

**Panel on Financial Affairs of the Legislative Council  
Follow-up to Meeting on 5 July 2010**

**Legislative Proposal to Enhance the Qualifying Debt Instrument Scheme**

This note sets out the Government's responses to the follow-up questions raised in the letter dated 6 July 2010 from the Clerk to the Panel on Financial Affairs.

**Details of the types of debt instruments available in the Hong Kong market, including their original maturity, their issuers and their percentages out of the total issuance in the market**

2. In 2009, the total issuance of HKD debt instruments amounted to HK\$1,242,073 million (including HK\$1,047,728 million of Exchange Fund Bills and Notes ("EFBN"), and HK\$194,345 million of other debt instruments). Details are at [Annex A](#).

**Analysis of the development of the debt market in Hong Kong**

*Latest developments in the HKD debt market*

3. The HKD debt market is mainly dominated by debt securities issued by the private sector, i.e. debt securities issued by entities other than the Exchange Fund, the Government, the statutory bodies and the Government-owned corporations (see [Chart 1 of Annex B](#)). While the market contracted slightly at the end of 2008 on weakened investor demand for debt securities as the global financial crisis deepened, it rebounded strongly in 2009 amid ample liquidity and lower funding costs. The rebound was broad-based, with debt issuance in both the public and private sectors registering vibrant growth. The implementation of the Government Bond Programme ("GBP") was also a milestone in furthering the development of the local debt market.

## *Issuer base*

### *Domination of financial institutions and overseas issuers*

4. Financial institutions were the largest issuers of HKD debt securities in the private sector in 2009. Nonetheless, the growth of the non-bank private sector outpaced that of the financial institutions during the year. In particular, utility companies became much more active in tapping the local debt market (see **Chart 2 of Annex B**). This was mainly driven by the demand for HKD assets from institutional investors, such as insurance companies and bond funds. The solid credit ratings and the diversity in range of the issuer companies were particularly attractive to institutional investors whose investment criteria govern their preference for higher quality credit and more choices in issues.

5. Furthermore, the issuer base of HKD debt market is characterised by high participation of overseas issuers. The proportion of HKD bonds issued by overseas borrowers other than multilateral development banks accounted for around 42% of the total issuances, excluding Exchange Fund papers, as at the end of 2009 (see **Chart 3 of Annex B**). Among them, overseas issuers from Australia topped the list, followed by those from Europe and North America. It is worth noting that borrowers from other Asian economies, such as South Korea, the Mainland of China and Singapore, were increasingly seen during the year, probably attributable to the relatively low funding costs in Hong Kong against the backdrop of the abundant liquidity in the local banking system. However, most foreign issuers do not have HKD funding needs, and they often swap the proceeds into foreign currencies (usually USD) after issuance. As such, their incentives to issue HKD debts largely hinge on the all-in cost, which depends on both the prevailing HKD yields and the cost of the currency swap.

### *Relatively small public segment*

6. Insofar as the public segment is concerned, its size has remained relatively small until fairly recently, where additional Exchange Fund bills were issued to meet the strong demand from banks to manage the huge surplus funds on their balance sheets arising from abundant liquidity in the banking system amid persistent capital inflows to Hong Kong since the unfolding of the financial crisis in 2008.

7. The relatively small public segment is mainly due to the Government's large fiscal reserves and budget surpluses, which render little need for the Government to finance its expenditures through debt issuances, as well as the Currency Board arrangements, which have limited the growth of the EFBN

market. Notwithstanding, the Government has established the GBP, with the inaugural issuance in September 2009, for the purpose of market development. The size of the public segment is expected to grow in the future following the consistent and systematic bond issuances under the GBP.

### ***Investor base***

#### ***Strong presence of local institutional investors***

8. While there are no comprehensive statistics for the breakdown of the holders of HKD debt securities, market anecdotes suggest that the market is typically dominated by a strong presence of local institutional investors, and that foreign participation tends to be small, probably due to the relatively lack of trading interest. In particular, commercial banks are the largest investors in local currency debt securities, taking up a large part of the market. Other institutional investors such as pension funds (including Mandatory Provident Fund schemes and Occupational Retirement Saving Ordinance schemes) and insurance companies are also major holders of HKD debt securities. Apart from these, there are a number of government funds (such as the Grant and Subsidized Schools Provident Funds) and public funds that also have significant investments in HKD debt securities.

