(2) Murabaha

Murabaha is an Islamic credit arrangement. Under a Murabaha arrangement, a customer requests the financial institution to purchase the desired good and then pay for it on a deferred payment arrangement (e.g., in installments). The payments made by the customer are equal to the original price of the good plus an agreed mark-up.

(3) Diminishing Musharaka

Diminishing Musharaka is an Islamic mortgage product wherein a form of declining partnership between the financial institution and the client generally used to finance real estates. When a customer requests a financial institution for financing to purchase an asset, the financial institution participates in the ownership of an asset by contributing required finance and the customer promises to buy the equity share of the financial institution gradually until the title of equity is completely transferred to him.

(4) Ijara

Ijara refers to a lease contract wherein the financial institution acquires an asset from a supplier and leases it to a customer. The ownership risks of the asset are born by the financial institution, while expenses relating to use the asset are the responsibility of the client.

In general, the aforementioned Sharia-compliant finance products/services reflect the key concepts in Islamic banking- the prohibition of predetermined fixed interest and the preference of profit/loss sharing.

2. Muslims in China and Their Demand for Sharia-compliant Financial Products/Services

2.1 Muslims in China

Muslims have been in China for the last 1,400 years of continuous interaction with Chinese society (Gladney, 2003). According to China 2010 Population Census, there are more than 23 million Muslims in China. Muslims account for 1.7% of 13 billion total populations of China. There are 56 officially recognized ethnic groups in China. Of the 56 ethnic groups, Han is the largest ethnic group (i.e., 91.6% of total Chinese populations). The ethnic groups excluding Han are known as minority ethnic groups and they comprise 8.4% total Chinese population. Of the 55 ethnic minority groups in China, ten groups are predominantly Muslim. These groups are Hui, Uyghur, Kazakh, Dongxiang, Kyrgyz, Uzbeks, Salar, Tajik, Bonan, and Tatar (see Table 1). Muslim Hui is the biggest Muslim group in China, which has a population over 10.5 millions in 2010 and accounts for about the 46% of Muslims in China. Muslim Uyghur is the second largest Muslim group in China which has a population over 10 million populations in 2010 and accounts for about the 44% of Muslims in China. While Muslims live in every region in China, they are primarily concentrated in the northwest regions including Xinjiang Uyghur Autonomous Region, Ningxia Hui Autonomous Region, Gansu Province, and Qinhai Province. According to a study by Pew Research Center in 2009, China is the country with the third largest number of Muslims living as minorities following India and Ethiopia.

Table 1 Chinese Ethnic Groups That Are Predominantly Muslim

Ethnic Groups	Groups Populations	% of Total Tabulated Muslims	% of Total Populations[2]
Hui	10,586,087	45.74%	0.79%
Uyghur	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%
Total	23,142,104	100%	1.74%

Data source: China's 2010 Population Census.

2.2 Chinese Muslims' Demand for Sharia-compliant Financial Products/Services

The faith and practice of Islam make Muslims in China different from the majority Chinese (i.e., Han Chinese) and from other ethnic minority groups in China. Islamic principles such as prohibition of predetermined

[2] According to China 2010 Population Census, the total population of China was 1,332,810,869 in 2010.

fixed interest influence Muslims' attitudes toward financial service worldwide. And this is true for Chinese Muslims as well. According to a survey of 5,000 Muslims in Ningxia Hui Autonomous Region, 24% of the respondents stated that they wanted to get the banking services that conform to *Sharia*-Islamic law. For respondents that were resident in rural areas, 86% of the respondents stated that they wanted to get the Sharia-compliant financial products/services (Sun, 2013). Because of lacking of Sharia-compliant financial products/services, there are lots of unbanked Muslims (Zhang & Zhao, 1987). Anecdotal evidence shows that some Muslims refuse to collect interest earned on their deposits when they have to save their money in a conventional bank. Some banks even set up special funds to collect those "unwanted" interests and then donate the money to charities. Collectively, both survey and anecdotal evidence indicate that Islamic principles influent Chinese Muslims attitudes toward financial services as well. Actually, KPMG's Global Islamic Finance and Investment Group identify Northwest China with the concentrated Muslim population as one of the emerging centers for Islamic Finance (see Figure 1).

