



## Sukuk Issuance in China: Trends and Positive Expectations

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### ABSTRACT

The paper assesses the potential and importance of Sukuk issuance in China. The research proposes that Sukuk can be used as an alternative financing instrument to materialize the “One Belt One road (OBOR)” strategy. Hong Kong as a gateway of China had launched two Sukuks in 2014 and 2015 respectively. This paper analyzes the two sovereign Sukuk issuances out of Hong Kong in the last 3 years. Meanwhile, by conducting un-structured interviews of the potential issuers and related scholars, it is found that Sukuk issuance in China will face some challenges such as policies and regulations of Sukuk, tax and stamp duty issues, investors’ protection, establishing of *Shariah* Supervisory Committee, etc. However “OBOR” initiative provides the best opportunity for Sukuk to move forward in China.

**Keywords:** Sukuk, Islamic Finance, One Belt One Road, Hong Kong, China

**JEL Classification:** O31, P47, Z33

### 1. INTRODUCTION

Sukuk (Islamic bond) as alternative financing instrument to conventional bond, its issuance is popular not only Muslim countries, and also it becomes popular in non-Muslim countries as well, like UK, China, etc. Islamic investing is growing rapidly as an alternative investment class for all investors, both Muslim and non-Muslim, for its foundation in ethical business practices, social responsibility and fiscal conservatism. The Islamic investors are mandated to invest only in an Islamic manner as denoted by Imam and Kpodar (2013) in their study on the determination of Islamic bank expansion around the world, that the interest rates were found to have a negative impact on banking selection among Muslims while the quality of institutions was not found to be a significant determinant. However, other investors such as non-Muslim do so for the benefits they derive, including greater stability of returns, transparency and diversification (Saiti et al., 2014; 2016). For example, Hong Kong as a gateway of China had launched two Sukuks in 2014 and 2015 respectively. There are many corporations and local governments in China interested in to issue Sukuk after such initiatives. Therefore, this paper explores the possibility of successful Sukuk issuance out of

China and explains the positive trend currently unfolding in China (including Hong Kong). The purpose is to illustrate how Sukuk can work as a financing instrument to provide funds for large projects, such as railway, roads, schools, hospitals and public infrastructures in China. As a flexible financing instrument, Sukuk is deemed necessary in China. The financing need of China has been growing quickly particularly after the “One Belt One Road (OBOR)” initiative is put forward and the Asian Infrastructure Investment Bank (AIIB) is established. The market in China is an attractive niche market for good risk-return investment opportunities and long-term financing instruments such as Sukuk. Even though the potential growth is great for China, Sukuk should be promoted by regulators through the introduction of facilitative framework and strategic measures. If a favourable environment is created for Sukuk issuance out of China, Sukuk can potentially attract excess liquidity into China for supporting strategic infrastructure projects in the country. The main objective of this paper is to find out the most effective means, which can boost Sukuk as a financing instrument in China, especially at a time when Hong Kong has completed two Sukuk issuances and has become the emerging role model to propel further opportunities for Sukuk in the Greater China region.

This paper attempts to show that Sukuk, including offshore Sukuk, is able to provide a suitable source of fund for the China construction boom. An additional objective of this paper is to foster a more profound understanding of Sukuk and the China market in order to increase the demand for potential issuance of Sukuk in the country. A summary of the more specific objectives of the paper is given below:

1. To illustrate how Sukuk can be applied in China market and which Sukuk structure is most appropriate in the current situation of China.
2. To demonstrate how China can promote its offshore Sukuk market.
3. To explain that setting up a facilitative and clear regulatory and legal framework would strengthen the viability of Sukuk issuance in China.
4. To identify how China could can unleash the potential of Sukuk market in the country.

The applications of appropriate research methods are necessary to achieve the objectives of this paper. The potential of China's Sukuk market is analyzed after gaining the perspectives of selected scholars and some potential Sukuk issuers from different mega-industries like the petrochemical, manufacturing, real estate development and services industries. There are two main aspects to this research method: (i) Selected case studies; and (ii) un-structured interview. This paper makes the literature review as a description method and uses sorting, tables and graphs for data collection in order to support the related analysis. The study also analyzed Hong Kong Sukuk issuances between 2014 and 2016 and interviewed probable investors, issuers and scholars to estimate potential market. Despite the limited number of Sukuk issuances in China, there are surprisingly strong demand for investment in the primary market, which indicated that Sukuk as a financing instrument can attract sufficient interest from investors to participate in.