#### ***Use of the Qualifying Debt Instrument (“QDI”) scheme to encourage debt market activities***

9. The proposed extension of tax concession under the QDI scheme to income derived from debt instruments with an original maturity of less than three years should encourage further investor participation. This will in turn encourage a wider spectrum of issuers in issuance activity and hence is in line with our policy objective of promoting debt market development.

### **Definition of “associate” in the context of the Inland Revenue Ordinance (“IRO”) (Cap. 112)**

10. In the IRO, the following provisions contain the definition of “associate” -

- section 16(3) and (3A) concerning the ascertainment of chargeable profits;
- section 16E(4) about purchase and sale of patent rights, etc.; and

- section 21A(3) on computation of assessable profits from cinematograph films, patents, trademarks, etc.

Extracts of these provisions are at **Annex C**.

11. Apart from the above, sections 9A(8), 20AA(6), 20AE(10) and 39E(5) of the IRO also contain the definition of “associate”, which is rather similar to that stated in the three abovementioned provisions.

**The criteria and legal backing for determining whether an instrument is a “QDI” under the existing QDI scheme, and the relevant legislative provision(s) specifying that structured financial products are not “QDIs” under the scheme**

12. Section 14A(4) of the IRO provides that “debt instrument” means an instrument specified in Part I of Schedule 6 that -

- (a) is in respect of a debt issue which in its entirety has been lodged with and cleared by the Central Moneymarket Unit operated by the Monetary Authority;
- (b) subject to subsection (5), is issued by a person and has at all relevant times a credit rating acceptable to the Monetary Authority from a credit rating agency recognized by the Monetary Authority;
- (c) *(Repealed 34 of 2003 s. 3)*
- (d) subject to subsection (5), has -
  - (i) where it is issued before 1 April 1999, a minimum denomination of \$500,000 or its equivalent in a foreign currency; or
  - (ii) where it is issued on or after 1 April 1999, a minimum denomination of \$50,000 or its equivalent in a foreign currency;
- (e) is issued to the public in Hong Kong;
- (f) if it is a scripless instrument, it is one that would qualify in the terms of this definition if it were in a physical form;
- (g) is issued on or after the commencement of this section.

13. Pursuant to Part I of Schedule 6 to the IRO, “instruments” mean -
- “1. A bill of exchange within the meaning of section 3 of the Bills of Exchange Ordinance (Cap. 19).
  2. A promissory note within the meaning of section 89 of the Bills of Exchange Ordinance (Cap. 19).
  3. Any other instrument which evidences an obligation to pay a stated or determinable amount to bearer or to order, on or before a fixed time, with or without interest, being an instrument by the delivery of which, with or without endorsement, the right to receive that stated or determinable amount, with or without interest, is transferable.”

14. In other words, the definition of “debt instruments” for the purpose of the QDI scheme can be divided into two elements. First, it has to be an instrument specified in Part I of Schedule 6 to the IRO. Second, it has to satisfy the conditions in section 14A(4)(a) to (g) of the IRO.

15. We have sought legal advice with regard to the question on whether structured products would be “debt instruments” within the meaning of section 14A(4) of the IRO. We note that one difference between conventional debt securities (e.g. bonds) and structured products (e.g. Credit Linked Notes and Collateralized Debt Obligations) is that the credit risk of the latter may not necessarily be tied to the issuer. Rather, the obligation to pay the determinable amount for such structured products is subject to contingencies and the investor may not be repaid upon the occurrence of certain specified event (e.g. credit event that may not be linked to the issuer). It is therefore arguable whether this structure deviates from the basic characteristics of a debt or a loan.

16. We have also looked into the enactment history of section 14A of the IRO and noted that the policy intent was to focus on debt papers like bonds. Given this and the legal advice above, our view is that structured products are unlikely to be “debt instruments”. That said, we will further examine this issue in the context of the current legislative exercise to see whether the definition of “debt instruments” should be amended so that the policy intent could be stated more clearly.

