Eddie Yue: Hong Kong: the natural gateway to Islamic finance in Asia – current developments

Keynote address by Mr Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority, at the 2009 Asia Sukuk Summit, Hong Kong, 18 February 2009.

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Ladies and gentlemen,

It is a great honour to be invited to speak at today's inaugural Asia Sukuk Summit in Hong Kong, and a pleasure to welcome you all, especially those of you who are visiting Hong Kong.

This is the first Sukuk Summit to be held in Asia and it takes place at the beginning of the Year of the Ox in the Chinese calendar. The ox symbolises strength, resilience, and – of course – bullishness. For, while it may be true that we are still in the middle of unprecedented financial turbulence, every crisis brings with it new opportunities for renewal and change. The remarkable turnout today clearly reflects a desire to explore new ways of restoring financial market stability and, most important of all, promoting growth. This Summit has assembled an impressive gathering of colleagues from both the public and private sectors from many parts of Asia, Europe and the Middle East. The theme of the Summit – "Towards A New Silk Route for Islamic Finance" – is an apt one: it is a call for partnership in creating new regional bonds and links of the kind that once allowed this ancient trade route to flourish in a diverse yet co-operative world. In the globalised world, such co-operation is more important than ever if our economies are to be able to meet future challenges successfully.

I have been asked to give a brief overview of Hong Kong, with particular emphasis on how this city is developing its Islamic finance capabilities. Hong Kong's strength as a free and open international financial centre has helped nourish its deep and liquid financial markets. Yet maintaining a free and open market in such a turbulent world is not an easy task. It is therefore reassuring that Hong Kong's monetary and financial systems have continued to be sound and robust, reinforced by a number of recent contingency measures to strengthen financial stability. There are many factors that underline the resilience of Hong Kong's financial markets: I would like to highlight two.

First, even when extreme volatility prevailed in the global foreign exchange markets following the collapse of Lehman Brothers, the exchange value of the Hong Kong dollar remained firmly anchored even as other major currencies suffered wide fluctuations, causing a ripple effect to other currencies in the region. Several reasons accounted for this extreme global volatility: the repatriation of large amounts of capital to the US to rescue the market; repositioning by those outside of the US who came to realise the severity and the contagiousness of the crisis; and deleveraging of large amounts of exchange and interest rate arbitrage activities triggered by the financial crisis.

These volatile conditions should, in theory, be destabilising for the Hong Kong dollar. Yet, not only has there been no depreciation pressure on the Hong Kong dollar: it has in fact strengthened following capital inflows into Hong Kong since the outbreak of the crisis in mid-September last year. Consistent with the principles of the Currency Board, the Hong Kong Monetary Authority (HKMA) has bought a total of US$23 billion, injecting HK$179 billion into the local money market.

The inflow of funds to the Hong Kong dollar was a welcome development, paving the way for monetary easing, which was fortuitously the appropriate monetary policy stance to support the economy. The reasons put forward for the inflow have not been a cause for concern for they did not seem to relate to exchange-rate speculation. Market consensus about the causes pointed to the unwinding of carry trades and the repatriation of funds by corporates to finance operations in Hong Kong. It is also likely that there have been some inflows to position for investment in Hong Kong, in light of the better economic prospects of the region, and in particular, China.

The second factor in the resilience of Hong Kong's financial markets is our robust banking system. One of the lessons from this experience is that the stability and effectiveness of the banking system becomes even more essential when financial crisis shuts down the two other financial intermediation channels: the bond market and the stock market. In economies across the world, new issuance of corporate debt and listing of new companies came to a halt, posing an enormous challenge for the banking channel to sustain economic activities: as we have seen, in many cases that challenge was insurmountable.

At the same time, the financial crisis grew to such exceptional proportions that governments worldwide had to implement a series of rescue measures of a kind never seen before, using public money to bail out the banking system. In a globalised world, it would be complacent to say that Hong Kong will continue to be less affected than their counterparts in Europe and the US: it is likely that the falling prices of financial assets, the economic downturn and other unfavourable factors will inevitably affect banks' asset quality and drive up the ratio of non-performing loans. Nevertheless, it is also true that Hong Kong has entered this crisis in a position of strength and should be able to weather it relatively well.

Despite the complex and stressful financial environment, the fundamentals of the banking sector in Hong Kong has remained strong and sound. The local banking sector here is well capitalised, at 13.8%, with a strong liquidity position averaging 45% in the fourth quarter of last year. The asset quality of retail banks is also high by historical standards, with preliminary figures showing overall non-performing loan ratio edging marginally from below 1% before the global financial crisis to just above 1% at the end of 2008. These very solid foundations will help Hong Kong cope with the challenge of a possible rise in non-performing financial assets and losses in the financial markets. They also supply the conditions for moving beyond crisis towards opportunity, and for exploring what seems set to become one of the strongest and more interesting of growth engines in markets in this region and beyond: Islamic finance.

Like most other asset classes, the growth of Islamic finance decelerated last year as a result of the global credit crunch and unfavourable economic conditions. New sukuk issuance retreated to US$14 billion last year, down from a high of US$31 billion in 2007.[1] And without a doubt, there will continue to be great challenges in the coming year. Market participants are reportedly expecting a slowdown in annual growth in global Islamic banking assets to 10-15% in 2009, compared with a growth of 20-30% last year.[2] Even so, a growth rate of 10-15% is robust by any standard, and especially so when set against the strong shrinkage in other areas of finance. There remains a healthy stock of sukuk issuance in the pipeline for this year, thus providing a good market to tap: one report conservatively estimates planned or announced sukuk for 2009 as being in excess of US$45 billion.[3]

As a new asset class, Islamic finance practices banking and investments in compliance with the principles of Islamic Shariah law, which prohibits excessive leverage, risk-taking and uncertainty, and promotes ethical practices. These are indeed universal principles in all markets – or at least they should be: one of the lessons of the present financial crisis is that too little attention has been paid to them. This is not to suggest that Islamic finance is without

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1 Source: Bloomberg.