The rest of the paper is organized as follows. Section 2 looks into two Sukuk case studies which issue in Hong Kong. Section 3 provides overview of Islamic finance in China. Section 4 tries to identify the issues and challenges of Sukuk issuance in China by conducting unstructured interviews of few *Shariah* scholars and regulators and the concluding remarks which is presented in Section 5.

## 2. CASE STUDIES

Hong Kong has always been at the forefront to connect between China and other countries in term of fund raising activity and cross-border investment. In fact, the Hong Kong government has already issued two sovereign Sukuk and recently reported that it will issue the third Sukuk in order to establish a platform, to enable and boost Chinese companies to raise funds from global investors.

In September 2014, "the Government of the Hong Kong Special Administrative Region of the People's Republic of China (the HKSAR Government)" successfully completed its inaugural Sukuk issuance as shown in Table 1. Investors from all over the world ordered more than 4.7 times the original US\$1 billion issuance at

the coupon rate of 2.005% per annum. The 5-year Sukuk was the first USD Sukuk issued by the Hong Kong government, which was an important event in the history of Hong Kong's Islamic capital market development. The *Ijarah* Sukuk were based on Hong Kong's two commercial properties and issued by an SPV - "Hong Kong Sukuk 2014 Limited," set up and wholly owned by the HKSAR Government. The paper was issued by Hong Kong Sukuk 2014 Limited with HKSAR Government as its obligor. The revenue would be distributed into the Hong Kong government general budget.

China will face two challenges when it issues Sukuk for the first time. First would be the related Sukuk law; and second, Sukuk *Ijarah* structure needs to be backed by appropriate assets. The support by government bodies, lead banks and legal agencies is important in order to solve these challenges.

The Legislative Council Panel on Financial Affairs wrote in the Implementation of the Government Bond Program on 2 December 2013:

"The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 ('the ABS Ordinance') enacted by legal committee on 10 July 2013 amends the Inland Revenue Ordinance (Cap. 112) ('IRO') and the Stamp Duty Ordinance (Cap. 117) to provide for comparable treatment for some common types of Sukuk vis-à-vis conventional bonds in terms of profits tax, property tax and stamp duty liabilities, thus removing a major impediment to the development of a Sukuk market in Hong Kong. Sukuk type instrument is referred to the ABS (Alternative Bond Schemes) ordinance as alternative bond scheme. In order to further promote Islamic finance through encouraging issuers to raise funds by issuing Sukuk, the Administration has proposed to allow the issuance of Sukuk under GBP (Government Bond Program) in response to market conditions and needs."

The Administration gazetted the Loans (Amendment) Bill 2014 ("the Bill") on 24 January 2014. The Bill seeks to:

(a) amend Loans Ordinances (LO) so that the money raised by the Government by alternative bonds issued under a specified alternative bond scheme set up by the Government is treated as money borrowed by the Government and may be credited to Bond Fund (BF); (b) make a related amendment to the BF Resolution (Cap. 2 sub. leg. S) to allow payments in relation to the alternative bond issued to be made out of BF; and (c) amend IRO to exempt from profits tax amounts derived from such alternative bonds. The Bill (through amendments to section 2 of LO under clause 3 and the addition of a new section 2A under clause 4) will leverage on Schedule 17A to IRO to broaden the meaning of the word "borrow" and introduce the concept of "specified alternative bond scheme" in LO to cover a situation when the Government raises funds by way of Sukuk issuance (p. 13-14).