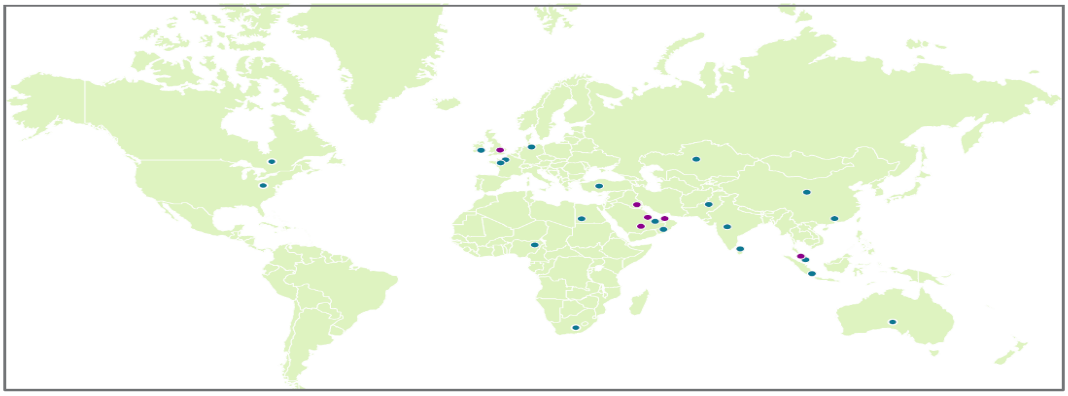

Figure 1 The Centers for Islamic Finance

Source: The figure is obtained from KPMG Sweden (2013).

3. Banking Services for Muslims in China: The History and Evidence

3.1 China's First Financial Company Providing Sharia-compliant Services: Hezhou Islamic Financing Company

The first attempt to provide Sharia-compliant services financing services to Chinese Muslims was made by the Muslim businessmen in Linxia, Gansu Province in 1980's. Linxia, formerly known as Hezhou, is the capital of the Linxia Hui Autonomous Prefecture. Although it is a small city and is located in the under-developed northwest region of China, Linxia is famous for its nickname—"the little Mecca of China". Linxia earns its nickname because it has been a religious, cultural, and commercial center for Chinese Muslim for centuries (Gladney, 1987).

Since China adopted the Reform and Opening Up policy in late 1970's, more and more Muslims in Linixia started their own businesses on the self-employed basis. Therefore, the demand for banking services started to surge. Businessmen need to put their money in a safe place—bank, to use banks as an agent to facilitate business transactions, and to take loans to finance the operation of their businesses when necessary. Although there were conventional banks, Muslim businessmen's demand for banking services could not be satisfied for two main reasons. First of all, conventional financial institutions were primary serving large businesses and it was very hard for individuals or small businesses to get loans from those conventional financial institutions at that time. Second, lots of Muslims were reluctant to use conventional banking services because of their religious beliefs. For instance, the Industrial and Commercial Bank of China (ICBC) conducted a survey in Ningxia in 1986 and the result showed that only 13% of the 200 self-employed Muslims surveyed had owned a formal account at a formal financial institution (Zhang & Zhao, 1987).

Recognizing Muslim's demand for finance services, local Muslim businessmen proposed Islamic banking service in late 1980's. With the supports from the local government and the central bank of China, the first Chinese financial institution providing Sharia-compliant services-the Hezhou Islamic Financing Company was established in February, 1987.

Hezhou Islamic Financing Company provided both deposit and lending services. For deposit services, the "interest rate" was replaced by a "rewards rate". The "rewards rate" was based on the benchmark deposit rate specified by the central bank, but it varied with the profit/loss earned by the company and other factor like Consumer Price Index. The rewards for deposits could be either in the form of cash or in the form of goods. As for lending services, the "interest rate" was replaced by a "profit sharing rate". The "profit sharing rate" was based on the benchmark lending rate specified by the central bank, but it varied with the profit/loss earned by the borrower and the riskiness of the industry to which the borrower belongs.