2 Source: "Islamic inroads" by AsiaRisk, February 2009.

3 Source: "Sukuk market declined sharply in 2008, but long-term prospects remain strong" by Standard and Poor's, Islamic Finance News, 6 February 2009.

risk – indeed many of the risks inherent in Islamic finance are similar to those of conventional finance, and, in fact, Islamic financial institutions may be subject to other unique risks from the liquidity and operational perspectives. But Islamic finance introduces an alternative form of financing, and one that offers many opportunities particularly when financial market conditions start to improve.

From the perspective of Hong Kong, we are optimistic that the coming together here of Islamic finance with development opportunities in neighbouring Asian markets and China will provide an exciting growth stimulus for financial market participants. A key part of the Government's strategy for developing Hong Kong as an international financial centre is a focus on Islamic finance. In support of this initiative, the HKMA, in collaboration with the Treasury Markets Association (TMA), has devoted considerable time and resources into establishing an appropriate infrastructure framework and developing an education and awareness programme both locally and worldwide. Although we are still in the infant stages of development, we have accumulated some experience, which I would like to share with you today.

First, since it is now such a hot topic to talk about change, I trust that you will agree with me that Islamic finance, at least for jurisdictions like Hong Kong, means change – a change in perception, a change in skills, a change in structures and techniques, in contracts, standards, and so on. Change, in all its many forms, is happening within the global Islamic finance arena, even as we speak. In the past year or so, we have seen the inception of several standardisation initiatives for Islamic financial documentation, spearheaded by international institutions like the Islamic Financial Services Board (IFSB) and the International Islamic Financial Market (IIFM). This form of change is significant towards facilitating harmonious practices, providing greater clarity for the Islamic financial services industry and thus acting as a boost to the development of global Islamic financial markets.

There have also been many exciting developments in the new markets for Islamic finance in Asia, where there is a growing tendency for sukuk issuance, such as the sovereign issues from Indonesia and Singapore to support the development of Islamic finance. At the same time, we have also seen enhanced co-operation and increased linkages, both internally within the region and externally with other Islamic financial centres in the Middle East. Malaysia, for one, has announced its co-operation with Bahrain and Dubai, to jointly cooperate and develop Islamic banking and finance in the region. At the market level, we have also seen a continuing trend of regional expansion by Islamic financial institutions beyond the traditional markets toward newly emerging centres in Asia. Such changes are happening, despite the challenging environment that firms are currently operating in.

One of the most daunting of the changes required for policymakers and regulators is the change in regulations and taxation rules to provide an equitable environment for the operation of Islamic finance within the overall financial market framework. Within Hong Kong, with the wealth of expertise drawn from members of the TMA, recommendations were put up and analysed by the Government as a priority in its comprehensive tax review. The Government has concluded that the legal system in Hong Kong is flexible enough to meet the demands of Islamic finance transactions. This is because, with our robust rule of law and our simple tax structure free of capital or interest gains tax, there have only been a minimal number of taxation issues that have to be dealt with. The legislation on tax also gives power to the Government to grant tax exemptions where necessary to those who apply for it. The legal architecture in Hong Kong therefore lends itself well to Islamic finance. There is therefore little time to spare, in the run up to a revival of the sukuk market and the lead time it takes to promulgate tax exemption rules for Islamic finance transactions; financial market players in Hong Kong must gear themselves up to embrace the change coming your way.

Secondly, there is in general a greater awareness of Islamic finance within the local financial community, particularly among banks. Banks in Hong Kong are in the position of being both investors in, and suppliers of Islamic finance products. Instruments, ranging from retail

Islamic investment funds and Islamic treasury placements at the interbank and corporate level, to Islamic loan syndication, have started to emerge in Hong Kong within the past year. Financial market participants have also set up Islamic banking windows here to signal their readiness to cater for these types of activities.

But even with all the significant developments achieved here in such a short period of time, more still needs to be done. While the recognition of Islamic finance as a viable fund-raising and investment alternative is gradually making its way to the corporate sector in Hong Kong, the pace of development is still rather slow. Furthermore, this market awareness should also be promoted beyond banks and other types of financial institutions to all related service industries, such as investment managers, asset managers, securities and brokerage houses, exchanges and commodity firms, pension funds, insurance agencies, solicitors, accountants, and trustees. Not only will this require a much wider network of collaboration among the trade associations in Hong Kong, it will also require the financial institutions themselves to play a role in educating their customers and stimulating the potential supply and demand of Islamic financial products in Hong Kong.

Last but not least, although Hong Kong is still a relative newcomer to this industry, it has the strengths and capabilities to make significant contributions to the global Islamic finance market. Hong Kong is in many ways fortunate to have access to the Islamic finance talents and knowhow through an extensive network of international and regional players here. And I believe that there is endless potential for us to innovate in the area of Islamic finance, especially in deploying our special strengths – our close affinity to China, our experience as an international fund raising centre and asset management hub, and our role as a testing ground for the Mainland's financial liberalisation. There is, for example, no obstacle to Hong Kong's becoming a centre for Islamic IPOs, given our distinct record as a leading IPO centre in the region. What is needed is maximum preparedness on the part not only of the regulators but also of financial market players, who are the driving force of financial innovation and growth.

With great challenges come great opportunities, and Islamic finance is an area that has shown much promise over the past years. I believe that now is the time to lay down the groundwork for future growth and development. With these remarks, ladies and gentlemen, let me wish the inaugural Asia Sukuk Summit a great success and all of you a most productive time here in Hong Kong.

Thank you.