**Updated position of the GBP, including the original maturity periods, quantity and amounts of bonds issued, the yields from the bonds in**

## **comparison with the Exchange Fund notes (“EFNs”), and the timetable for issuance of Government Bonds (“GB”) to retail investors**

### *Institutional Programme*

17. Following the passage of relevant resolutions by the Legislative Council on 8 July 2009, six GB tenders under the Institutional Programme of the GBP were completed as at the end of June 2010. A total of HK\$16 billion worth of GBs were offered in three benchmark tenors, namely, 2-year, 5-year and 10-year. The key parameters of the GB tenders are set out in **Table 1 of Annex D**.

18. It is worth noting that the tenders held in May and June 2010, i.e. those of the 10-year and 5-year GBs respectively, were conducted through re-opening outstanding issues. This allows for the build-up of benchmark sizes of the individual bond issues and avoids market fragmentation, thereby helping to improve secondary market liquidity.

19. In general, the issues were well-received by the market, as evidenced by the high bid-to-cover ratios.<sup>1</sup> This reflects the strong demand for high quality public debt paper in the market.

### *Yield level of GBs*

20. The constant maturity yields of the 2-, 5- and 10-year benchmark tenor points of EFNs and GBs as at the end of June 2010 are set out in **Table 2 of Annex D**.<sup>2</sup> Yields of the 5- and 10-year segments were trading at a premium over EFNs of comparable tenors. This largely reflects the fact that GBs cannot be used to access the Discount Window from the Hong Kong Monetary Authority. Thus, market players, especially the banks, usually pay a lower price (which translates into a higher yield) for the difference.

21. As for the 2-year segment, the yield was trading at a discount to EFN. Market players suggested that this largely reflected traders’ preference for EFNs to GBs as trading instruments. In particular, GBs are not fungible and the size of total outstanding issuances remains smaller than that of EFNs. EFNs, considered more cost-effective as trading instruments, are traded more actively in the market, whereas the 2-year GBs tend to be kept as investment, and hence the yield stays closer to the level at issuance.

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<sup>1</sup> The bid-to-cover ratio is calculated as the ratio of the bonds applied for to the bonds issued.

<sup>2</sup> These are yields interpolated from the daily curves for GBs and EFNs respectively. By interpolation, yields of EFNs and GBs in the same maturity segment can be directly compared. For instance, it allows for direct comparison of EFN and GB yields in the 10-year segment even if no outstanding security has exactly 10 years remaining to maturity.

### ***Retail Programme***

22. As for the Retail Programme, we will continue to monitor market conditions closely and seek professional advice from the co-arranger banks for the retail GBs in determining a suitable time for the launch of the inaugural retail issue under the GBP.

**Financial Services and the Treasury Bureau**  
**27 July 2010**

**Issuance of HKD Debt Instruments in 2009 (by types of issuer)**

	<b>Total Issuance</b>	<b>Exchange Fund <sup>(1)</sup></b>	<b>Total Issuance other than Exchange Fund <sup>(1)</sup></b>	<b>Government</b>	<b>Multilateral Development Banks (“MDBs”) <sup>(2)</sup></b>	<b>Statutory bodies and government-owned corporations <sup>(3)</sup></b>	<b>Authorized institutions <sup>(3)</sup></b>	<b>Local corporations <sup>(3)</sup></b>	<b>Non-MDB overseas borrowers <sup>(2)&amp;(3)</sup></b>
Value (HK\$ million)	1,242,073	1,047,728	194,345	5,500	13,145	29,852	43,878	19,539	82,431
Percentage in total issuance <sup>(1)</sup>			100.00%	2.83%	6.76%	15.36%	22.58%	10.05%	42.41%

**Outstanding HKD Debt Instruments in 2009 (by types of issuer)**

	<b>Total</b>	<b>Exchange Fund <sup>(1)</sup></b>	<b>Total other than Exchange Fund <sup>(1)</sup></b>	<b>Government</b>	<b>MDBs <sup>(2)</sup></b>	<b>Statutory bodies and government-owned corporations <sup>(3)</sup></b>	<b>Authorized institutions <sup>(3)</sup></b>	<b>Local corporations <sup>(3)</sup></b>	<b>Non-MDB overseas borrowers <sup>(2)&amp;(3)</sup></b>
Value (HK\$ million)	1,111,326	534,062	577,264	7,000	24,348	69,723	84,675	79,462	312,056
Percentage in total issuance <sup>(1)</sup>	-	-	100.00%	1.21%	4.22%	12.08%	14.67%	13.76%	54.06%

