

# Islamic Finance

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**I. Introduction to the Islamic Financing Concept**

**II. Commonly Used Islamic Financing  
Techniques**

**III. What the Hong Kong Government has done  
to create an Islamic Financing Platform**

**IV. Challenges**

# Introduction

- Islamic finance is one of the fastest expanding fund markets in the world
- Emerged relatively unscathed from the global financial crisis
- Great potential: Muslims account for one fifth of the world's population
- The Middle East is undergoing expansion and development funded by petrodollar wealth

# Rapid Growth

- Growth rates tremendously outpace conventional banking:
  - Growth rate of 15-20% per year
  - Signs of consistent future growth
- Present value estimated at over US\$1 trillion
- Estimated that Islamic banking assets would exceed US\$4 trillion in 5 years time (Moody's)



# Introduction - Why Hong Kong?

- Hong Kong is a well established global finance centre with liquid markets
- Islamic investors wish to partake in China's growth
- Hong Kong can act as a gateway for Middle East and Malaysian investors

*“Obviously if you don't have Islamic finance you are missing a big market segment...”*

Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority

# Introduction - Shariah

- Shariah: the body of Islamic religious law
- 5 key principles governing Islamic banking
- Presents some challenges in structuring finances: need to ensure that they are 'halal' (permissible)



# Introduction - No speculation (maisir)

- Contracts which involve speculation are not permissible and considered void
- The test: **chance vs productive effort**



- Forms of speculation akin to gambling are not permitted, including over the counter derivatives

# Introduction - No unfair exploitation

- Contracts where one party is regarded as having gained unjustly at the expense of another are not permitted
  - The Shariah principle of unjust enrichment is wider in scope than that applied by the English laws of restitution
  - Includes the enrichment of one party who exercises undue influence or duress over another





# Introduction - No interest (riba)

- Payment and receipt of interest is prohibited under Islamic law
- Islamic law regards money as having no intrinsic value and no time value



# Introduction - No uncertainty

(gharrar)

- Shariah requires absolute certainty on all the fundamental terms
- Contracts which contain any uncertainty as to any of the fundamental terms of the contract are considered void
  - Conventional insurance is not permitted on the basis that it is uncertain whether the insured event will occur or not



# Introduction - No unethical

- Alcohol investments
- Pornography
- Gambling
- Pork-related products
- Leisure and entertainment



# Introduction - Shariah Board

- Religious board comprising eminent Islamic scholars
  - Knowledgeable in Shariah
  - Understanding of modern banking, finance and economics
- Scrutinizes proposed transactions to ensure compliance with Islamic precepts

# Introduction - Shariah Board

- Found in most Islamic banks as well as conventional banks with an Islamic ‘window’
  - e.g. HSBC Amanah, UBS Islamic Finance, Citi Islamic, Standard Chartered Saadiq, Hong Leong Bank



- Indonesia has a National Shariah Board which issues rulings that are mandatory for all Shariah boards in the country

