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STRENGTHENING THE ENVIRONMENT FOR ISLAMIC FINANCE IN HONG KONG – A REGULATORY ANALYSIS

Abstract

Islamic finance has become of increasing interest within the last several decades, given the significant economic rise of many Islamic nations and their growing economic engagement with the People's Republic of China. Major Islamic nations such as those in the Middle East, South Asia, and Southeast Asia have multiplied their investment and trade volumes with China, with Hong Kong naturally acting as a middleman in terms of financing. Furthermore, most of these nations have become more adamant in aligning their religious beliefs together with their investment and financing principles. Hong Kong's banking ordinance represents the major regulatory framework in connection with the SFC's requirements on securities. The article represents a regulatory analysis of the Hong Kong banking and securities framework utilizing a descriptive approach. While existing regulations may provide a basic framework to assist the provisioning of Islamic financial products, a separate regulatory framework that addresses the specific requirements of Islamic financial products and provides targeted regulations is needed. Given the nature of risk sharing between creditors and debtors, in addition to the absence of the charging of interest, this requires that both transactions can be conducted efficiently, as well as that contractual implementation of the connection of assets to the lending requires little overhead. A dedicated regulatory framework for Islamic finance represents a unique opportunity for Hong Kong to place itself at the center of Islamic finance engagement with the People's Republic of China and support the growth of the sector.

Keywords: Islamic Finance, Hong Kong, Financial Regulations, Fintech regulations, HKMA, Securities

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1. Introduction

Islamic finance has seen strong interest in Hong Kong, given the growing engagement of Chinese entities with the Muslim world and the growing importance of trade and financial transactions with these nations [Huang 2016]. Given the importance of the banking sector and its impact on the provisioning of Islamic finance, understanding the regulatory and institutional banking environment in Hong Kong is fundamental for evaluating the regulatory requirements for supporting the growth of Islamic finance within Hong Kong and as a gateway to China. Islamic finance has seen tremendous growth given the significant economic growth of many primarily Islamic nations, such as Indonesia, Saudi Arabia, Turkey, and Malaysia. This has led to a growing demand for Shariah-compliant financial instruments by investors and corporations. With the rising engagement between these countries and China, Hong Kong has been an attractive location for Chinese entities to acquire financing from foreign investors. Due to the significant increase in economic collaboration, there has been a growing need to provide Islamic finance-compliant financial instruments in Hong Kong to capitalize on these opportunities. This requires a solid regulatory framework to support Islamic finance within Hong Kong.

1.1. Hong Kong Banking System

Hong Kong has a three-tier system of banking institutions that covers both licensed banks, banks with a restricted license, and other deposit-taking corporations [Phan, Anwar, Alexander, Phan 2019]. The various money lenders and money brokers have different licensing regimes, laws, and regulations that apply to them. Given the more than 159 licensed banks, which include several virtual banks, and 15 restricted-license banks, there are various specific regulations that apply to these entities [Drake, Hall, Simper 2006]. The main authority overseeing the banking sector is the Hong Kong Monetary Authority (HKMA), which is responsible for maintaining the monetary and banking stability within the special administrative region of China. In terms of regulations, the Banking Ordinance is the major regulatory framework that requires that any corporation carrying out banking businesses or taking deposits have to be authorized by the HKMA. These institutions are also denoted as authorized institutions (AIs). The HKMA has several objectives, such as the maintenance of currency stability and the promotion of the stability and integrity o the financial system [Wong, Fong, Choi 2011]. Furthermore, it shall support Hong Kong in maintaining its status as an international financial center in addition to managing the exchange fund, which are the official reserves of Hong Kong. As compared to conventional central banks, the HKMA

formulates and implements the monetary policy, supervises the banks, and manages the exchange fund, but does not issue bank notes. This is performed by commercial banks in Hong Kong.