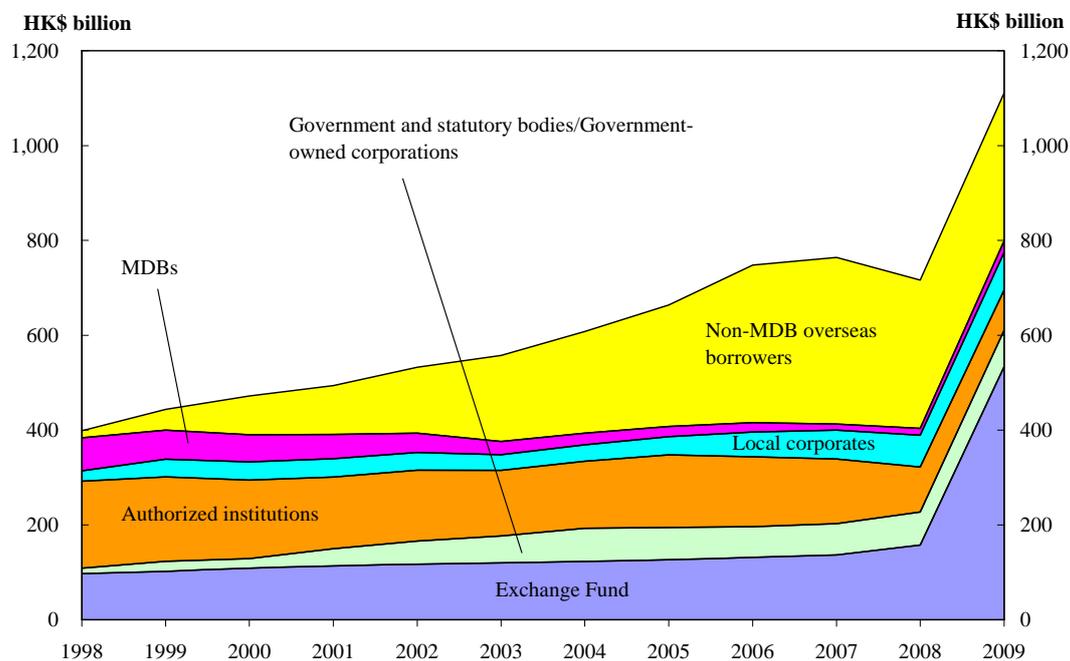
### Issuance of HKD Debt Instruments in Corporate Bond Market <sup>(3)</sup> in 2009 (by original term of maturity)

	Original maturity of less than 3 years	Original maturity of not less than 3 years but less than 7 years	Original maturity of 7 years or longer	Total
Value (HK\$ million)	81,770	70,520	23,410	175,700
Percentage in total issuance	46.5%	40.1%	13.3%	100.0%

