

Islamic finance in Hong Kong: supervisory issues

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Islamic finance has been growing rapidly worldwide in recent years. In his 2007 Policy Address, the HKSAR Chief Executive identified its introduction and the development of an Islamic bond market in Hong Kong as key government initiatives. This article explains the HKMA's current supervisory approach to Islamic finance in Hong Kong, covering primarily the approval criteria for setting up an Islamic Banking Window as part of an existing Authorized Institution's operation and the supervisory treatment for AIs' exposures to Islamic bonds.

Introduction

In supporting the Government's initiative to develop a platform for Islamic finance in Hong Kong, the HKMA recognises the need to clarify its regulatory approach to such activities. This article aims, at least in part, to serve this purpose.

Approval requirements for Islamic Banking Windows

AIs may participate in Islamic finance activities through two generally accepted organisational forms. First, they may operate a separate business unit within the institution itself, with the unit's operations based on Islamic law or Shariah. This unit is known as an Islamic Banking Window (IBW). Alternatively, they may establish and operate a subsidiary for the sole purpose of conducting Islamic finance business. If such a subsidiary is to be involved in banking, or deposit-taking business, it will be required to obtain an authorization from the Monetary Authority under section 16 of the Banking Ordinance (BO). Overseas Islamic banks may apply for an authorization under the same section of the Ordinance for the establishment of a branch in Hong Kong.

An IBW is a business unit within a conventional AI, usually a bank, enabling it to offer Islamic financial

services using the bank's existing infrastructure and branches. It can therefore be established quickly and at relatively low cost. Hong Kong's first IBW was recently established within a branch of a Malaysian bank in the city. From a market perspective, the setting up of IBWs by existing AIs can be seen as an efficient way of providing a critical mass of players offering Islamic financial services, which will be crucial in developing Hong Kong's Islamic finance platform.

An AI proposing to establish an IBW is not required to obtain a separate authorization under the BO. However, the AI should discuss its plan with the HKMA before launching the IBW. The plan should be credible and based on realistic assumptions in relation to the particular nature of the Islamic financial operation. Topics to be covered in the discussions between the AI and the HKMA are likely to cover:

- (i) the AI's risk management process to ensure that the risks inherent in the Islamic financial products to be offered by the IBW are well understood, assessed, monitored and controlled;
- (ii) the AI's policies, procedures and controls to ensure that the products are Shariah-compliant;
- (iii) the preparation of the contractual documentation underpinning the Islamic financing transactions to minimise legal disputes; and

(iv) the proper disclosure of risk and return to depositors.

These issues will also be applicable to the evaluation of an application for separate authorization under section 16 of the BO for an institution seeking to specialise in Islamic financial activities. The HKMA's views and assessments on each of these are discussed in detail in the following paragraphs.

(i) Risk management

While conventional banking is based primarily on an interest-based debtor-creditor relationship, Islamic financial transactions are more complex given the diverse contractual relationships between the banks and their customers, ranging from lease-based to equity-based modes of finance. Therefore, a new Islamic banking product or service should be subject to careful evaluation and pre-implementation review by the AI. This is to ensure the Board, or its designated committee, and management, fully understand the risk characteristics inherent within the new product or service, and that there are adequate staffing, technology and financial resources to launch and support its operation.

The general process of evaluating an Islamic product or service prior to launch is similar to that for a conventional product. A proposal to introduce the new product or service should include a full description, a detailed risk assessment; a cost and benefit analysis; consideration of the related risk management implications and identification of the resources required; an analysis of the proposed scale of the new activities in relation to the bank's overall financial strength; and the procedures to be used for measuring, monitoring and controlling risks. Due internal consultation, including legal and compliance aspects, should be carried out regarding the proposal.

(ii) Shariah compliance

Banks are responsible for ensuring that Islamic products or services are Shariah-compliant both before and after launch. It is important to maintain the integrity of the products and to avoid possible

subsequent disputes. Effective monitoring of Shariah compliance can be done through appropriate Internal Shariah Audit processes and by developing more knowledge and expertise among staff.

As an industry practice, a new Islamic financial product or transaction should be reviewed by a bank's Shariah supervisory board to declare the product or transaction's compliance. In approving the establishment of an IBW or a new product to be launched by an Islamic Banking Window, the HKMA, being a secular regulator, does not review the role or composition of the Shariah supervisory board, nor does it express an opinion on the validity of that board's recommendations and decisions. However, the HKMA expects the basis on which a bank claims that its products or services are Shariah-compliant will be clearly communicated to its customers.