1.2. Hong Kong Banking Regulatory Framework

The Banking Ordinance (BO) is the primary legal framework for banking regulations and is supplemented by the Supervisory Policy Manual and the Guide to Authorization [Eastwell 1986]. The policy manual outlines the supervisory policies and practices, while the authorization guide focuses on the authorization criteria and the procedures for processing such applications for authorization. Furthermore, it also stipulates the criteria when licenses are revoked. In order to become authorized, there are several criteria that have to be fulfilled [Li 1999]. Specifically, the AI has to be a corporation in general. In case the applicant is a bank incorporated outside Hong Kong, then the HKMA has to liaise with the relevant overseas banking supervisory authority to ensure that there is consent related to the establishment of a branch in Hong Kong. The criteria for the authorization are outlined in the Seventh Schedule to the Banking Ordinance and require that the institution taking public deposits has to be fit and proper [Law: 2021]. Besides the HKM, the Securities and Futures Commission of Hong Kong (SFC) regulate jointly any institutions that have activities defined in the Securities and Futures Ordinance (SFO). These activities incorporate dealing with securities, advising on securities, and also on corporate finance and asset management. Carrying out a business within a regulated activity without proper licensing is a criminal offense, and the institutions have to become registered institutions by satisfying the requirements of the SFC [Lee 2021].

The SFO stipulates a limited number of regulated activities that can be carried out by institutions without a license. Such activities are leveraged foreign exchange trading and certain types of securities margin financing.

In terms of the insurance industry, the Insurance Authority regulates via the Insurance Ordinance any business that provides insurance products. Therefore, any corporation that provides insurance products is required to have licensing from the Insurance Authority.

For the virtual asset (VAs), there is specific guidance issued by both the SFC and the HKMA, which relates to the distribution of VA-related investment products and related dealing, advisory, and asset management services. The guidance outlines a framework for institutions and intermediaries that provide these services and distribute the productions to professional investors. This requires compliance with investor protection safeguards [He 2014].

Cross-border marketing plays an important role within the regulatory framework as it prohibits marketing that represents an invitation to make deposits. This equally applies to individuals that are outside Hong Kong and market the deposits to individuals in Hong Kong. There are specific exceptions related to specific institutions and deposits that have specific disclosures, but a proper license is required by the SFC in order to provide the active marketing of their services [Huang, Yang, Loo 2020].

Overseas regulators may be recognized in order to provide services and products in Hong Kong, but generally, various regulations are applicable as well. This excludes corporate governance and capital adequacy-related provisions that are addressed by the overseas regulator. There are certain capital thresholds that the bank has to fulfill in order to be authorized. The HKMA also ensures supervision based on the day-to-day operations that incorporate internal risk control and risk management, in addition to liquidity management and trading activities [Yang 2017].

When it comes to risk management, the institutions need to follow the guidelines of the HKMA in having a solid risk management system and solid internal controls in order to have solid stability in the banking system. The major risks outlined by HKMA are the credit, interest rate, market, liquidity, operational, legal, reputational, and strategic risks. The main risk management rating system is the CAMEL system in order to reflect the HKMA's focus on safety and soundness. The HKMA performs regular supervisory reviews and assesses the inherent risks for risk-based supervision. The HKMA provides rules based on Basel III technical guidance and stipulates the review process based on Basel III capital standards [King: 2013]. This implies that banks need to have capital conservation buffers and countercyclical capital buffers. Furthermore, there is also the requirement to have a higher loss absorbency (HLA) support. These buffers shall aim to strengthen liquidity requirements for these entities.

An interesting development in the area of banking is the new module GS-1 in the Supervisory Policy Manual that deals with climate risk management. The module provides guidance for institutions to enhance climate resilience, taking into account climate considerations in governance, strategy, risk management, and any disclosures. These climate-related issues include both physical and transition risks and focus on governance, climate strategy planning, and implementation, as well as the incorporation of climate-related risk considerations into the risk management framework. This also includes disclosure. The module has the view that climate risk can be managed with the existing traditional risk management framework [Tsang 2018].