**Notes:**

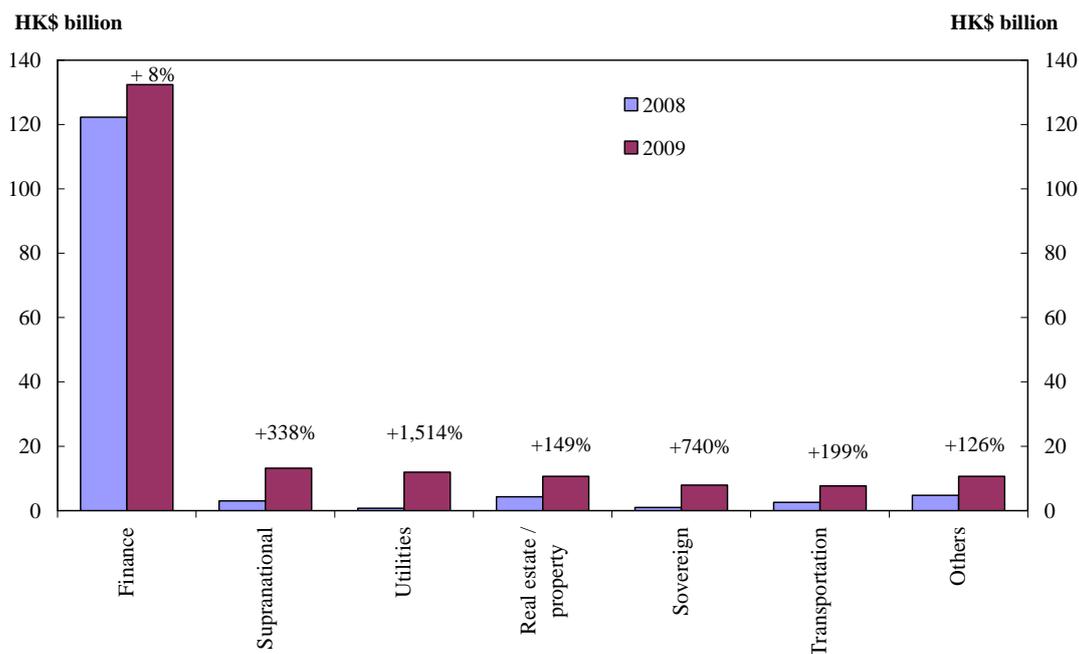
- (1) Exchange Fund Bills and Notes (“EFBNs”) are excluded from the computation of percentage shares in order to avoid distorting the comparison. The issuance figure for EFBNs is largely dominated by issuances of Exchange Fund Bills, which are short-term papers and thus not comparable to the figures for longer-term debt instruments presented in this table.
- (2) Examples of MDBs are Asian Development Bank and International Finance Corp. Non-MDB overseas borrowers refer to overseas corporations and banks.
- (3) Corporate bonds include debt instruments issued by statutory bodies and government-owned corporations, authorised institutions, local corporations, and non-MDB overseas borrowers.

**Chart 1: Outstanding size of HKD debt securities**



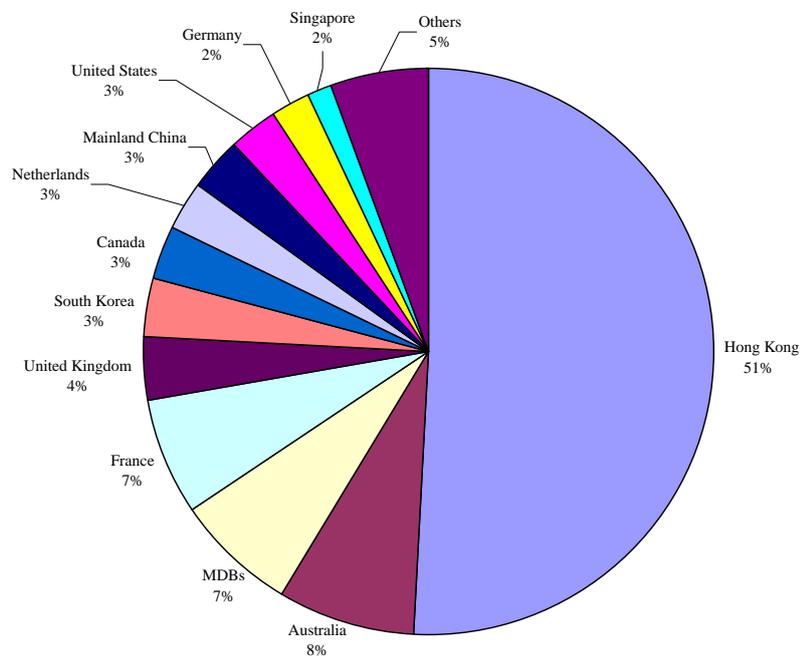
Source: Hong Kong Monetary Authority (“HKMA”)

**Chart 2: Issuance of HKD debt securities excluding Exchange Fund paper (by industry of issuer)**



Source: HKMA

**Chart 3: Issuance of HKD debt securities in 2009  
excluding Exchange Fund paper (by nationality of issuer)**



*Source: HKMA*

**Definition of “Associate” in the Inland Revenue Ordinance**

**Section 16(3) - Ascertainment of chargeable profits**

In this section- (Amended 12 of 2004 s. 6)