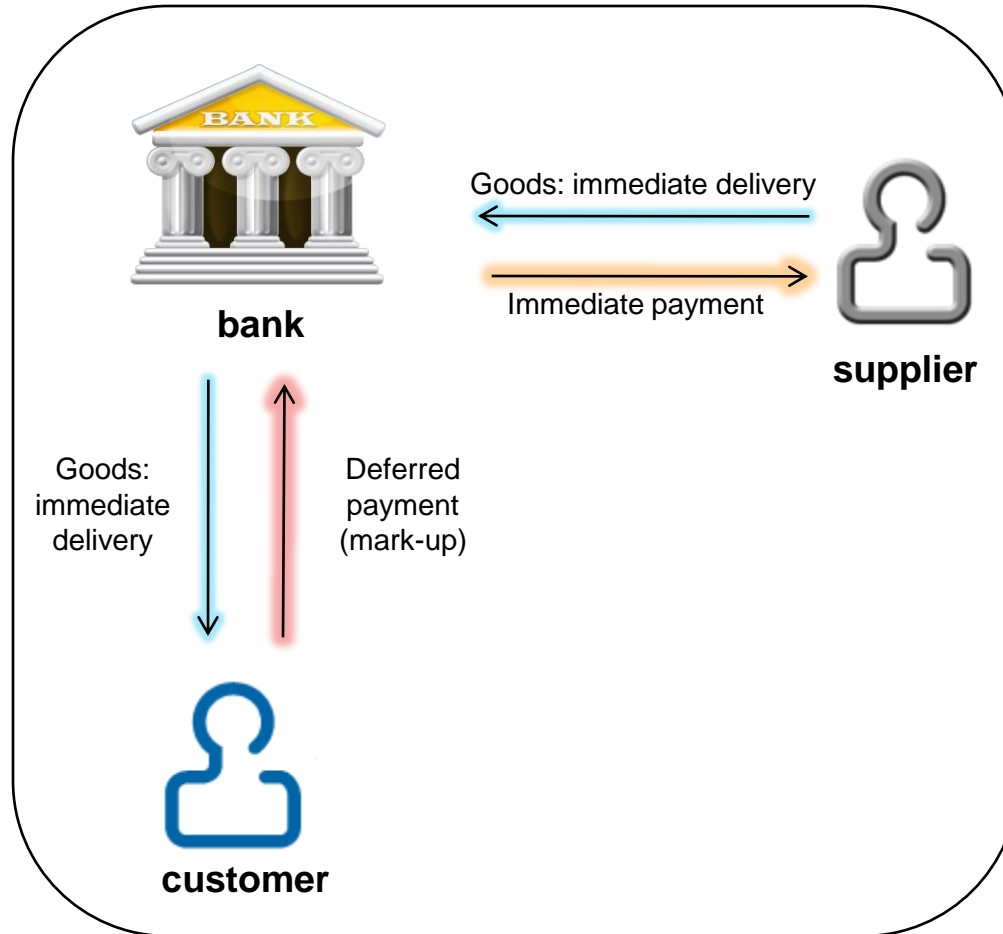


## **II. Commonly used Islamic Financing Techniques**

# Murabaha

- Cost plus financing/deferred sale finance
- The bank buys an item and sells it to the customer on a deferred basis
- Agreed profit margin to be paid on agreed date
  - Benchmark: LIBOR
- Economic effect similar to an interest calculation