Why Sukuk *Ijarah* structure is the most appropriate for the Sukuk issuance? There are three factors to support the above. The IFN Special Awards Report (2015) appraised below:

**Table 1: Hong Kong Sovereign Sukuk 2014 summary**

Issuer/trustee	Hong Kong Sukuk 2014
Obligor	HKSAR government
Issuance price	US\$1 billion
Tenor	5-year
Periodic distribution rate	2.005% per annum
Maturity date	18 <sup>th</sup> September of 2019
Joint global coordinators	HSBC and Standard Chartered Bank
Joint book runners and joint lead managers	HSBC, Standard Chartered, CIMB Investment Bank and National Bank of Abu Dhabi
Co-managers	Abu Dhabi Islamic Bank, Emirates NBD Capital, Hong Leong Islamic Bank, OCBC Hong Kong, QInvest and RHB Islamic
Governing law	English Law and Hong Kong Law
Legal advisors	Norton Rose Fulbright and Allen & Overy
Underlying assets	Selected units in Wu Chung House, No. 213 Queen's Road East, Hong Kong and Fairmont House, No. 8 Cotton Tree Drive, Hong Kong
<i>Shariah</i> advisors	HSBC Saudi Arabia, Standard Chartered, CIMB Islamic Bank and Shaikh Nedzham Mohamed Saleh Abdulrahman Yaqobi
Structure	<i>Ijarah</i>

From: IFN Special Awards Report (March, 2015)

**Table 2: Hong Kong Sovereign Sukuk 2015**

Issuer	Hong Kong Sukuk 2015
Hong Kong Sukuk 2015	HKSAR government
Tenor	5-year
Issuance size and profit rate	US\$1 billion: 1.894%
Maturity date	3 <sup>rd</sup> June 2020
Lead managers	HSBC, Standard Chartered, National Bank of Abu Dhabi, CIMB
Co-managers	BOCOM Hong Kong Branch, Maybank, Hong Leong Islamic Bank, NCB capital
Book runners	HSBC, Standard Chartered, National Bank of Abu Dhabi, CIMB
Governing law	English/Hong Kong law
Legal advisors	Allen & Overy (issuer's counsel), Linklaters (arrangers' counsel)
Listing	Hong Kong Stock Exchange, NASDAQ Dubai, Bursa Malaysia,
Underlying assets	Selected units in government-owned buildings and <i>Shariah</i> compliant commodities
Rating	"AAA" (S&P)/"Aa1" (Moody's)
Structure	<i>Wakalah</i>
Investor breakdown	By geography: Asia (43%), Middle East (42%), Europe (15%) By investor type: Banks (74%), central bank/sovereign wealth funds (23%), others (3%)

"(1) It is the most acceptable structure among many *Shariah* scholars; (2) the majority of investors are familiar with the *Ijarah* structure; (3) all sovereigns use *Ijarah* structure for their debut Sukuk (p. 12)."

In June 2015, the "HKSAR Government" completed its second Sukuk issuance under the "Government Bond Program." Adopting a unique arrangement, the transaction utilizes a *Wakalah* structure comprising one-third tangible assets (selected units in an office building in Hong Kong), and two-thirds *Shariah*-compliant receivables from the sale of commodities as shown in Table 2. Selection of the *Wakalah* structure with a lower amount of tangible assets was to demonstrate the flexibility of the Hong Kong Sukuk issuance platform to potential issuers from the private sector. The engineering of the Sukuk made several firsts in the Sukuk market. Hong Kong was the first sovereign Sukuk to utilize one-third tangible assets, the deal was the first *Wakalah* Sukuk apart from "the Organization of Islamic Cooperation (OIC)" and the first to be offered by a "triple A" rated sovereign.

Compared to its previous issue, the "HKSAR Government" debut Sukuk in 2014 was based on an *Ijarah* structure consisting of 100% tangible assets. In the second Sukuk structure, the tangible

