

Peter Pang: Sukuk as a viable fund-raising and investment instrument

Opening remarks by Mr Peter Pang, Deputy Chief Executive of the Hong Kong Monetary Authority, at the HKMA-BNM Joint Conference on Islamic Finance, Hong Kong, 14 April 2014.

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Dato' Muhammad Ibrahim, distinguished speakers and guests, ladies and gentlemen,

1. Good morning. It gives me great pleasure to welcome you all to this Islamic finance conference jointly organised by the Hong Kong Monetary Authority and Bank Negara Malaysia (BNM), with the support of the Treasury Markets Association. I am particularly grateful to Dato' Muhammad Ibrahim, Deputy Governor of BNM, who leads a delegation of Islamic finance experts from Malaysia to share with us their experience and knowledge on a wide range of matters concerning sukuk, from the latest developments of the global sukuk market to the practical issues in structuring sukuk products.
2. This conference marks the third Islamic finance-related event organised in collaboration with BNM within the past year or so, following an Islamic finance workshop held in March last year and the first meeting of the Joint Forum on Islamic Finance between Hong Kong and Malaysia held last December. This series of events is a testament to our determination to deepen co-operation with Malaysia in the development of Islamic finance.
3. The theme of today's conference is "Sukuk as a viable fund-raising and investment instrument". Looking around, I am delighted to see many friends from corporates, banks, fund management firms and other industry professionals sitting here, keen to learn more about sukuk. I am sure that the experts gathered here today will be able to shed light on how sukuk can be a viable fund-raising tool and an attractive investment instrument. Before that, allow me to take this opportunity to say a few words, from a policy perspective, on why developing an Islamic finance platform is important for Hong Kong, and our plans in building this platform.

What's in it for Hong Kong to develop Islamic finance?

4. Islamic finance has become increasingly important in the global financial market, registering exponential growth over the past few years. Compared with a size of only US\$700 billion in 2008, the global Islamic financial industry has expanded remarkably to an estimated US\$1.8 trillion by the end of 2013, representing an annual average growth rate of 21%.¹ According to market estimates, there is huge potential for further growth, with Islamic financial assets expected to reach US\$6.5 trillion by 2020.²
5. A major growth area for Islamic finance is the sukuk market. Ten years ago, new sukuk issuance was only a modest US\$5 billion. In just ten years' time, annual sukuk issuance has already surpassed US\$100 billion, amounting to US\$117 billion in 2013 which was more than 20 times higher than the figure in 2003.³
6. The strong momentum of the sukuk market is underpinned by the increasing demand for sukuk, especially sukuk of high credit ratings, from Islamic investors. Over the years, the Gulf region has accumulated a huge amount of oil revenue. The

¹ Source: KFH Research

² Source: KFH Research

³ Source: Zawya

current account surpluses in the Gulf Cooperation Council (GCC) countries last year were estimated to be more than US\$300 billion,⁴ while assets under management by sovereign wealth funds in those countries amounted to as much as US\$2 trillion at the end of last year.⁵ Islamic investors in the Middle East and other Islamic countries generally have a preference for investing in Shariah-compliant assets. With the expanding liquidity pool in the Islamic world, naturally, there is a commensurate increase in the demand for Islamic investment instruments globally.

7. As an international financial centre and given our unique role as a gateway to China, Hong Kong is well-positioned to provide an effective platform to channel the surplus funds from the Islamic world to this part of the world where there is a huge financing need to sustain the high growth of the Asian economies. Our platform will enable Islamic investors to access investment opportunities in Asia, particularly China, while at the same time allowing fund raisers to tap into the liquidity pool in the Islamic world.
8. What's more, sukuk are becoming a mainstream asset class in the global financial system. Financial innovation and tax reform in major international financial centres have made sukuk largely comparable to conventional bonds. Apart from Islamic investors, sukuk are increasingly appealing to conventional investors as a way to diversify their investment portfolios. With such promising growth potential, developing Islamic finance would open up vast business opportunities and bring tremendous benefits to the financial services industry in Hong Kong. It would also help widen the range of financial products and broaden the types of market players here, adding to the breadth, depth and diversity of our financial market and consolidating our role as an international financial centre.