1.3. Capital requirements

The capital adequacy ratio is the amount of financial resources required in order to cope with the inherent risks in its business operation in order to reduce the risk of insolvency. The main requirements in the Banking Ordinance are based on the Basel III framework that should have a CET1 capital ratio of a minimum of 4.5 percent, while the Tier 1 capital ratio is at least 6 percent, and the total capital ratio should be around 8 percent. The Hong Kong branches are not subject to the requirement, but generally, there has been the requirement to have a capital adequacy ratio of at least 8 percent or the minimum risk-weighted capital ratio. The main power of the HKMA is that it can vary the capital requirement under the Banking Ordinance. When it comes to leverage, then leverage is a non-risk-based measure to ensure that no excessive leverage in the banking sector is encountered. This provides an additional safeguard for model risk and measurement error in risk-based capital adequacy ratios. The capital buffers are the capital conservation buffer, the countercyclical capital buffer, and the HLA requirement. The capital conservation buffer represents an additional band of CET1 capital with 2.5 percent [Yung 2013].

Another critical part is the ability of banks to have the capacity of absorbing losses for corporations that are incorporated in Hong Kong. The loss-absorbing capacity (LAC) requirement will be computed both in terms of external and internal LAC. The LAC has the requirement that some of it are in the form of debt. This ensures that there is a buffer that ensures that there is an equity-independent fund available in order to support the orderly resolution.

When it comes to the consolidation of the capital requirements, then the capital requirements are based on a solo and consolidated basis. There is a general requirement for every single institution to have sufficient capital adequacy ratios. Additionally, if the banking and financial businesses are conducted via subsidiary companies, then the institutions are required to have sufficient capital on a consolidated basis. This shall ensure that the capital position is sufficient in order to support any challenges arising from the financial difficulties of its subsidiaries. There are exceptions in terms of this provided that a supervisory review process delivers proper justification [Jumah, Burt, Buttram 2012].

Institutions are required to report over-the-counter (OTC) derivatives that cover interest rate swaps, non-deliverable forwards, FX derivatives, equity derivatives, credit derivatives, and commodity derivatives. The mandatory clearing requirements focused on standardized interest rate swaps between major institutions, and a licensed financial service provider. If an institution exceeds the average three-month clearing threshold, then the institution is

subject to mandatory clearing and has to keep the corresponding records related to it. For foreign transactions, only those that are recorded on the books in the local affiliate have to be taken into account [Garcia-Herrero 2011].

A crucial new development is the promotion of sound corporate cultures for banks and concentrating on governance and incentive systems. Additionally, the institutions shall ensure proper assessment and feedback mechanisms. This implies that the senior management shall set an appropriate tone and lead by example, and avoid the incentive of short-term business performance at the cost of the safety and soundness of the bank. Furthermore, behavioral standards and whistle-blowing mechanisms need to be put in place. This requires institutions to conduct self-assessments of the banking culture and to have both site visits as well as meetings with senior management and board members in order to provide lessons learned [Zheng, Ho 2012]. These self-assessments provide the basis along which companies shall conduct their business operations. The self-assessments shall be used as a guide for the promotion of sound culture and the prevention of misconduct, as well as ensure that the employees are engaging in continuous professional development in order to implement such policies. In connection with this is the requirement for the establishment of a code of conduct that sets the standards for behavior expected by both the management and employees. This shall discourage conflicts of interest, bribery, and personal investments when insider information is available. Furthermore, reporting illegal activities and supporting the effectiveness of the code of conduct are of utmost importance [Gangi, Meles, D'Angelo, Daniele 2019].

Deposits of customers represent the majority of funding for banks, and the HKMA has a stable funding requirement that ensures that banks with significant growth in loans have adequate funding to support the lending business. In addition to these requirements, there are specific resolution facilities where the full liquidity facilities comprise the settlement facilities, standby liquidity facilities, contingent term facilities, and resolution facilities. The resolution facility ensures that an institution that experiences a resolution process has sufficient liquidity [Zhang 2008].

The depositors have credit protection for specified deposits under the Deposit Protection Scheme Ordinance. These eligible deposits do not include structured deposits, bearer instruments, term deposits that have a maturity greater than five years, and offshore deposits. The regulations also exclude financial products beyond deposits. The objective of the protection scheme is to protect small depositors, and the scheme is funded by each member of the scheme.