Because the Hezhou Islamic Financing Company met the local Muslims' demand for banking services that are consistent with their religious beliefs and it focused on small businesses' finance needs, it had been serving the local Muslim community very successfully for many years. However, as China's economy and banking industry continued to develop, small financial institutions like the Hezhou Islamic financing company faced many challenges. With few services (e.g., just deposit and lending) and weak control mechanisms over uncollectible loans, they could not compete with large financial institutions. After twenty years of operations, the Hezhou Islamic Financing Company went out of business (later known as Ningxia Jiefang Road rural credit cooperative) in 2007.

3.2 Customized Services Provided by Conventional Commercial Banks

With the deepening of the economy reform in China, the retail banking industry became more and more competitive. To compete successfully, certain conventional commercial banks started to expand their outreach to the Muslim community and attempted to provide customized services to local Muslim community. For example, 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 1989. In those savings banks, "interest rate" for deposit was replaced by a "rewards rate". In order to be more attractive to Muslim customers and to provide better services to Muslim customers, those savings banks were decorated with Muslim style and the tellers were encouraged to learn Arabic expressions. In 1997, Lanzhou Bank in Gansu province established its first Muslim branch. In 2011, Lanzhou Bank issued China's first special bank card for Muslims, that is, a debit card that is only issued to Muslims and has special features like getting discounts from affiliated stores and merchandisers.

3.3 China's First Commercial Bank with an Islamic Division-Ningxia Bank

China's economic development has made remarkable achievement after the adoption of the Reform and

Opening up policy in late 1970's. However, the regional inequality-the economic gap between the coastal and western regions and the gap between the rural and urban areas have been widening as the reform progresses. To narrow the regional gap, new policies favoring the development of western and rural regions (e.g., the Grand Western Development Program) has been formulated. To prompt the development of the Ningxia Hui Autonomous Region by utilizing its culture and economic connections with the Islamic countries, local government initiated new plans for turning Yinchuan, the capital city of Ningxia, into a regional trade center with Islamic countries and an Islamic financial center in mainland China. In 2009, a commercial bank in Ningxia Hui Autonomous Region-Ningxia Bank established an Islamic Division to offer Sharia-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. The Sharia-compliant banking services that provided by Ningxia Bank include the following.

Selan account—a special banking account that does not pay interests. However, the bank gives gifts to those depositors who have been maintaining a running balance above RMB ¥5,000. The gifts are distributed at the bank's discretion. That is, there are no specified dates on which gifts will be given and there are no particular types of gifts promised by the bank in advance. Usually, the bank distributes the gifts during holidays, especially during religious holidays and the gifts are typically carpet or kettle that would be used by Muslims. The value of the gifts is on average higher than the interests paid to other similar accounts.

Islamic investment fund. Funds raised are managed by Ningxia Bank (or other trust companies) and can only be invested in Sharia-compliant assets. The return on the investment assets after the deduction of service fees are shared among investors. In January 2010, Ningxia Bank issued RMB ¥40 million such investment products.

Islamic credit arrangement. Under this type arrangement, a client requests Ningxia Bank to purchase the desired good and then pay for it on a deferred payment arrangement (e.g., in installments). The payments made by the client are equal to the original price of the good plus an agreed mark-up. Currently, the type of service can only be used to finance non-fixed assets and the term of the arrangement is shorter than one year. This arrangement works like Murabaha that an Islamic bank offers.

4. Why Islamic Banking Is Not Yet an Established Part of Banking Services in China

Evidence indicates that resistance to non-Sharia-compliant financial products creates a significant barrier to financial penetration of Muslims in China, particularly in rural areas. Despite the fact that there have been initiatives to address this issue since late 1980's, there are just few financial institutions in China offer Sharia-compliant financial products and services on a pilot basis today. The following reasons could probably explain why Islamic banking is not yet an established part of the banking system in China.

First, China adopted the "ladder-step" or the uneven development theory when designed its economic reform and opening up policies in late 1970's (Fan, 1997). That is, the eastern region, which has readily accessible geographic location, relatively well-developed infrastructure and stronger economic base, was designated to be developed before the western region. While the eastern region had experienced rapid growth due to the series of "preferential policies", the development of the western region had been less emphasized for many years. Since Chinese Muslims are concentrated in the western region, their financial needs had not been well understood because of the "ladder-step" theory which in general neglects the development of the western region. To correct the increasing gap between the eastern region and the western region, Chinese government adjusted its development model and adopted a “leapfrog” model which encourages the western region to match the eastern region in economic growth. Hopefully, under the new development model, Chinese Muslims’ financial needs could be better understood and satisfied.