“associate”, in relation to a person, means-

- (a) where the person is a natural person-
  - (i) a relative of the person;
  - (ii) a partner of the person and any relative of that partner;
  - (iii) a partnership in which the person is a partner;
  - (iv) any corporation controlled by the person, by a partner of the person or by a partnership in which the person is a partner;
  - (v) any director or principal officer of any such corporation as is referred to in subparagraph (iv);
- (b) where the person is a corporation-
  - (i) any associated corporation;
  - (ii) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person;
  - (iii) any director or principal officer of that corporation or of any associated corporation and any relative of any such director or officer;
  - (iv) any partner of the corporation and, where such partner is a natural person, any relative of such partner;
- (c) where the person is a partnership-
  - (i) any partner of the partnership and where such partner is a partnership any partner of that partnership, any partner with the partnership in any other partnership and where such partner is a partnership any partner of that partnership and where any partner of, or with, or in any of the partnerships mentioned in this subparagraph is a natural person, any relative of such partner;
  - (ii) any corporation controlled by the partnership or by any partner thereof or, where such a partner is a natural person, any relative of such partner;
  - (iii) any corporation of which any partner is a director or principal officer;
  - (iv) any director or principal officer of a corporation referred to in subparagraph (ii);

“associated corporation”, in relation to a person, means-

- (a) a corporation over which the person has control;
- (b) if the person is a corporation-
  - (i) a corporation which has control over the person; or

(ii) a corporation which is under the control of the same person as is the first-mentioned person;

“principal officer” means-

- (a) a person employed by a corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors for the conduct of the business of the corporation; or
- (b) a person so employed who, under the immediate authority of a director of the corporation or a person to whom paragraph (a) applies, exercises managerial functions in respect of the corporation;

“relative” means the spouse, parent, child, brother or sister of the relevant person, and, in deducing such a relationship, an adopted child shall be deemed to be a child both of the natural parents and the adopting parent and a step child to be the child of both the natural parents and of any step parent. (Replaced 63 of 1997 s. 2)

### **Section 16(3A)**

In this section- (Added 12 of 2004 s.6)

- (a) a corporation shall be regarded as being controlled by a person if the person has the power to secure-
  - (i) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or
  - (ii) by virtue of any power conferred by the articles of association or any other document regulating that or any other corporation, that the affairs of the first-mentioned corporation are conducted in accordance with his wishes; and
- (b) a person (other than a corporation) shall be regarded as being controlled by another person if the first-mentioned person is accustomed or under an obligation, whether express or implied, and whether or not enforceable or intended to be enforceable by legal proceedings, to act, in relation to his investment or business affairs, in accordance with the directions, instructions or wishes of that other person.

### **Section 16E(4) - Purchase and sale of patent rights, etc.**

In this section-

“associate”, in relation to a person who purchases (including a person who is deemed to have purchased) rights of a kind referred to in subsection (1), means-

- (a) where the purchaser is a natural person-
  - (i) a relative of the purchaser;

- (ii) a partner of the purchaser and any relative of that partner;
  - (iii) a partnership in which the purchaser is a partner;
  - (iv) any corporation controlled by the purchaser, by a partner of the purchaser or by a partnership in which the purchaser is a partner;
  - (v) any director or principal officer of any such corporation as is referred to in subparagraph (iv);
- (b) where the purchaser is a corporation-
- (i) any associated corporation;
  - (ii) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person;
  - (iii) any director or principal officer of that corporation or any associated corporation and any relative of any such director or officer;
  - (iv) any partner of the corporation and, where such partner is a natural person, any relative of such partner;
- (c) where the purchaser is a partnership-
- (i) any partner of the partnership and where such partner is a partnership any partner of that partnership, any partner with the partnership in any other partnership and where such partner is a partnership any partner of that partnership and where any partner of, or with, or in any of the partnerships mentioned in this subparagraph is a natural person, any relative of such partner; (Replaced 65 of 1993 s. 2)
  - (ii) (Repealed 65 of 1993 s. 2)
  - (iii) any corporation controlled by the partnership or by any partner thereof or, where such a partner is a natural person, any relative of such partner;
  - (iv) any corporation of which any partner is a director or principal officer;
  - (v) any director or principal officer of a corporation referred to in subparagraph (iii);

“associated corporation” means-

- (a) a corporation over which a person who purchases (including a person who is deemed to have purchased) rights of a kind referred to in subsection (1) has control;
- (b) a corporation which has control over such a purchaser, being a corporation; or
- (c) a corporation which is under the control of the same person as such a purchaser, being a corporation;

