



## **Far Eastern Promise: Can Hong Kong Become an Islamic Finance Hub?**

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Hong Kong has long been considered one of the major financial hubs of Asia and indeed the world. Yet Hong Kong has never been considered an active player in the rapidly growing field of Islamic finance. This may soon change, however, if the financial authorities in Hong Kong are successful in implementing their plans to transform the city into a significant global centre for Shariah-compliant investments.

Hong Kong will face a number of challenges in its quest to become an Islamic finance hub, but certain unique traits are in its favour. There have been a handful of notable successes so far but Hong Kong has not yet proven itself in this emerging field. There are nevertheless a number of reasons to be optimistic about Hong Kong's (and, more broadly, China's) future role in supporting the burgeoning global Islamic finance market.

Most importantly, Hong Kong is well-positioned to serve as a conduit for Shariah-compliant investment between the Middle East and the Far East, especially in promising areas such as Islamic capital markets (including Sukuk) and in infrastructure project finance.

### **First Steps**

Over the past year, the government of the Hong Kong special administrative region has repeatedly announced its commitment to establishing the city as a legitimate competitor in the Islamic finance arena. Since then, there has been a fair amount of media 'buzz' and industry gossip on the subject.

With a few notable exceptions, however, most of the media coverage to-date has focused on the promise of Hong Kong as an Islamic financial centre, not on substantive accomplishments. Nevertheless, the Hong Kong government should be commended for continuing to reaffirm its commitment to making Hong Kong a hospitable environment for Shariah-compliant financial services.

Although it remains too early to tell whether Hong Kong will ultimately reach its goal, it is certainly clear that the Hong Kong government is making a determined effort. It has sponsored a number of events both in Hong Kong and abroad to raise awareness of the potential for Hong Kong to play a role in global Islamic finance.

Donald Tsang, the chief executive of Hong Kong, toured several leading Islamic finance centers, meeting with government leaders, executives, bankers and regulators in Kuala Lumpur, Dubai and other key Islamic finance marketplaces. The Hong Kong Monetary Authority (HKMA) has also toured the Gulf States to drum up support for Hong Kong's ambitions in the Islamic finance field, likening the city to the nexus of a 'New Silk Road' between the Far East and the Middle East.

Among the most important initiatives in recent months involves the memorandum of understanding between the HKMA and the Dubai International Financial Center Authority (DIFCA), signed in May 2008, to foster cooperation in the development of Shariah-compliant financial products and the financial infrastructures. This will include cooperation on standardisation and harmonisation of financial regulations, the exchange of advice, the promotion of training and education programmes (including the facilitation of dialogue between Shariah scholars and boards), the fostering of cross-border transactions and payment systems to support Shariah-compliant investments between the two regions, and other related initiatives aimed at furthering the growth of Islamic finance in both cities.

It has also been reported that Hong Kong is reviewing and revising its tax laws, including stamp duties and taxes on profits generated by Islamic structured products. Hong Kong does not tax interest – such as that generated by a conventional bond – as income, but it does currently tax profits as income, which creates a tax barrier for profit-based Shariah-compliant products like Sukuk. Changing such laws will be necessary to make the city competitive as an Islamic finance hub.

There have also been a few isolated but noteworthy developments in the financial products market in Hong Kong in the field of Shariah-compliant investment. Foremost, in November 2007 the Hang Seng Bank introduced an equities index fund which complies with Shariah precepts.



The Hang Seng Islamic China Index Fund tracks certain large Hong Kong and mainland Chinese company stocks traded on the Hong Kong exchange that satisfy a Shariah compliance screen established by the bank in conjunction with Dow Jones Indexes. Another factor in Hong Kong's incipient Islamic finance marketplace involves the proposed issuance by the Hong Kong Airport Authority of a global Sukuk.

### **Unique Attributes**

Two things stand out which may make Hong Kong an ideal Islamic finance hub: (1) its role as a conduit for investment in mainland China, and (2) its existing financial markets platform. The city is an established global financial market, a distinction that is shared with other major financial centres like Tokyo, New York and London.

Hong Kong's connection with mainland China, however, is truly unique and presents special opportunities for expanding commerce between the Middle East and the Far East. It may prove to be the ideal place for Muslim investors and Shariah-compliant institutions to look to in order to bridge the gap between the Islamic world and the rapidly growing economies of China and, more generally, the developing countries in East Asia.