1.4. Regulatory Technology

Regulatory technology is a major change in the industry in order to manage the risks with associated treasury activities, which include operational, legal, liquidity, and market risk. Regtech may significantly help in strengthening risk management controls for treasury operations that involve a large volume of trading via multiple systems. Treasury activities typically have a number of manual processes, and the risk assessment is based on the collation and analysis of a significant number of data. The systems for these data are different within the same institution. There are several softwares available for the standardization of the digital representation of derivative products, and this may enhance to achieve consistent representation of the trade information. Regulatory technology may also help in reducing the risk related to rogue trading and identifying suspicious transactions [Restoy 2021]. Additionally, cloud-based data management solutions may improve the efficiency of the liquidity risk of banks and predict the modeling. The main objective of the regulation is to incorporate various technologies, such as speech-to-text, machine learning related to sentiment, tone and keyword detection, such that it enables the detection of early warning signals. This was partially integrated into the Regtech Adoption Practice Guide that focuses on cloud-based regtech solutions. This shall enhance offsite support and lead to a faster implementation and scalability. The importance also arises with respect to regulatory technology focusing on stress testing, and monitoring customers [Yang, Gan, Li 2019].

An essential part of the Supervisory Policy Manual is the inclusion of Climate Risk Management such that operations shall reduce their impact of their own operations, and also reduce financing of heavily emitting projects. Furthermore, helping clients to transition and support collective efforts transition to a net-zero economy is essential.

A recent initiative was the incorporation of supervisory and enforcement-related initiatives for insurance-regulated activities. The main purpose is for the HKMA to utilize the inspection and investigation powers based on insurance-regulated activities that are carried out by the institutions. Both the distribution, and aspects related to the anti-money laundering and counterfinancing of terrorism are dealt with in the manual [Yim, Lee 2021].

The Greater Bay Area has been a major element of strengthening the economic integration and cross-development along the pearl river delta. This has led to the development of the cross-boundary wealth management connecting the GBA. They may invest via a closed-loop funds flow channel into the wealth management products provided by the markets. There are both Southbound and Northbound Schemes and pilot schemes have been established. This has also led to the establishment of a memorandum of understanding where the PBOC’s

Fintech Innovation Regulatory Facility is linked to the HKMA Fintech Supervisory Sandbox. This shall permit to have a one-stop platform to enable FIs and technology firms to pilot test their fintech initiatives [Auer, et al. 2022].

2. Islamic Finance – Regulatory opportunities

Islamic finance has seen strong interest in Hong Kong given the growing engagement of Chinese entities with the Muslim world and the growing importance of trade and financial transactions with these nations. The financial institutions may support the provisioning of Islamic finance via two organizational forms. They may either operate as a separate business unit within an established institution. The operations of the units have then to be based on Shariah law. This can be also considered as an Islamic Banking Window (IBW) of the organization [Hasan, Hassan, Aliyu 2020]. An alternative is the establishment and operation of a subsidiary that solely provides Islamic finance products and services. Such subsidiaries may have to apply for an authorization from the Monetary Authority under Banking Ordinance section 16 in case they provide banking or deposit services. Any Islamic banks from overseas may have to apply for authorization under the same section 16 for the establishment of a branch in Hong Kong. The IBW is different from this as it offers Islamic financial services based on the existing bank infrastructure and branches. The advantage of such an approach is the relative ease of establishment and low cost. This enables to provide an efficient way to provide Islamic financial services and achieve a critical mass for its offering of Islamic financial services. For Hong Kong, a separate authorization for the provisioning of this service is not required per the bank ordinance. Nevertheless, any such offerings have to be discussed with the HKMA to ensure that the offerings have a solid plan and provide realistic assumptions. These topics focus on the risk management process in order to ensure that the inherent risks in the Islamic financial products are well understood, assessed and monitored. Furthermore, the risk has to be controlled. Additionally, the policies, procedures and controls have to be investigated in order to ensure that the products are compliant with Shariah law. Additionally, the contracts and contractual clauses for the Islamic financing transactions have to be solidly documented in order to minimize any legal disputes. Finally, risk and return to depositors have to be properly disclosed (Hanieh, 2020).