“control”, in relation to a corporation, means the power of a person to secure-

- (a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or
- (b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation, that the affairs of the

first-mentioned corporation are conducted in accordance with the wishes of that person;

“principal officer” means-

- (a) a person employed by a corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors for the conduct of the business of the corporation; or
- (b) a person so employed who, under the immediate authority of a director of the body corporate or a person to whom paragraph (a) applies, exercises managerial functions in respect of the body corporate;

“relative” means the spouse, parent, child, brother or sister of the relevant person, and, in deducting such a relationship, an adopted child shall be deemed to be a child both of the natural parents and the adopting parent and a step child to be the child of both the natural parents and of any step parent. (Replaced 15 of 1992 s. 2)

**Section 21A(3) - Computation of assessable profits from cinematograph films, patents, trademarks, etc.**

In this section-

“associate”, in relation to a person, means-

- (a) where the person is a natural person-
  - (i) a relative of the person;
  - (ii) a partner of the person and any relative of that partner;
  - (iii) a partnership in which the person is a partner;
  - (iv) any corporation controlled by the person, by a partner of the person or by a partnership in which the person is a partner;
  - (v) any director or principal officer of any such corporation as is referred to in subparagraph (iv);
- (b) where the person is a corporation-
  - (i) any associated corporation;
  - (ii) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person;
  - (iii) any director or principal officer of that corporation or of any associated corporation and any relative of any such director or officer;
  - (iv) any partner of the corporation and, where such partner is a natural person, any relative of such partner;
- (c) where the person is a partnership-
  - (i) any partner of the partnership and where such partner is a partnership any partner of that partnership, any partner with the partnership in any other partnership and where such partner is a partnership any partner of that

partnership and where any partner of, or with, or in any of the partnerships mentioned in this subparagraph is a natural person, any relative of such partner;

(ii) any corporation controlled by the partnership or by any partner thereof or, where such a partner is a natural person, any relative of such partner;

(iii) any corporation of which any partner is a director or principal officer;

(iv) any director or principal officer of a corporation referred to in subparagraph (ii);

“associated corporation”, in relation to a person, means-

(a) a corporation over which the person has control;

(b) if the person is a corporation-

(i) a corporation which has control over the person; or

(ii) a corporation which is under the control of the same person as is the first-mentioned person;

“control”, in relation to a corporation, means the power of a person to secure-

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation, that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person;

“principal officer” means-

(a) a person employed by a corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors for the conduct of the business of the corporation; or

(b) a person so employed who, under the immediate authority of a director of the corporation or a person to whom paragraph (a) applies, exercises managerial functions in respect of the corporation;

“relative” means the spouse, parent, child, brother or sister of the relevant person, and, in deducing such a relationship, an adopted child shall be deemed to be a child both of the natural parents and the adopting parent and a step child to be the child of both the natural parents and of any step parent. (Replaced 65 of 1993 s. 3)

**Table 1: Highlights of Government Bond tenders as of end June 2010**

<b>Issue code</b>	<b>Benchmark tenor</b>	<b>Tender date</b>	<b>Issue size (HK\$ billion)</b>	<b>Bid-to-cover ratio</b>
02GB1109	2-year	2 Sep 09	3.5	6.45
05GB1411	5-year	2 Nov 09	2.0	4.56
10GB2001	10-year	11 Jan 10	2.5	4.72
02GB1203	2-year	3 Mar 10	3.5	4.02
10GB2001	10-year (Re-open)	5 May 10	3.0	2.65
05GB1411	5-year (Re-open)	2 Jun 10	1.5	3.19
<b>Total issued</b>			<b>16.0</b>	

*Source:* Hong Kong Monetary Authority (“HKMA”)

**Table 2: Constant maturity yields of Government Bonds (“GBs”) and Exchange Fund Notes (“EFNs”) (30 June 2010)**

	<b>2-year</b>	<b>5-year</b>	<b>10-year</b>
<b>GB</b>	0.739%	1.651%	2.435%
<b>EFN</b>	0.795%	1.560%	2.286%
<b>Spread between GB and EFN (basis points)</b>	-5.6	9.1	14.9

*Sources:* Thomson Reuters and HKMA