Now that China has opened up somewhat to foreign investment and is looking to spend its foreign reserves, there is enormous opportunity to invest in the Chinese economy. Yet despite this new receptiveness to outside investment and mainland China's willingness to engage in commerce abroad, doing business in mainland China can be challenging and complicated. Given this, Muslim investors from abroad will likely be encouraged to play the mainland China market by way of Hong Kong.

Hong Kong has long been the key access point for investment into mainland China. This may prove to be the key pillar to support Hong Kong as an Islamic finance centre. Given its respected common law legal system, less restrictive immigration policies, laissez faire capital markets regulations, low taxation, English language proficiency and freely traded currency pegged to the US dollar, Hong Kong remains the financial services hub for the region.

Hong Kong, which is governed as a semi-autonomous unit of China, benefits from its own commercial laws and capital market system. With a well-established stock market and a critical mass of international banking professionals, it is already a world leader in conventional finance.

Much of the infrastructure needed to promote an Islamic finance marketplace is already in place, including the presence of seasoned regulators, a stock market, major trading houses, investment banks, and accounting and law firms.

### **Special Opportunities**

The combination of Hong Kong's existing financial sophistication and its role as the traditional gateway to mainland China makes it uniquely qualified to serve as an Islamic finance hub in Asia. If it can overcome the obstacles it currently faces and charge ahead boldly without losing the momentum it has gained in the past year, Hong Kong may well be able to transform itself into a key Islamic finance centre.

In particular, Hong Kong has the potential to excel in promoting Shariah-compliant project finance for infrastructure and energy projects. Hong Kong can also play a useful role as a regional, or perhaps even global, Islamic capital markets centre (especially with respect to Sukuk issuance and trading).

It is predicted that over the coming decades China will continue to develop its infrastructure on a colossal scale as it continues its march towards modernity. In particular, China will have to continue to greatly expand its energy industry.

This will likely include the large scale construction of power plants, refineries, transmission grids, pipelines, ports and liquefied natural gas (LNG) terminals. For instance, Qatar and China have entered into contracts for the long-term delivery of potentially billions of dollars worth of LNG imports, and the country is planning to build up to a dozen LNG import terminals in coming years.

Many of these infrastructure and energy projects will be ripe for project financing – an area of expertise in which Hong Kong banks and professionals already excel. Financing for energy projects can be accomplished,



in most instances, in a Shariah-compliant manner and several significant energy projects in the Gulf (including the Dolphin gas project in the UAE) have already utilised Islamic finance structures.

Muslim investors could therefore play a pivotal role in energy project development and financing in mainland China. This is especially true given the fact that a significant portion of the energy investments will likely be made in collaboration with Middle Eastern nations, sovereign wealth funds and corporations which likely would prefer to use Shariah-compliant techniques.

Given the tendency in the energy industry for energy producers and consumers to cooperate on massive infrastructure development projects, ideal opportunities for Middle Eastern investment into Chinese projects may arise. LNG projects in particular require considerable investment in new facilities, ships and related infrastructure, and typically the sponsors of such projects include both the source of the natural gas (for example, countries such as Qatar, Algeria, Malaysia and Indonesia) and the users of the imported natural gas (for example, South Korea, Japan and, increasingly, China).

With interests aligned in this fashion, Shariah-compliant investment from the Middle East into the Chinese LNG, oil and gas, electric power and related sectors could eventually be measured in the tens of billions of dollars. Hong Kong is perfectly positioned to coordinate, promote and benefit from such investment.

Hong Kong could also prosper as an Islamic capital market hub. A declared goal of the Hong Kong government is the establishment of an active Sukuk trading market to complement the city's existing well-respected capital market system. Hong Kong has deeply liquid markets trading a variety of conventional financial products and serving investors throughout Asia and beyond.

Hong Kong is well positioned to take advantage of longstanding relationships with capital-hungry companies in mainland China and throughout the Asia-Pacific region which may look to Sukuk issuance as a means of raising capital. A Sukuk platform (the issuance, listing and secondary trading of Sukuk) would complement the city's existing financial services portfolio.