There is a shortage of appropriately-qualified Shariah scholars in the Islamic financial industry. This raises the concern that individual scholars could be responsible for various functions within a bank, and hence may have a conflict of interest. For example, a scholar may be responsible for Shariah compliance audit functions as well as for approving the products initially for Shariah compliance. The HKMA expects these conflicts to be diligently and properly managed.

Depending on the position of a Shariah scholar within the organisational structure of an AI, the scholar may be regarded as a "manager" appointed under section 72B of the BO. The AI will be required to ensure that the scholar meets, and continues to meet, the fit and proper criteria set out in the HKMA's relevant guideline.

As an industry practice, the risks arising from Islamic business and products are often pooled with risks from conventional business in the case of IBWs; and conventional tools are used to manage those risks, at business unit or group level. Separate books are, however, kept for Islamic business and conventional business. These practices have been accepted by Islamic scholars.

(iii) Contractual documentation

It is generally understood that the enforceability of an Islamic financial contract is dependent on the governing law of the contract. Therefore, it is advisable that contracts evidencing Islamic financial transactions should be carefully written to minimise potential disputes and should clearly set out the governing law of the contract.

(iv) Disclosure of risk and return to depositors

Deposits placed with an Islamic bank or IBW are mainly in the form of investment deposits. The depositors adopt the role of quasi-shareholders who are not only entitled to share in the profits of the Islamic banking business, but are also exposed to the risk of losing their capital in the event of losses. It should be noted that, as matters currently stand, investment deposits are not regarded as “protected deposits” under the Deposit Protection Scheme Ordinance or the temporary deposit guarantee by the Exchange Fund announced on 14 October 2008. Improved financial disclosures on the risk and return profiles of the different categories of deposits, as well as their status under the DPS, will enable depositors, potential or otherwise, to make informed decisions.

Supervisory requirements and procedures for IBWs

The supervisory issues raised by an AI participating in Islamic financial activities are similar in many respects to those of an AI engaging in conventional banking business. For example, both types of AI will need to have adequate financial resources and maintain a risk-weighted capital adequacy ratio of not less than 8%, and adequate liquidity to meet their day-to-day funding needs. In general, the regulatory framework and prudential standards for conventional AIs set out in the Banking Ordinance and in the supervisory guidance issued by the HKMA are applicable to the regulation of AIs participating in Islamic financial activities.

Similarly, AIs with IBWs are subject to the same supervisory processes, including off-site reviews and on-site examinations that are applicable to other conventional AIs. However, the HKMA may require AIs with IBWs to provide separate information regarding their IBW operations, such as a segregated balance sheet and income statement and discrete information about liquidity and customer deposits within the IBW, in addition to the usual statistical returns containing data on both the IBW and conventional activities of an institution. The HKMA will also take into account the separate characteristics and scale of the operation of the IBW in determining the exact scope and extent of off-site reviews and on-site examinations.

Supervisory treatment for sukuk

A significant and growing volume of the business generated in Islamic finance has taken the form of Shariah-compliant asset or equity-based securities known as sukuk. Consistent with its role as an international financial centre, Hong Kong is taking steps to develop its own sukuk market. Hence, it is useful to clarify the regulatory principles and treatment for holdings of sukuk, particularly for capital adequacy, large exposure and liquidity requirements.

The HKMA's supervisory policy for holdings of sukuk is based on the principles of a level playing field and economic substance. The supervisory standards to be applied to AIs' exposures to sukuk will be the same as those applying to their conventional equivalents. In deciding on specific supervisory treatment, the HKMA will consider whether sukuk, irrespective of their legal form, can be regarded as the economic equivalent of conventional bonds. This determination will, in turn, govern how sukuk should be treated under the existing law and regulations. For example, many sukuk may superficially resemble securitisation transactions because of the existence of a pool of underlying assets which generate cash flow for repayment, but in substance their investors can only rely on the ultimate obligor of the sukuk for repayment, with no or limited recourse to those

underlying assets. Consequently, applying the regulatory requirements for securitisation in such cases will be inappropriate. The HKMA is developing its supervisory policy on sukuk and other Islamic finance activities of AIs by reference to the guidance issued by the Islamic Financial Services Board¹ (IFSB) and regulators in major Islamic jurisdictions to ensure its policy is appropriate to the risk exposures in such business and activities and in line with international standards.