assets were one-third and the remaining two-thirds were *Shariah* compliant receivables from sale of commodities on a *Murabahah* basis. In terms of profit rate, this second offering was priced at 1.894%, lower than its debut Sukuk which was 2.005%. The transaction demonstrates that the Hong Kong's legal, regulatory and taxation frameworks can facilitate Sukuk issuance well and this paves the way for local and international fundraisers to follow. Proceeds from the issuance is to be credited to the "BF" which was set up on the 8<sup>th</sup> of July 2009 under "Section 29 of the Public Finance Ordinance." On the basis of loans (Amendment) Bill 2014 "the money raised by the Government by alternative bonds issued under a specified alternative bond scheme set up by the Government is treated as money borrowed by the Government and may be credited to BF." Commenting on the challenges faced during the issue, the challenge was to ensure that the *Wakalah* structure was compatible with the "Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013" so that the Sukuk benefited the tax neutrality provisions therein. The Sukuk managed to woo the interest of a wide range of both conventional and Islamic investors, where it received orders from 49 international institutional investors. According to the "Hong Kong Monetary Authority," the success of both this issuance and its maiden offering last year demonstrates



the robustness and flexibility of the administrative region's Islamic finance capabilities. The Sukuk issuance will serve to catalyze further development of the Sukuk market in Hong Kong and the Greater China region as well as attracting more parties to take part in the HKSAR's Islamic finance platform.

### 3. CHINA MAINLAND

Modern Islamic finance may have found its way into China as early as 2006 with several *Shariah* compliant investments reaching its shores and when Islamic banking products were made available in 2009. However, the development has since then been largely stagnant. Things took a huge turn, however, in 2014 when Hong Kong, which was considered by many as the window into China, approved Sukuk legislation that ignited once again the interest of global participants and even attracted serious consideration from domestic players.

"OBOR" aims at developing the infrastructure and trade of South-east Asia, central Asia and Middle East in order to channel China's overcapacity and capital. Islamic finance will play a more important role in China's "OBOR" financing strategy due to a large Muslim population along the "OBOR" route. There are sufficient opportunities for state-owned and private enterprises to tap the Islamic capital market. Over the past years, there have been some deals entering into the market, which is an expected trend. A local state-owned company, Sichuan development holding, has planned to raise fund via Islamic financing for US\$300 million and continue to raise further money by Sukuk issuance for a total amount of US\$1 billion. The Sichuan province, which is at an intersection of "OBOR" and has a number of infrastructure projects, is attracting investors of "OBOR" initiative to tap into the China market.

In March 2016, it was reported that a number of the largest projects from the China-Pakistan economic corridor, would raise money via Islamic financing. Pakistan, a part of "OBOR" strategy, will raise money using Islamic instruments for Block II coal mine and two 330 MW coal-fired power plants in Thar. This deal, with an Islamic financing tranche, is worth around US\$1.95 billion. They are also one of the key projects of "OBOR" in the China-Pakistan economic corridor. With the expectation to facilitate the projects of "OBOR," the Chinese government and its financial advisor are currently in negotiations with another south Asian country about sovereign Sukuk issuances.

"Hainan Airlines Group (HNA Group)," the owner of Hainan Airlines, is also reportedly intending to secure up to US\$150 million in *Shariah* compliant financing to procure ships. "Country Garden Real Estate Sdn. Bhd.," the Company's wholly-owned subsidiary established in Malaysia, made its first issuance of "Islamic Medium Term Notes" worth US\$341.3 million on 21 December 2015. After this deal, "Country Garden Holdings" is promoting a deal of around US\$368.1 million Sukuk program in Malaysia.

In the Shandong province of China, a railway project is also reported to be considering Islamic financial instrument to fund CNY30 billion (US\$4.65 billion). The Dubai International

Financial Center in September 2015 was reportedly in discussions with a bank in China to issue a renminbi-denominated Sukuk.

## 4. UNSTRUCTURED INTERVIEWS AND FINDINGS

### 4.1. Insights of Scholars, Potential Investors and Issuers through the Un-structured Interviews

The three relevant scholars and other five leading company directors came from different industry in China. The purpose of this interview is to collect information about the recent trends and expectations of Sukuk issuance in China. The interviewees were optimistic and considered that raising funds through Sukuk would be possible. They expect to see Sukuk issuance from state-owned enterprises in the coming years. Under great pressure, banks could not provide long-term loans for economic expansion. This will push them to look for other long-term borrowing alternatives. The interviewees agreed that Sukuk can provide a solution for broadening and deepening the debt market in China. Sukuk solutions suit some of their financing needs that have not been satisfactorily met due to more restrictions on bank loans.