# Murabaha

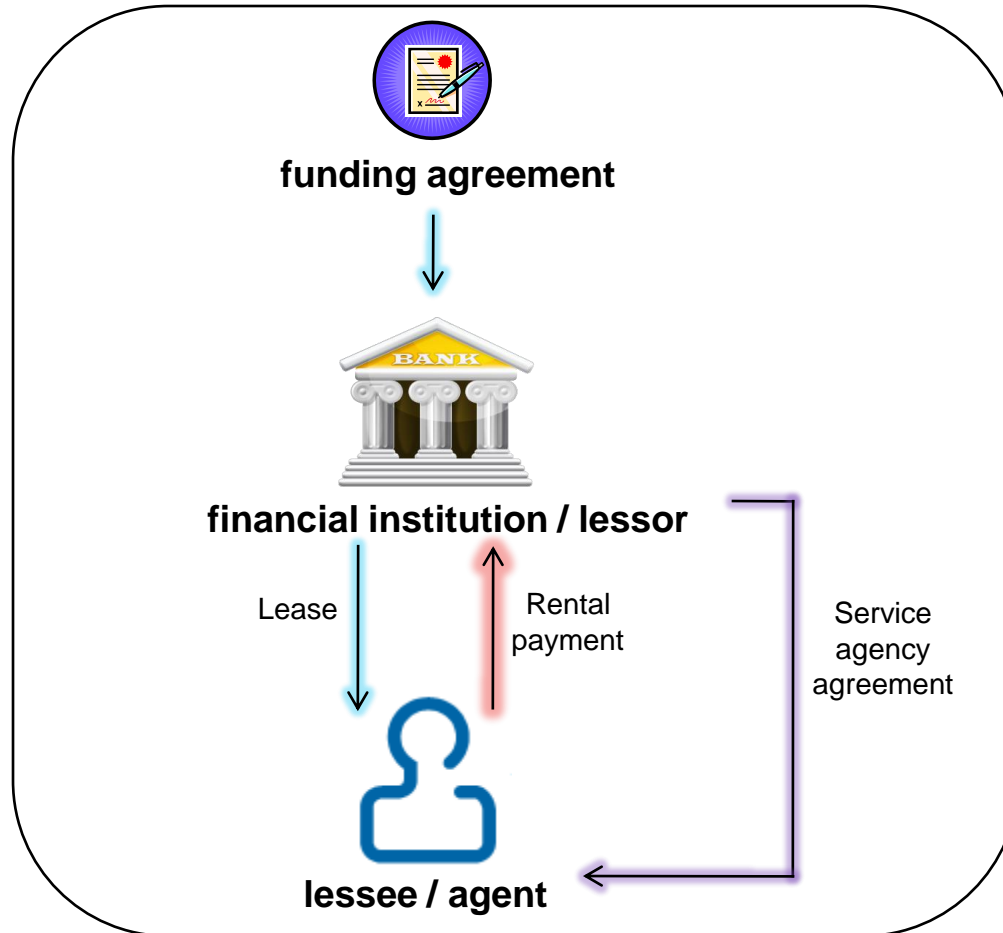




# Ijara

- Lease: the bank buys an item for a customer and then leases it to him/her over a specific period, for an agreed price
- The customer makes regular payments to the bank, consisting partly of the rental payment and partly a payment towards buying the property
- Hybrid between conventional operating and finance leases

# Ijara



# Sukuk

- Islamic bond: an investment certificate which represents a proportionate interest in an underlying tangible asset and revenue
- Assets are pooled together, transferred to a SPV, repackaged as tradable certificates and transferred to a large number of investors by issuing certificates
  - Defined period of investment, giving investors a relatively predictable stream of income
  - Returns are linked to the performance of the asset

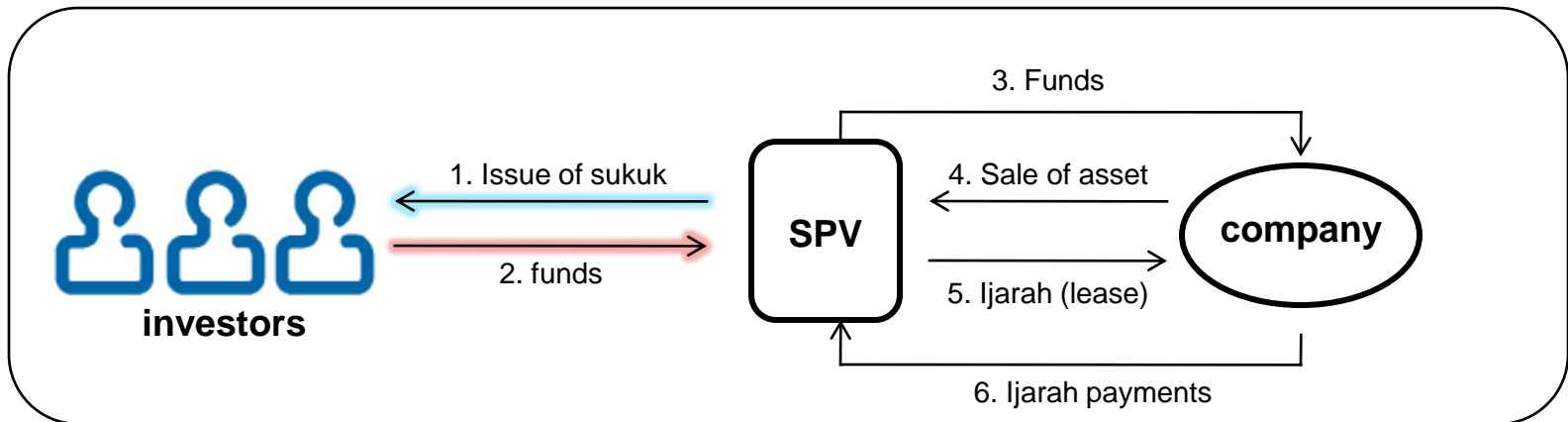
# Sukuk

- Can be sold and purchased on secondary market
- Primary credit risk is that of the issuer who is obliged to pay the Sukuk holder irrespective of the performance of the underlying asset