Platform building for sukuk issuance

9. With this in mind, we have taken concrete steps over the past few years to build a conducive platform for sukuk issuance. Just last July, we have put in place a tax framework for common types of sukuk to level the playing field between sukuk and conventional bonds.
10. Generally speaking, sukuk are no different from conventional bonds in terms of economic substance, enabling issuers to raise funds while giving investors interest-like return. However, the more complicated structure of sukuk, which involves the setting up of a special purpose vehicle and multiple transfers of underlying assets, had led to additional tax liability for sukuk issuers. The tax law amendments have overcome this obstacle by removing the additional profits tax and stamp duty charges incurred in issuing sukuk as compared with conventional bonds.
11. With the tax framework in place, Hong Kong's financial platform is ready for sukuk issuance. We highly welcome local and overseas entities to make use of Hong Kong's platform to issue sukuk.
12. To play a lead-off role for this market, we took another important step recently by putting in place a legal framework for the Government to issue sukuk under the Government Bond Programme. We are very pleased to see that the relevant bill was passed by the Legislative Council a few weeks ago, paving the way for the launch of the inaugural Government sukuk.

⁴ Source: *Institute for International Finance*

⁵ Source: *SWF Institute*

Inaugural HKSAR Government sukuk

13. The Government sukuk is intended to meet two important objectives.
14. First, it aims to demonstrate to the global financial markets that the legal, regulatory and taxation frameworks in Hong Kong can well accommodate sukuk issuance. Leveraging on the HKSAR Government's triple-A credit rating, the expected low funding cost of Government sukuk will provide a useful benchmark for other potential sukuk issuers in Hong Kong. Hopefully, this will in turn encourage more sukuk issuers to participate in our market, providing impetus to the sustainable development of the sukuk market here.
15. Second, we hope to attract more international investors to our financial market. Given the shortage of high-quality sukuk in the global market, the strong credit rating of the HKSAR Government is well-positioned to fill the gap by providing high-quality sukuk to meet the strong demand from investors. The global roadshows of the Government sukuk will also provide an ideal opportunity for us to reach out to global investors and showcase our credit strengths and Islamic finance capability.
16. As the Government's representative under the Government Bond Programme, the HKMA is now working closely with the Government to prepare for the inaugural issuance of Government sukuk. A detailed issuance plan is being devised with reference to international practices and market conditions. According to our current plan, the inaugural Government sukuk would be based on the Ijarah structure and target institutional investors globally.

What's in it for fund raisers to issue sukuk?

17. As I have mentioned earlier, the key objective of the Government sukuk is to play a catalytic role, paving the way for local and international fund-raisers, no matter from the public or private sector, to follow suit.
18. For the potential sukuk issuers sitting here today, you may wonder what benefits you will get by issuing sukuk. Well, let me highlight two key benefits here.
19. First, you would be able to broaden your investor base. By issuing conventional bonds, you will only be able to tap conventional investors. But by issuing sukuk, you will be able to get both conventional and Islamic investors to participate. In particular, issuing sukuk will help you to gain access to the large pool of liquidity in the Middle East and other Islamic countries, where investors are progressively looking for Shariah-compliant assets in this part of the world. At the same time, more and more conventional investors are also looking to diversify their portfolios into sukuk as a new asset class. So, issuing sukuk would enable fund-raisers to enjoy a wider and more diverse investor base.
20. Second, you would be able to diversify your funding sources. With the additional option of sukuk in your arsenal, you can choose to issue either conventional bonds or sukuk, depending on the pricing and liquidity in the market at the time of issuance. This would provide more flexibility and a more stable source of funding to fund-raisers, particularly at a time when the funding cost of sukuk is more attractive than that of conventional bonds or when there is difficulty in obtaining liquidity in certain markets.
21. Having said that, sukuk remain a relatively new product type in Hong Kong's financial market. Some of you may have questions about the mechanics of sukuk, such as what would be suitable underlying assets, how to ensure Shariah-compliance, etc. Malaysia's experience has clearly shown that there are readily available solutions to address these issues. In particular, while sukuk are asset-based, a number of different sukuk structures are available. So, for companies that do not have much fixed assets, some asset-light sukuk structures may be utilised to

overcome issues concerning availability of tangible assets. I am certain that the experts present here today will be able to provide more guidance and address such questions in detail in later sessions.

Concluding remarks

22. Ladies and gentlemen, I hope that you now have a better idea on the opportunities and benefits brought by the development of Islamic finance in Hong Kong. It is essential for all of us to get well-prepared in order to make the most out of these upcoming opportunities. Your presence at this conference today is highly encouraging and reflects that you are actively gearing yourselves up. I am confident that you will have a lot to take away from the advice of the experts gathered here today.
23. At the same time, we will continue our efforts to promote market awareness of Islamic finance in Hong Kong. In particular, today's event demonstrates the concerted efforts of Hong Kong and Malaysia in creating market awareness and promoting understanding of Islamic finance. We very much appreciate the close partnership we have established with Malaysia in developing Islamic finance. I wish this conference every success and I certainly look forward to more co-operation opportunities in the future.

Thank you.