Sukuk is expected to attract more investors because of its lower risk compared to the stock market. The Hong Kong Sukuk offering was met with enormous demand, reaching 2.7-to-1 bid-to-cover ratio. Hong Kong, the world financial center, has decided to tap the Sukuk market. In fact, Hong Kong has issued two sovereign Sukuk and is planning to raise money through its third sovereign Sukuk. All interviewees believe that Sukuk will be an important financial solution in Hong Kong and mainland China. Hong Kong has cooperated with related financial institutions for their third sovereign Sukuk. The government of Hong Kong expresses interest in Sukuk and thinks that Sukuk is a strategic choice for the local investors to benefit from the local debt market.

All eight experts also expect a surge of Sukuk that can provide a real and ideal financing platform for entities to seek new business opportunities. They all agreed that Sukuk is becoming an international debt financing instrument. With its global appeal evidenced by very frequent Sukuk issuances, over subscriptions on the Sukuk by international investors. In fact, Sukuk can be used to raise money for a longer term at a lower cost for real estate developers in order to balance the asset-liability mismatch. The introduction of Sukuk market in China is considered to be having the biggest potential due to its high liquidity and financing needs. Building and construction industry is one of the largest sectors of the real economy in China and it has seen a strong growth in recent years. Construction and foreign direct investment promote private sector development. Most of the construction projects belong to Chinese government, of which about \$2000 billion dollar worth of projects is currently underway. The projects are mainly for housing, education and transportation industry. The construction company who is eager to diversify its sources of funding can tap the Sukuk market for their fund raising purposes.

Yu Xin Li from University of Xiamen states the obstacles of issuing Sukuk in China. First, regulators should do more research

on the policies and regulations of Sukuk. Hong Kong as a leading international finance hub, has made the financial system reform to cope with the development of Sukuk through amending “Inland Revenue Ordinance” and removing related profits tax and stamp duty in order that Sukuk possess the tax structure similar to conventional bonds. It is a favor of issuing Sukuk in Hong Kong. In the China Mainland, the bond market is more mature. Three active areas, for example Yangtze River Delta, the Pearl River Delta and other places could carry out pilot projects in order to support the development and design of a set of rules. Particularly, we need to have appropriate rules designed in a step-by-step manner for investor protection. Meanwhile, we should enhance investor education, especially for Sukuk investment, operational mechanism and risk behaviors.

Experts from Commercial Bank of China explained that the first step is to establish a *Shariah* Supervisory Committee to ensure that the product is not against the principles of Islam, while conducting Islamic financial business. Given the distinct regional characteristics in the interpretation of Islamic principles, the development of Islamic finance should be supported by the early establishment of the *Shariah* Supervisory Committee to reduce non-compliance risk of Chinese corporations doing business in the Islamic world. The Committee should consist of well-known experts from different regions, including well known scholars in Southeast Asia (Malaysia and Indonesia), India, Pakistan, Qatar, Saudi Arabia and the United Arab Emirates and other regions. They also explained further that there is a bullish market for project finance due to surplus liquidity. In addition, China is keen to invest abroad, because RMB (yuan)-the currency of China is currently devalued. It is reported that “China’s investment and construction overseas is already worth \$1.2 trillion” (IFN, 2014). The government is fully committed to support all main infrastructure projects coming from AIIB or the Silk Road Fund. However, diversified sources of funding are extremely needed to provide the funding base and Sukuk is the most proper instrument to solve the problem of alternative funding.

#### 4.2. “OBOR” Initiative and Sukuk

Potential for construction in China is massive and this is based on substantiated demand in the most populous country in the “OBOR.” The China construction sector grew by 3.9% in real terms in 2009, supported by real demand from the “OBOR” proposal.

Khaled Al-Aboodi, CEO of the Islamic Corporation for the Development of the Private Sector (ICD), at the inaugural China OIC Forum which took place in Beijing, China on the 22<sup>nd</sup> March 2016 said:

“As China is undergoing a major economic recalibration, Islamic Development Bank (IDB) Group can be a partner in China’s quest to make growth more inclusive and sustainable. To this end, ICD’s aim is to encourage development, especially infrastructure, as well as access to fair finance, making our mission entirely aligned with the UN’s Sustainable Development Goals. With its emphasis on transparency and fairness, Islamic finance has much to offer to any economy. The *Shariah* based financial principles,

if applied properly, can prove to be more robust and sustainable to support systematic economic growth, for which speculation driven activities are largely curtailed.”