# Sukuk in Hong Kong

- Hong Kong is taking steps to develop its own Sukuk market. The HKMA is developing its supervisory policy on Sukuk by reference to guidelines issued by the Islamic Financial Services Board
- In April 2009 HSBC announced that it received approval from the HKMA to sell Sukuk in Hong Kong, the first local bank to do so
- The Hong Kong Airport Authority also has plans to issue Sukuk in Hong Kong

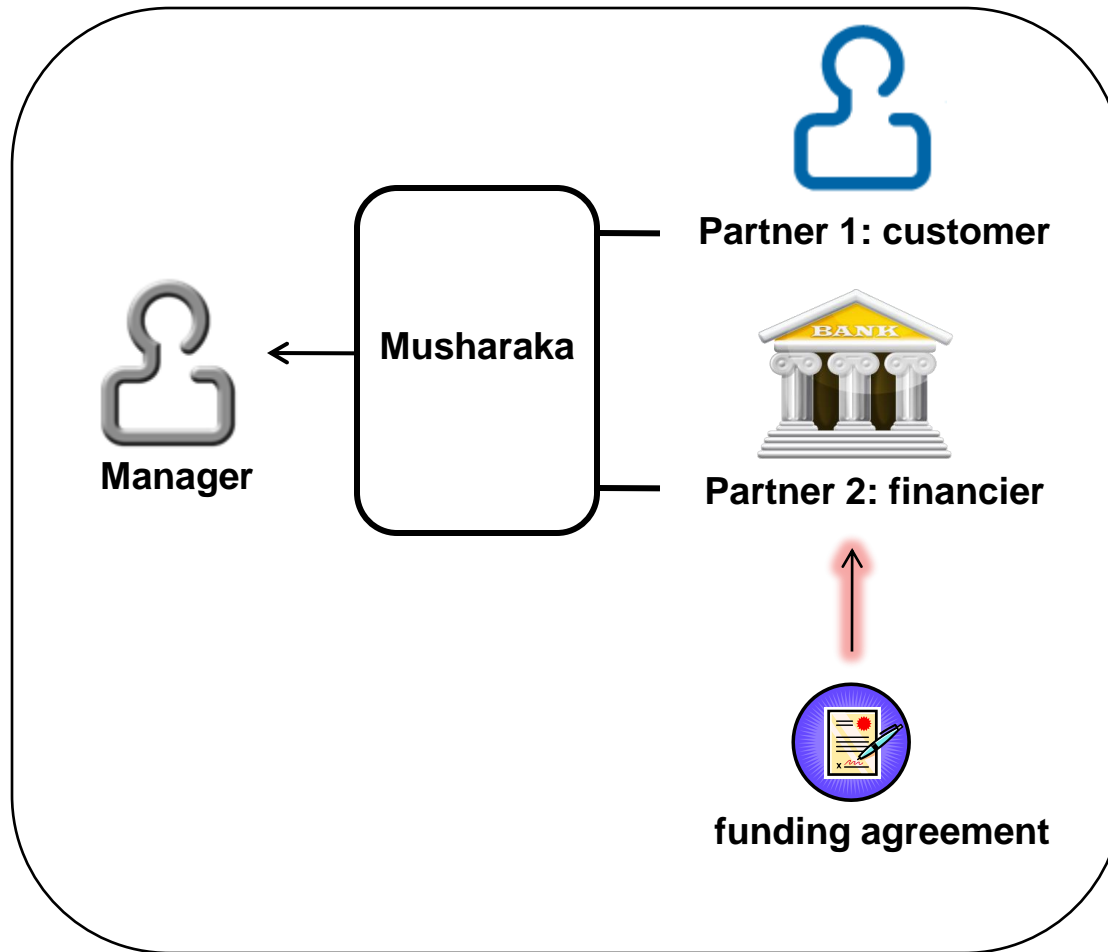
# Sukuk



# Musharaka

- Equity financing
- Investment partnership in which profit sharing ratios are agreed in advance and losses are pegged to the amount invested
- Joint business venture
- Parties may offer funds, efforts or skills