For capital requirements for credit exposures to sukuk, AIs are expected, at this stage, to calculate the necessary capital charge based on the Standardized (Credit Risk) Approach set out in the Banking (Capital) Rules (BCR). This reflects the early stage of development of the sukuk market in Hong Kong and the need to accumulate sufficient historical data before applying the Internal Ratings-Based Approach to such activities. Although there may be cases where the capital treatment may vary according to the structure of a given sukuk issue, AIs in general should treat sukuk as conventional bonds and risk weight them in accordance with their External Credit Assessment Institutions (ECAI) ratings. The IFSB capital adequacy guidance provides for a “look-through” approach² for unrated issues. As this approach is not permitted under the current BCR for non-securitisation exposures, it will not be made available to AIs for sukuk issues in order to maintain a level playing field. If a particular issue of sukuk is regarded by the Securities and Futures Commission or an overseas regulator as a Collective Investment Scheme (CIS), exposures to these sukuk

should attract the appropriate risk-weighting treatment for CIS as set out in the BCR.

Under section 102 of the BO, all AIs, irrespective of their place of incorporation, are required to maintain a liquidity ratio of not less than 25%. In calculating its liquidity ratio, an AI may include its holdings of marketable debt securities, which are defined under the Fourth Schedule to the Ordinance, as debt securities that have an established secondary market in Hong Kong or elsewhere in which they can be sold readily. Where the underlying assets of sukuk are financial assets (for example, receivables, as in the case of Salam sukuk), such sukuk are non-tradable since debt trading is against Shariah principles. Some other sukuk are tradable, but trading of these sukuk may be rare due to inactive markets. Therefore, sukuk may not satisfy the definition of “marketable debt securities” for liquidity ratio purposes.

Holders of sukuk are usually denoted as having an undivided beneficial ownership interest in the assets underlying the sukuk, which may contain interests in land or shares. This raises the issue of whether a holding of sukuk will potentially constitute a financial exposure to, and an ownership interest in, the underlying assets or equity, which should be subject to the statutory limitations imposed on locally-incorporated AIs by Part XV of the BO. While recognising that this assessment should be based on the structure and terms of each individual issue, the HKMA notes that sukuk holders will normally only have very limited rights in the underlying assets and these rights are usually enforceable only between the issuer and the obligor of the sukuk concerned. As such, a holding of sukuk will generally be caught by section 81(2)(b) of the BO as a holding of securities, but it might not amount to a holding of any interest in the underlying assets.

In addition to sukuk, the HKMA has also been analysing some other common forms of Islamic financing such as Ijara (leasing), Murabaha (cost plus financing) and Musharakah (partnership financing) to determine if any adjustment to the existing regulatory

¹ The IFSB serves as an international-standard setting body of regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Islamic Shariah principles, and recommending them for adoption. In relation to banking supervision, the work of the IFSB complements that of the Basel Committee on Banking Supervision. The HKMA is an associate member of the IFSB.

² “Look-through” approach, in relation to sukuk, means the methodology of allocating risk-weights to sukuk based on the credit risk of their underlying Islamic contracts. For example, if the underlying contract of a sukuk issue is Ijara (leasing), the risk-weight of the lessee can be allocated to the sukuk.

framework is required to cater for exposures to these transactions. The result of the HKMA's preliminary review is that no major change to the existing framework appears necessary, except possibly for some discrete areas, such as the introduction of a specific capital treatment for inventory risk³, which may require further deliberation. Given the complex structure of Islamic financial products and the wide variety of contract terms underpinning them, AIs intending to engage in Islamic finance should fully understand the regulatory treatment applicable to the particular types of products involved in their activities and perform self-assessments of compliance with the relevant statutory requirements. The HKMA should be consulted in case of doubt.

Conclusion

While this article discusses a number of issues that are peculiar to Islamic financial activities, it suggests the regulatory issues raised by AIs' participation in them are similar to those arising in conventional banking business. It follows that, in general, the regulatory framework and standards applicable to conventional banks also apply to AIs participating in Islamic banking activities. As Islamic finance is relatively new in Hong Kong, the HKMA will closely monitor developments in this area and will continue to review the need to adjust its regulatory framework or supervisory approach for the supervision of AIs' participation in this business.

³ Inventory risk refers to the risk of losses arising from fluctuations in the value of physical assets held by lending institutions for leasing or selling under certain types of Islamic contracts such as Ijara and Murabaha.