While Hong Kong can generally be described as a lightly regulated, low tax environment with deep liquidity and substantial financial flexibility, special rules (such as the tax rules on profits as discussed above) will need to be reviewed in order to make Hong Kong competitive with major Sukuk players like Dubai and Kuala Lumpur, where laws have been specifically tailored to focus on Islamic products.

Hong Kong will benefit from the lessons learnt by – and may well seek to emulate some of the successful initiatives undertaken by – other Islamic markets. Because Hong Kong already has a well diversified and long established financial markets system, grafting Islamic finance products onto it will merely add another layer to an already robust and complex system.

### **Challenges and Competition**

Despite the promise of Hong Kong as an Islamic finance hub, the city faces a number of challenges. Islamic finance continues to be regarded as somewhat exotic in Hong Kong, where terms like Musharakah and Sukuk remain largely unknown.

Financial professionals in Hong Kong have nonetheless exhibited at least a curiosity (if not outright enthusiasm) for the subject, if one can adequately judge their interest from attendance at Islamic finance seminars and related events. Besides, Hong Kong has only a handful of experts in Islamic finance. This is likely due to the fact that Hong Kong, out of a population of about seven million, only has at most a few hundred thousand Muslims. This is in stark contrast to existing Islamic finance hubs in Southeast Asia and the Middle East.

Although worldwide the Islamic finance marketplace is still a relatively new phenomenon, there are already a number of established competitors with quite a headstart over Hong Kong – most with large Muslim populations and boasting of strong Islamic finance banks and exchanges (many backed by substantial government support). Nations in the Gulf (particularly the UAE, Saudi Arabia and Bahrain) already have decades of experience in Islamic markets. In East Asia, Hong Kong faces direct competition from a number of sources. Malaysia remains the traditional Islamic finance powerhouse in Asia and is still one of the world's largest Sukuk markets. Its capital, Kuala Lumpur, is already home to a substantial number of respected Shariah scholars and Islamic finance experts.



Upstart Singapore is actively pursuing initiatives of its own and DBS Group Holdings, Singapore's largest bank, recently established the Islamic Bank of Asia to focus on Shariah-compliant investment activities. Islamic countries in Southeast Asia such as Indonesia and Brunei have large Muslim populations from which to develop a retail market in Islamic products. Even Tokyo recently announced its intention to support the growth of Islamic finance activities in its market. Hong Kong will no doubt face stiff competition from these other players, but there is also room for collaboration.

On closer inspection, however, many of these seemingly intractable obstacles are perhaps not as challenging as they initially appear. First, if the dramatic growth in global Islamic markets continues, the rising tide may lift all boats. In other words, there may be room for several regional Islamic finance hubs, even in East Asia (especially if each specialises in particular areas of expertise).

Second, a lack of experts and expertise can be remedied by education and immigration. Hong Kong has long been a magnet for mobile expatriate professionals and is already home to a well-educated population eager to learn more about new and novel opportunities for economic success.

It is also clear that the government is making a determined effort to educate itself and inform local commercial leaders on Islamic finance. Finally, Hong Kong enjoys certain unique advantages that may eventually ensure its long-term success as an Islamic finance centre.

### **Way Forward**

Hong Kong has made some progress in the Islamic finance arena but still has a long way to go. For it to become an Islamic finance hub, the government as well as private enterprises interested in Islamic finance should take bold action to establish an environment that is conducive to Shariah-compliant finance and investment.

This includes revising existing capital markets and tax laws so that they are compatible with Sukuk and related products and competitive with the regulatory regimes in other Islamic finance markets. This will be necessary for a Hong Kong Sukuk market to succeed amid competition from other established exchanges like Dubai and Malaysia.

Hong Kong should continue to build relationships and strengthen business connections with the Middle East and Southeast Asia and learn from the successes and failures of other Islamic finance market players. Already an attractive location for both local and expatriate professionals, Hong Kong should also seek to educate its business leaders on Islamic finance matters and encourage Islamic finance professionals and institutions to establish a presence in the city.

With its unique attributes, if Hong Kong is able to nurture its nascent Islamic finance marketplace, it could in short order be transformed into the primary proponent of that 'New Silk Road', with responsibility for coordinating both massive Shariah-compliant investment into Chinese infrastructure and developing a thriving East Asian Sukuk market.

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