These issues and addressing them with the relevant authorities is a critical aspect when investigating the regulations. In terms of risk management, Islamic financial transactions have a significantly more complex relationship between the debtor and creditor. This ranges from lease-based to equity-based modes of finance that differ significantly from

conventional interest-based debtor-creditor relationships. This requires a more solid evaluation and pre-implementation review by the institution and shall ensure that the board and management have a complete understanding of the risk characteristics that are inherent in the new products or services. Additionally, there should be sufficient staff, technology and financial resources in order to support and launch the operations. For any new Islamic product or service there has to be a proposal to introduce the new product or service, which includes a full description, detailed risk assessment, and a cost and benefit analysis.

2.1. Islamic Finance risk management requirements

Furthermore, the impact on risk management and the associated resources required in order to tackle the impact has to be identified. Also, the new activities have to be analyzed in relation to the financial strength of the bank, in addition to the procedures for risk to be measured, monitored and controlled. Furthermore, legal and compliance aspects have to be carefully considered and analyzed [Mnif, Jarboui, Hassan, Mouakhar 2020].

Shariah compliance is an important responsibility for the provider of these services, and these instruments have to be compliant both before and after the launch. This requires solid integrity of the products that are offered to avoid possible disputes and this requires the setup of Internal Shariah Audit processes. Furthermore, the development of knowledge and expertise among staff is critical.

The Shariah supervisory board needs to ensure that new Islamic financial products or transactions are reviewed and provide a declaration of the compliance of the product or the transaction. The HKMA may set up a separate supervisory board or expert council that validates the board's recommendations on the Shariah compliance, as this will strengthen the oversight. Furthermore, it ensures that the Islamic requirements are equally applied to all providers of such Islamic finance products. There may be potential conflicts of interest given that in some instances, the Shariah scholars may have multiple functions in entities that they are operating in. This has to be addressed carefully by the HKMA with an expert team that diligently analyzes the services and products. Generally, risks are pooled together with the risks of conventional businesses for many financial institutions that provide both conventional and Islamic financial products [Saeed Meo, Jameel, Chowdhury, Ali, 2021].

The enforceability of Islamic financial contracts is fundamental for any strong provisioning of Islamic financial products. Therefore, it's dependent on the governing law of contract. This requires that the contracts are solidly drafted and to minimize the potential disputes. This is also in the context of the risk of disclosure and the expected return to depositors.

Islamic deposits are in the form of investment deposits, where the depositors take on a quasi-shareholder role. This implies that they are entitled to share profits, but are also exposed to any risk of losing their capital. This implies that the Deposit Protection Scheme Ordinance does not consider such investment deposits as protected deposits and this implies that there is currently considerable more regulatory requirements needed in order to support the sphere and outline the differences to people [Oseni, Hassan, Hassan 2019].

Supervisory requirements for Islamic finance products are similar to those in conventional banking environments, but the supervisory bodies should have a solid knowledge of the requirements of Shariah law. With respect to minimum financial requirements, Islamic banking institutions may follow the same requirements of having a risk-weighted capital adequacy ratio of at least 8 percent and have sufficient liquidity resources for their daily needs. In the current framework, the regulatory framework and prudential standards for ordinary financial institutions are applied to those Islamic banking institutions. Given the different nature of the Islamic financial services, this may not be adequate and requires separate liquidity and customer deposit information. The characteristics of the Islamic financial institutions and scale of operations are significantly different from conventional banking institutions [Alam, et al. 2019].