“OBOR” route includes a number of Muslim countries. If China wants to interconnect with the related countries along the route, it should develop Sukuk and consider it as a priority. Sukuk lays the foundations to make China more approachable to new segments of investors. There are diverse ways in which China can benefit from promoting Sukuk. First, fostering Sukuk can strengthen financial interconnectivity with Muslim countries. The five major goals of the “OBOR” initiative are fostering of policy coordination, financial integration, unimpeded trade, facility connectivity and people-to-people bonds. Sukuk is perhaps the most viable way to achieve these goals. Second, promoting Sukuk will extend the international influence of the AIIB. As the IDB is exploring the feasibility of using Sukuk through the AIIB, it will elevate the international standards of the AIIB, as well as alleviate concerns that AIIB is not merely focused on China. Third, the Islamic financial activities and volume of Sukuk are expanding rapidly, which will allow related countries and regions to tap from this fast expanding asset class, including China. Fourth, developing Sukuk could push China to engage in the drafting of related regulations to facilitate sukuk issuance and trading. The sooner China promotes development of Sukuk, the sooner China can gather experience from it, and effectively participate in the setting up of internationally recognized Sukuk standards. This will also strengthen China’s voice in the global economic regulatory and governance network.

In order to foster Sukuk in China, we should make efforts to improve the following aspects. At the central government level, the government should consider setting up a high-ranking dedicated committee to examine different issues and formulate policies on the development of Sukuk in China. Depending on the domestic environment, the committee could cooperate with different government departments to foster the establishment of Sukuk regulation and supervise Sukuk issuance and trading. Likewise, local governments could establish working groups to deal with the technical details. Next, in the newly launched Guangdong Free Trade Zone, which aims to develop financial innovation, the government could consider setting up a Maritime Silk Road Islamic finance experimental zone to study possible Sukuk programs. They could also try to attract and train competent professionals who are familiar with Islamic Law and have expertise in Sukuk in order to move forward relevant activities towards activating the sukuk market. Furthermore, the practice of Sukuk in China is currently restricted to a small number of enterprises and people. Efforts should be made to encourage more financial institutions and corporations to participate in Sukuk.

Sukuk is not only cost saving, but could also hedge against risks from exchange rate fluctuations especially corporate debts that are denominated in the dollar. Offshore Sukuk issuance in Kong Kong, Dubai or Kuala Lumpur, is an effective method for hedging. The proceeds would not be channeled into China, but just operate and flow in abroad. This may promote enterprises to expand their business along the route of the “OBOR” initiative. In addition, as

Sharia-compliant bonds, Sukuk would potentially attract diverse investors from different regions along the route. Chinese investors' involvement with Sukuk would strengthen communication with Muslim countries. Further, since Chinese people are not familiar with the concept of Sukuk, and since Muslim countries do not fully understand China's circumstances, to effectively foster financial and cultural interconnectivity between Islamic world and China requires unique and different communication techniques at home and abroad. Mass communication channels can make useful contributions towards enhancing mutual understanding between people, which would help promote the development of Sukuk in China as well as international cooperation.

## 5. CONCLUSION

Hong Kong has proven itself as the Islamic finance torchbearer for China. It amends loans ordinances to cater for Sukuk issued under a specified alternative bond scheme and the Inland Revenue Ordinance to exempt amounts derived from such alternative bonds from profits tax. Nowadays "OBOR" strategy is driving a lot of activity. The "OBOR" initiative intends to channel China's over-liquidity towards ASEAN, Central Asia and Middle East for promoting trade and developing regional infrastructure. China wants to attract investment along the silk route countries into China. Meanwhile, China is investing a remarkable amount abroad. Hence, she wants to unlock the potential investment between both China and the countries along the silk route, which include Muslim-majority countries. Sukuk is expected to play an increasingly large role in China's "OBOR" funding strategy.

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