

# A Pious Proposition

*Strong demand for February's landmark issue of a 10-year Islamic bond in Hong Kong has revived the discussion on the merits of Islamic finance*

By Jennifer Khoo

**H**ong Kong set a benchmark for issuers of Islamic finance when it became the first AAA-rated government to issue sukuk with a 10-year tenor. February's US\$1-billion issue was the government's third U.S. dollar-denominated Islamic bond, following two Sharia-compliant issuances in 2014 and 2015.

In the face of global economic uncertainty and the prospect of U.S. interest rates rising during the investment's long tenor, the demand for the securities was strong. Twice as many orders were received as there were securities issued, with investors outside the Islamic world and first-time investors in sukuk heavily involved.

## Principled Funds

Islamic finance follows three basic principles in order to comply with Sharia law. First, the payment of interest is not allowed because money is regarded as a medium of exchange, without intrinsic value. Second, transactions involving excessive uncertainty and speculation are avoided, which often means investments are asset-backed. Third, investors cannot make transactions that support activities considered irresponsible or unethical. Investing in the manufacture of arms or the production of alcoholic drinks, for example, is prohibited.

So, sukuk are asset-based securities that afford investors partial ownership of a tangible asset, project, service or business that is considered Sharia-compliant. By contrast, the closest corresponding investment in conventional financial markets, a bond, is a debt instrument used to finance virtually any endeavor.

Instead of interest, the sukuk investor is rewarded with a share of the profits generated by the asset. The investor must also bear a share of the loss if the asset fails to perform as expected.





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An ancient investment instrument, but one that did not have a global appeal, modern sukuk became prominent in the 1990s as a device to improve short-term liquidity. Some corporates, such as insurance companies and private banks, are attracted to sukuk because of their potential for a long-term, steady return on assets.

### **Morals of Moneymaking**

Dollars are just one measure of wealth and they might be considered a very poor one at that. The moral principles that guide Islamic banking may provide the community with value that goes beyond profit. The World Bank specifies that Islamic finance is “equity-based, asset-backed, ethical, sustainable, environmentally and socially responsible. It promotes risk-sharing, connects the financial sector with the real economy and emphasizes financial inclusion and social welfare.”

More than four-fifths of Muslims avoid banks and other conventional sources of finance for religious reasons. The community’s involvement makes Islamic finance more inclusive, making it easier for small- and medium-sized enterprises, the poor and the unbanked to obtain finance.

Islamic finance may also contribute toward economic growth and encourage a more equitable distribution of wealth. The accessible and uncomplicated arrangements for sharing profits, as well as losses, can lead to finance that facilitates economic activity that boosts productivity and creates jobs. That speculation is restricted and tangible assets are at the heart of the transactions ensures financiers support only transactions that contribute real value to society.

By specifying that investors behave ethically, Islamic finance might also promote greater financial stability. Protected by the fundamental principles that risk should be shared and financial speculation avoided, many Islamic financial institutions emerged unscathed from the Global Financial Crisis of 2008.

At 3.132 percent, the yield of February’s sukuk is less than that of most other AA-rated 10-year sukuk in the market. But demand for the securities shows a willingness to accept lower returns in exchange for a safer, more stable investment.

The potential for developing a significant market for Islamic finance is acknowledged by the Hong Kong government. “The success of the transaction is a testament to investor confidence in Hong Kong’s credit strengths and economic fundamentals,” Hong Kong’s Financial Secretary Paul Chan said after February’s issuance. “I hope that the sukuk issuance will provide momentum for further growth of the sukuk market in Hong Kong and attract more issuers and investors to participate in our bond market.”



# Unlocking the Potential

*AmCham member Deborah Leerhsen, the managing director of HSBC Global Banking and Markets, explains Hong Kong's advantages as a center for Islamic finance*

## **Why should Hong Kong embrace Islamic finance?**

The development of Islamic finance in Hong Kong is a natural extension of the city's role as an international financial center. Hong Kong is unique in that it is a financial gateway to the People's Republic of China and therefore is an ideal place to intermediate between Islamic finance investors and issuers. Economic growth in the mainland has also led to increased funding and investment needs, prompting Chinese issuers to consider the Islamic finance market as a potential source for funding and investment.

## **Why is Hong Kong suitable as a center for sukuk?**

The Hong Kong government has launched three sukuk offerings – in 2014, 2015 and this year, based on the ijarah and wakalah structures – each of which was jointly led by HSBC. The success of these issues demonstrates that the city is qualified to be a hub for sukuk. The most recent transaction attracted a number of international and local investors.

In addition to highlighting Hong Kong's established profile in the international capital markets, this deal demonstrates that the city's legal, regulatory and taxation frameworks are well-suited for capital markets issuance, including sukuk. The deal capitalized on the city's credit strength, its investment-grade credit rating of AA+ by Fitch Ratings and AAA by Standard & Poor's, and it set an important benchmark for private-sector issuers in the sukuk market.



*Deborah Leerhsen*

## **How can AmCham members find out more about Islamic investment?**

The government is promoting further development of the Islamic finance market in Hong Kong and there is a website providing updates at [www.hkgb.gov.hk](http://www.hkgb.gov.hk). HSBC has a dedicated Islamic finance team, with considerable experience in structuring and executing sukuk transactions. For more information, see [www.hsbccamanah.com](http://www.hsbccamanah.com) or contact me. 