# Musharaka

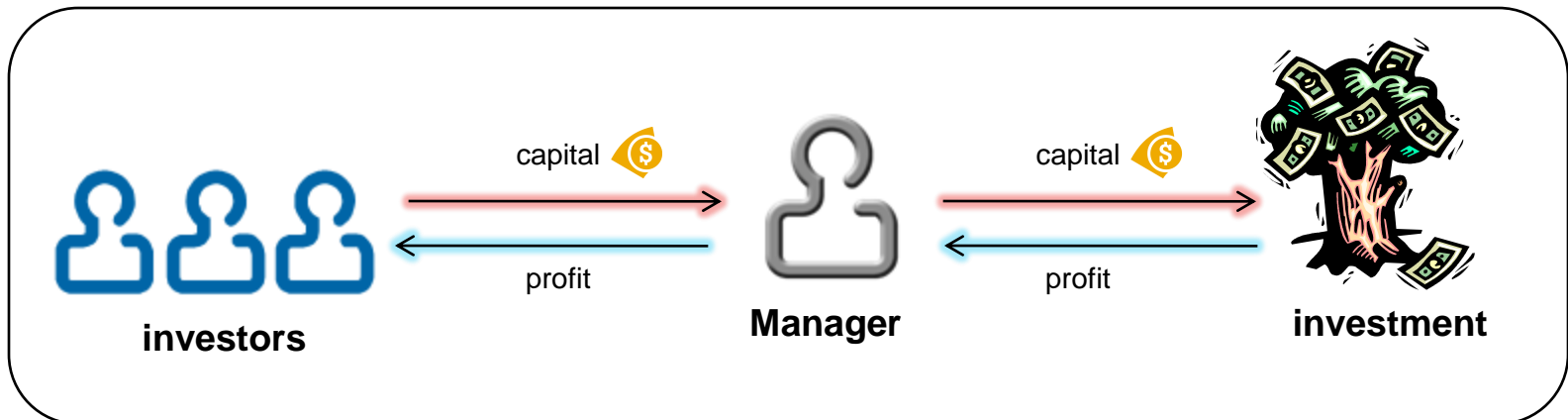




# Mudaraba

- Participation financing
- Agreement between a group of investors and a manager
- Investors put up capital which the manager invests
- Earned profit replaces interest

# Mudaraba



# **III. What the Hong Kong Government has done to create an Islamic Financing Platform**



# Chief Executive's Address 2007

- *“We should actively leverage on this new trend by developing an Islamic financial platform in Hong Kong. Apart from stepping up our efforts to promote Hong Kong’s financial services to major Islamic countries and regions, we will focus on developing an Islamic bond market”*



# Progress

- The first Islamic retail fund for sale to retail investors in Hong Kong had already attracted about US\$45 million worth of orders by 10 December 2007, mainly from local investors
- On 25 November 2008, CIMB Islamic launched a Shariah compliant commodity murabaha deposit in its Hong Kong branch and signed its first transaction with Hong Leong Bank



# Hong Kong Showcase on Islamic Finance

- The Hong Kong Monetary Authority (HKMA), Treasury Markets Association (TMA) and Hong Kong Trade Development Council (HKTDC) jointly presented the Hong Kong Showcase on Islamic Finance on a roadshow in the Middle East:
  - Dubai, UAE on 11 May 2008
  - Amman, Jordan on 12 May 2008



# HKMA & DIFC 2008 Memorandum

- The Hong Kong Monetary Authority (HKMA) and the Dubai International Financial Centre Authority (DIFC Authority) signed a Memorandum of Understanding on 20 May 2008 aimed at fostering cooperation in the development of Shariah-compliant financial products and the financial infrastructures in their respective jurisdictions

## 2008 Study

- The HKMA and TMA set up a team, in conjunction with market players, to study the possible challenges and implications of the growth of Islamic finance in Hong Kong
  - It found no major legal and regulatory impediments to transactions involving wholesale Shariah-compliant financial instruments in Hong Kong
  - But further clarification and fine-tuning in the tax laws is needed to avoid extra tax obligations



# HKMA 2008 Annual Report

- Four-part approach in promoting the development of Islamic finance in Hong Kong
  - Facilitating infrastructure: assisting the Government in drawing up legislative proposals for modifying tax laws in Hong Kong
  - Raising Hong Kong's international profile
  - Encouraging product development
  - Raising market awareness



