# Eddie Yue: Islamic finance – its potential to bring new economic growth to Hong Kong

Keynote address by Mr Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority, for the Hong Kong Islamic Finance Forum, Hong Kong SAR, 25 November 2008.

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Ladies and gentlemen,

I would like to thank the organisers for inviting me to speak at this forum, which is being held in Hong Kong for the first time.

In the past several months, we have witnessed the unfolding of a global financial crisis. The sub-prime problem in the US and the ensuing credit crunch in the industrialised economies have spread and brought about a weakening of confidence in the solvency of the financial system. Concerns about credit risk exposures among financial market participants mounted following the failure of Lehman Brothers. Interbank money markets in many economies came under extreme pressure or seized up entirely. Extraordinary and concerted efforts by governments and central banks to restore confidence, inject liquidity and recapitalise the banking system appear to have paid off to the extent of preventing the collapse of the banking and financial system although credit and money markets remain stressed. As the turmoil deepened, people have also focussed attention on the wider impact of the crisis on the real economy, leading to a grimmer outlook for global economic performance.

Against the backdrop of this global financial crisis, Islamic finance is inevitably affected and subject to challenging conditions reflected by a steep slowdown in activities such as sukuk issuance and declines in equity value managed by Islamic funds. New sukuk brought to the market in the first three quarters amounted to some US$13 billion, down 40% from the same period last year.[1] But the pullback in new sukuk issuance and the widening of sukuk yield spreads are generally in line with what has been happening in the conventional market. This broadly suggests that the global sukuk market slowdown has more to do with the general market conditions and a general reluctance to issue US dollar instruments. Observers say that while there are still those who wish to issue sukuk, investors would prefer to stay on the sidelines in the current volatile market environment. It is true that the industry is experiencing a temporary setback, but this also reflects how closely integrated Islamic finance is with the global financial system, which is not at all bad news for the industry because when global markets stabilise and take a turn for the better – as they must in the long run – Islamic finance will ride on that curve and excel.

While we are in the midst of a global financial turmoil and there are many challenges lying ahead of us, I'm delighted to find this impressive gathering of regulators, shariah scholars, business leaders and practitioners who commit themselves to the future development of the financial market. Your presence here is ample evidence that there remains plenty of opportunities even in circumstances like these and that a forward-looking view is more important than ever. Today, I'm particularly honoured to join you in the discussion of a topic that has been recognised as a source of sustainability and growth – Islamic finance. There are two main issues that I would like to talk about today.

**First**, despite the current financial turmoil, we continue to see the long term potential in Islamic finance. There are two good reasons for this. One is that the Islamic finance industry is in many ways fortunate to be at an early stage of development during this turmoil. Despite the effects of a temporary shortage of liquidity, which has been a worldwide phenomenon,

[1] Source: Bloomberg.

the degree of damage has been far lower than that to the much wider network of international finance, primarily because of the more restricted spread of Islamic financial instruments across regions and the generally lower level of leverage allowed in Islamic financial transactions. Although Islamic finance has grown by leaps and bounds in recent years, assets held by Islamic financial institutions and insurance operators known as takaful providers are estimated to be US$1 trillion, accounting for only about 1% of the financial assets in the overall banking and insurance sectors.[2] The industry's remarkable annual growth rate of 15% to 20% has to be viewed in perspective: after all it began from a small base. This suggests that there is still ample room for growth on the supply side in the provision of Islamic financial products.

On the demand side, the potential of Islamic finance is often linked to the 1.4 billion-strong Muslim population worldwide, and some people appear to believe that this obviates the need for further development of Islamic finance. But population is not the only factor: economic development in Islamic regions also has to be taken into account. The IMF has estimated that there are some US$800 billion worth of investment projects under way or in the pipeline in countries of the Gulf Cooperation Council (GCC) over the next five years, with major projects in the oil and gas sectors, infrastructure and real estate. According to a UK research report, the annual investment rate in the range of US$200 billion to US$300 billion in the GCC is about half the annual rate of India and one-tenth that of China.[3] As some of the deals may be of a scale that requires financial risks to be spread internationally, global banks are already geared up to tap this market through the formation of Islamic bank subsidiaries and Islamic banking windows. With the increased participation of global and regional players, project financing opportunities will increasingly attract interest from investors worldwide and that project finance will need to be delivered in forms that comply with the principles of Islamic finance. This in turn will fuel the demand for Islamic finance. There is clearly very significant long-term potential across most of the region.

The **second** issue is our continuous commitment to developing Islamic finance in Hong Kong. The Chief Executive of the Hong Kong Special Administrative Region acknowledged in his Policy Address in 2007 that Islamic finance offers huge potential for development. To further consolidate Hong Kong's position as a global financial centre, Hong Kong should actively leverage on this new trend by developing an Islamic financial platform. Our priority is to push ahead with the development of an Islamic bond market. There should be no doubt about our determination to establish a platform for Islamic finance in Hong Kong.

In a recent speech, the Secretary for Financial Services and the Treasury also mentioned that having reviewed Hong Kong's legal, taxation and regulatory regimes, there is no fundamental obstacle to accommodating a sukuk market in our existing system. Technical modifications to the taxation regime to provide a level playing field for Islamic finance transactions are being pursued as a priority.

With our commitment and status as an international financial centre, we believe that Hong Kong is well positioned to develop Islamic finance. We should play to our key strengths and capabilities and I would like to highlight <u>two</u> very important aspects on which Hong Kong intends to capitalise.