2.2. Regulations for Islamic Financial Instruments

Sukuk instruments have been very attractive in recent years by major enterprises and governments in order to raise funds. Sukuk are Shariah-complaint asset or equity-based securities, and require a different regulatory environment and treatment of the holdings, taking into account the capital adequacy, exposure and liquidity treatment. The standard regulatory question that arises from the treatment of sukuk is whether they are equivalent to conventional bonds. This is in fact not the case given the different characteristics of sukuk as compared to a bond. Hence, applying the same regulations and laws would distort the characteristics of the sukuk and may misrepresent the sukuk format. Additionally, the regulatory requirements should be in agreement with the guidance and regulations in other major Islamic jurisdictions. This ensures that investors have a solid understanding and trust in the regulations and that these are in alignment with generally accepted Islamic finance principles and regulations. Furthermore, it enables to strengthen possible dual listing opportunities and attract foreign Islamic investors to utilize Hong Kong for their investment decisions. While for the capital requirements for risk exposure to sukuk, a standardized approach based on credit risk may be of interest, such an approach is definitely not adequate

in taking into account the features of the sukuk instruments, and would be a very simplistic approach to the variety of different sukuk structures that are encountered in the market. Furthermore, sukuk instruments are either equity or asset-based which provides them with a different evaluation requirement. Given that for conventional bonds External Credit Assessment Institutions (ECAI) ratings may be used as a guidance, these have to be considered in terms of the sukuk structure and repayment schedule. This necessarily requires a solid risk-weighting treatment in case these are considered as Collective Investment Schemes (CIS). Taking into account the section 102 of the banking ordinance, all these institutions require have a liquidity ratio of at least 25 %. The calculation can include holdings of marketable debt securities that are debt securities with a solid secondary market in either Hong Kong or any other market. In the case that the assets of the sukuk are in the form of financial assets, such as Salam sukuk, where the assets are receivables, then such a sukuk is not tradable. Specifically, the trading of debt is not compliant with Shariah principles. The challenge that arises is that only few sukuks are tradable and may not be considered a marketable debt security for the purpose of liquidity. This outlines the necessity to have a different regulatory framework for such Islamic finance instruments as the current regulations may not be adequately applied to sukuk instruments [Kepli 2012].

The holders of sukuk are declared as individuals that have a beneficial ownership interest in the assets that underlie the sukuk. This may contain interest in either land or shares. This may be considered as a form of ownership interest in the underlying asset or equity, which may represent a core part of the regulations that are analyzed. One has to take into account the potential challenges that arise from the limited rights in the underlying rights with respect to the existing regulations.

While recognizing 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. Hence, according to regulations in section 81 (2)(b) of the banking ordinance that they may not satisfy the holding of the interests in the underlying assets.

Additionally, there has been consideration for other forms of Islamic financing, such as the Ijara (leasing), Murabaha (cost-plus financing) and the Musharakah (partnership financing). While on the surface, the existing regulatory seemed to be fit for purpose, a more comprehensive investigation outlines the importance to have a dedicated regulatory framework in order to fully support the Islamic finance environment and address the complexity and different nature of Islamic financial products [Kirk 2013].

Substantial questions arise in terms of how financial services will be provided in such an environment and how existing financial regulations can support the provisioning of new financial services and products in China incorporating Islamic principles. Furthermore, questions arise on how artificial intelligence and blockchain play a critical role in strengthening the finverse and making it compatible with Shariah law.

3. Conclusion

Islamic finance has become of increasing interest within the last several decades, given the significant economic rise of many Islamic nations and their growing economic engagement with the People's Republic of China. Major Islamic nations such as those in the Middle East, South Asia, and Southeast Asia have multiplied their investment and trade volumes with China, with Hong Kong naturally acting as a middleman in terms of financing. Furthermore, most of these nations have become more adamant in aligning their religious beliefs together with their investment and financing principles. Hong Kong's banking ordinance represents the major regulatory framework in connection with the SFC's requirements on securities. While existing regulations may provide a basic framework to assist the provisioning of Islamic financial products, a separate regulatory framework that addresses the specific requirements of Islamic financial products and provides targeted regulations is needed. Given the nature of risk sharing between creditors and debtors, in addition to the absence of the charging of interest, this requires that both the transactions can be conducted efficiently, as well as that contractual implementation of the connection of assets to the lending requires little overhead. A dedicated regulatory framework for Islamic finance represents a unique opportunity for Hong Kong to place itself at the center of Islamic finance engagement with the People's Republic of China and support the growth of the sector.

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