# The 2009-10 Budget

- *“Since the structure of most Islamic financial products involves the sale and re-purchase of assets, such transactions may entail tax liabilities in Hong Kong.*

*Therefore, we plan to submit to the Legislative Council in 2009-10 a proposal to create a level playing field for Islamic financial products vis-à-vis conventional ones. The proposal will include making changes to or clarifications of the arrangements for stamp duty, profits tax and property tax”*





## IV. Challenges

# Weak infrastructure

- Due to lack of markets in which to sell trade and negotiate financial assets of Islamic banks
- Lack of market integration:
  - Urgent need to develop marketable Shariah-based instruments by which asset portfolios generated in Muslim countries can be marketed in the West

# Liquidity risk

- Liquidity risk is the risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss or make the required profit
  - Arises when a party that wants to trade an asset cannot do so because no-one in the market wants to trade that particular asset e.g. no ready market for Sukuk
  - The bank therefore cannot easily offset or unwind specific exposures

# Shortage of Shariah Scholars

- Shortage of appropriately qualified Shariah scholars who are equally skilled in conventional banking and Islamic law
  - Currently estimated between 100-200
  - About 12 of them are particularly sought after

# Shortage of Shariah Scholars

- Common for individual scholars to hold positions in a number of firms
  - Concerns over ability of Shariah Supervisory Boards (SSBs) to provide a rigorous challenge and oversight of the firms' products and services
  - Scholars may be advising direct competitors
- Conflict: SSBs may be responsible for both the annual Shariah audit and approving products for Shariah compliance

# Excess of Liquidity for Islamic Banks

- Liquidity: an asset's ability to be easily converted into cash with minimal loss of value
- Islamic banks face excess of liquidity: they are almost 50% more liquid compared to conventional financial institutions
- This means that these liquid assets are either generating no return or a very low one
- Negatively affects competitiveness



# Shariah Arbitrage

- Some products and services may be approved as being Shariah-compliant by some Shariah scholars but not by others
  - Some scholars oppose certain practices because they find hidden elements of riba and gharar in them
  - In Britain, a famous Muslim scholar advises against taking out Islamic mortgages due to the structure being interest-bearing debt in disguise

# Shariah Arbitrage

- There are four main schools of thought within Islamic jurisprudence, which may give rise to differing views:

Islamic School of Thought	Area
Shafi	Far East
Hanbali	Middle East
Hanafi	South East Asia
Maliki	Africa

- Approval of products and services may also depend on the particular jurisdiction they are offered in
  - Restrictions are more liberal in Malaysia than in the Middle East



## Uneven playing field

- In order for Islamic Financing strategies to receive the same tax treatment as traditional ones, legislative amendments must be introduced to the Inland Revenue Ordinance and Stamp Duty Ordinance
- If the law is not changed, then petitions for exemption from Profits Tax, Property Tax and Stamp Duty remission must be made on a case by case basis, costing both time and money

# Tax law in Hong Kong

- Tax law treats debt and equity differently
- Islamic finance strategies such as Sukuk and Murabaha operate in the form of equity finance, but are in substance similar to debt finance
- Treating them as equity products rather than debt finance could lead to a heavier tax burden, thus placing them at a competitive disadvantage in the market

# Reform of tax law – UK



- The 2007 Budget included the introduction of a new framework for listed Sukuk which would allow Sukuk to be held, issued and traded in the same way as corporate bonds

# Reform of tax law – Singapore

- Singapore government introduced tax measures to:
  - Remove double stamp duty for Islamic real estate mortgage financing structures
  - Re-characterise profits derived from certain Islamic products as interest income for Singapore income tax and GST purposes
  - Extend concessionary tax treatment applicable to conventional financial instruments to payouts from Islamic bonds



## Reform of tax law – Malaysia

- Malaysia aims to become the hub of Islamic financial services
- Additional tax incentives to the Islamic financial sector include:
  - Tax deduction on expenses incurred on the issuance of Islamic products
  - Additional 20% stamp duty exemption on Islamic financing instruments for 3 years
  - Income tax exemption for 10 years to fund managers who manage Islamic funds for foreign investors