The <u>first</u> aspect relates to the core strengths of Hong Kong in providing a stable and free economy. Hong Kong has been ranked the freest economy in the world for 14 consecutive years by the Heritage Foundation. We have no foreign exchange controls and do not impose tax on offshore income, capital gains, dividends, estate or sales. There is free movement of capital, talent and goods. It is a combination of many factors including political stability, a

2 Sources: Islamic Financial Services Board; IFSL Research.

3 Source: Chatham House report on "The Gulf as a Global Financial Centre".

strong legal and regulatory regime, and a pro-business market environment which makes Hong Kong a popular city for international business in Asia. Given these core values, there are no barriers to entry and no obstacles to mobility for financial and human capital from local and overseas financial institutions planning to engage in Islamic or conventional finance in Hong Kong.

The second aspect is the unique role Hong Kong plays in the economic development of China. In the past three decades when the Mainland was achieving economic liberalisation, Hong Kong has capitalised on its strong cultural and geographic links to become the gateway connecting the Mainland market to the world. Our close and increasing economic cooperation with the Mainland undoubtedly makes Hong Kong the natural choice for anyone wishing to tap into China's high savings rate and huge growth potential.

Hong Kong is the premier capital formation centre for the Mainland and hence a global investment platform for enterprises from around the world wishing to gain exposure to China's growth. This is demonstrated by the fact that we have the largest, deepest, and most open Chinese capital markets outside of the Mainland: half of our stock market capitalisation comprises Mainland related companies. At the end of August, our stock market was the sixth largest in the world and the second largest in Asia in terms of market capitalisation. It ranked first in the world in securitised derivatives turnover, and first in Asia for stock options turnover and exchange-traded funds turnover. It also ranked fifth in the world in total equity raised through IPOs.[4]

In the other direction, many Mainland companies have set up regional headquarters or offices in Hong Kong as part of their strategies to step up their international presence. Continuously high growth in recent years has resulted in a vast accumulation of wealth on the Mainland and the authorities there are progressively liberalising the requirements for Mainland financial institutions to invest overseas. As a result, Hong Kong has benefited from the outward investment flows given our geographic, cultural and linguistic affinities with the Mainland and our ability to provide a broad access to numerous Asia-Pacific and global markets. The potential demand for wealth management thus presents capital-market intermediaries in Hong Kong with huge opportunities.

We are also the first jurisdiction outside of the Mainland with the ability to conduct renminbi banking business and deal in renminbi-denominated financial products. The establishment of a renminbi bond market in Hong Kong last year marked a key milestone in the development of renminbi business here. It has helped entrench Hong Kong as a testing ground and pilot market for China's continuing financial reform and liberalisation.

There is clearly immense scope for us to leverage on our key strengths as a close business partner, a capital formation centre and a financial intermediary for the Mainland economy in the development of Islamic finance. There are opportunities for us to extend our reach to potential Islamic investors and financiers in the Middle East and Asia. The addition of Islamic finance as a new asset class in our financial system will add value to Hong Kong as a thriving financial centre and a leading financial services hub in Asia.

As a major financial centre, Hong Kong – with its flexible and innovative market participants and its responsive government – has always stood ready to adapt to and embrace new ideas. Even if the current financial environment appears unfavourable to the development of Islamic finance in the short term, this is, at worst, a temporary setback as future prospects remain promising. We at least do not intend to be put off by temporary difficulties from our goal of making Hong Kong an Islamic financial hub. Indeed we believe that this is a good time to do the groundwork of installing the necessary legal, taxation and market infrastructure.

[4] Source: World Federation of Exchanges.

To name just a few developments in the past 12 months: a new Dow Jones Islamic Market Index was launched to track China-related equities listed on the Hong Kong Stock Exchange; Islamic mutual funds were introduced by a local bank and an asset management company featuring China-related equity investments through the stock market platform in Hong Kong; and an exchangeable sukuk linked to the shares of a Mainland company listed in Hong Kong was issued in March, enabling investors to gain exposure to China's growth story. The response so far has been highly encouraging: for example, the sukuk was 10 times oversubscribed.

Likewise, positive progress is achieved in the development of Islamic banking in Hong Kong. Following the first Islamic banking window introduced three months ago, I'm glad to witness yet another market player who is set to launch its Islamic banking window in Hong Kong at this auspicious occasion today. The increasing number of banks taking part in Islamic banking activities will add further momentum to the development of an Islamic capital market in Hong Kong by providing an important tool for funding and liquidity management.

The Hong Kong Monetary Authority will continue to give full support to the HKSAR government in its initiative to develop Islamic finance in Hong Kong by acting as a market enabler and infrastructure provider. The HKMA has taken important steps and devoted considerable resources to promote the industry in Hong Kong. We are now focusing our efforts on four major areas: first, building Hong Kong's international profile and forging closer ties with market participants in the Middle East; secondly, promoting market infrastructure and establishing policies conducive to the development of Islamic finance; thirdly, promoting talent and knowledge of Islamic financial principles among market professionals in Hong Kong; and fourthly, encouraging the development and launch of Islamic finance products in Hong Kong.

## Concluding remarks

Ladies and gentlemen, the potential for the growth of Islamic finance is clear. The foundations for its development here in Hong Kong have already been laid. It is essential for all of us to look beyond the current global financial turbulence and treat the development of Islamic finance as an investment in the future. With this in mind, I would like to encourage all of you, whether you are regulators, financial institutions or investors, to look critically at the opportunities that lie before us. Islamic finance is a new asset class that has the potential to bring new economic growth to Hong Kong and the region given our wealth of knowledge in financial intermediation, our experience, and our agility in adopting innovative products. So let us work together towards building a stronger and stronger link and increasing cooperation with other global players to identify and capitalise on new opportunities. Today's holding of the Islamic Finance Forum in Hong Kong is a significant step on a journey that is just beginning. I look forward to travelling this road with all of you.

Thank you.