Second, current regulations and tax code are not favoring commercial banks to offer Sharia-compliant services. For instance, China’s Commercial Bank Law (i.e., the law regulates the operation of commercial banks) explicitly requires commercial banks to disclose the interest rate on deposits. The law also specifies commercial banks’ obligation to pay interest to depositor and commercial banks’ right to collect interest on loans from borrowers (see article 29, 31, 33, 42 of Commercial Bank Law of China). If any commercial banks intend to provide Sharia-compliant services which are designed following the interest-free principle, they need to seek special permissions from the regulatory authorities. Therefore, certain commercial banks are reluctant to offer Sharia-compliant services. In terms of taxation, assets acquired under the Islamic credit arrangement are subject to double taxation under the current tax code. That is, taxes are levied twice for an asset acquired under the Islamic credit arrangement—one when the asset is transferred from the supplier to the bank and one when the asset is transferred from the bank to the customer. This double taxation makes the Islamic credit arrangement not as competitive as the conventional credit arrangement.

Third, lacking of sound monitoring mechanism makes certain Sharia-compliant services risky. The failure of the Hezhou Islamic Financing Company is an example. The Hezhou Company charged a “profit sharing rate” rather than a predetermined “interest rate” on the loans to borrowers. The “profit sharing rate” was based on the benchmark lending rate specified by the central bank, but could vary with the profit/loss earned by borrowers. However, because there was no sound mechanism to monitor the profit/loss earned and reported by borrowers, Hezhou Company started to incur losses and eventually went out of business. The risk associated with Sharia-compliant services deters commercial banks entering this market.

5. Recommendations on Removing Barriers for Islamic Banking Services in China

Banking services are argued as in the nature of public good and making banking services available to the entire population without discrimination is the prime objective of financial inclusion public policy (Hameedu, 2014). Although not all Muslims resist the conventional banking service when Sharia-compliant financial services are not readily available, the needs for Sharia-compliant financial services of this specific segment of the population should be addressed. Because encouraging Muslims to participate in economic activities without compromising the basic religious beliefs has both the economic impact and the social impact (Guene & Mayo, 2001). In order to effectively remove financial exclusion due to religious beliefs, the Chinese government needs to better understand Muslims’ attitude towards financial services and to investigate what regulatory amendments are needed for enabling Shariah-compliant banking services in China.

In addition, China intends to open it financial market further as its economic reform depths. This provides both opportunities and challenges for China’s financial institutions. On one hand, financial institutions have more flexibility to provide products/services to their clients. On the other hand, financial institutions must offer personalized and customized products/services to survive and thrive in the increasingly competitive environment. Since Northwest China with the concentrated Muslim population is forecasted as one emerging centers for Islamic Finance (KPMG Sweden, 2013), conventional commercial banks should make more effort to understand and address the demands of this specific segment of the market. Commercial banks should design a wider range of financial products/services to the Muslim community. And they also can increase the awareness about Sharia-compliant financial services among the wider community, since Sharia-compliant financial services is an alternative financial system which is available to all the communities including both Muslims and non-Muslims. Most important, for commercial banks that intend to enter this market, they need to learn lessons from those polite companies and realize the importance of sound control mechanism to minimize risk when they enter this market.

6. Summary

There are more than 23 million Muslims in China. Chinese Muslims are different from other Chinese ethnic groups because of their faith and practice of Islam. Islamic law has significant influence on Muslims including their attitudes towards accessing financial services. Although not all Muslims resist the conventional banking service when Sharia-compliant financial services are not readily available, evidence shows that the resistance to non-Sharia-compliant financial services leads to a large portion of unbanked Muslims in China, especially in the rural areas. Attempts to provide Sharia-compliant financial services have been made since late 1980's. However, there are just few financial institutions in China offer finance products and services compliant with Islamic principles on a pilot basis as of today. The main reason has been the "ladder-step" development policy adopted by the Chinese government at the early stage of the economic reform which in general neglects the development of the western region. Hopefully, with the adoption of the "leapfrog" development model which aims at speeding up economic growth of the western region, Muslims' financial needs could be better understood and satisfied.

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