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Legislative Council
Panel on Financial Affairs

Proposed legislation to facilitate development of an Islamic Bond (sukuk) market in Hong Kong - Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill

Why developing Islamic finance?

- Help diversify products and services available to our financial markets, and consolidate Hong Kong' s status as an IFC and asset management centre

- Among the fastest growing segments in the international financial system
  - Islamic finance assets expanded from US$150 billion in the mid-1990s to US$1.3 trillion in 2011
  - The first half of 2012 saw an impressive year-on-year growth for global sukuk issuances by 40%
  - Market expects that, by the end of 2012, the global volume of outstanding sukuk will exceed US$220 billion

- Hong Kong' s role as a leading IFC and China' s global financial centre
  - Matching the needs of fund raisers and investment demand of investors among China, the Middle East, and other parts of the world interested in Islamic financial products

Characteristics of sukuk

- "Sukuk" : a broad range of financial instruments designed to conform with the principles of Islamic law ("Shariah")

- The Shariah prohibition on interest means that the creation of a purely debt based saleable security is not possible

- Sukuk may attract additional profits or property tax exposures, or stamp duty charges under our tax laws
  - They are usually structured with special purpose vehicles and multiple asset transfers
  - These transfers will normally not exist under a conventional bond structure but for the purposes of establishing the sukuk

Objective of the Bill

- To amend the Inland Revenue Ordinance and the Stamp Duty Ordinance to provide a comparable taxation framework for sukuk vis-à-vis conventional bonds, thereby removing an impediment perceived by the market to developing a sukuk market in Hong Kong

- Not conferring special tax favours – simply ensuring financial instruments of similar economic substance are afforded similar tax treatments

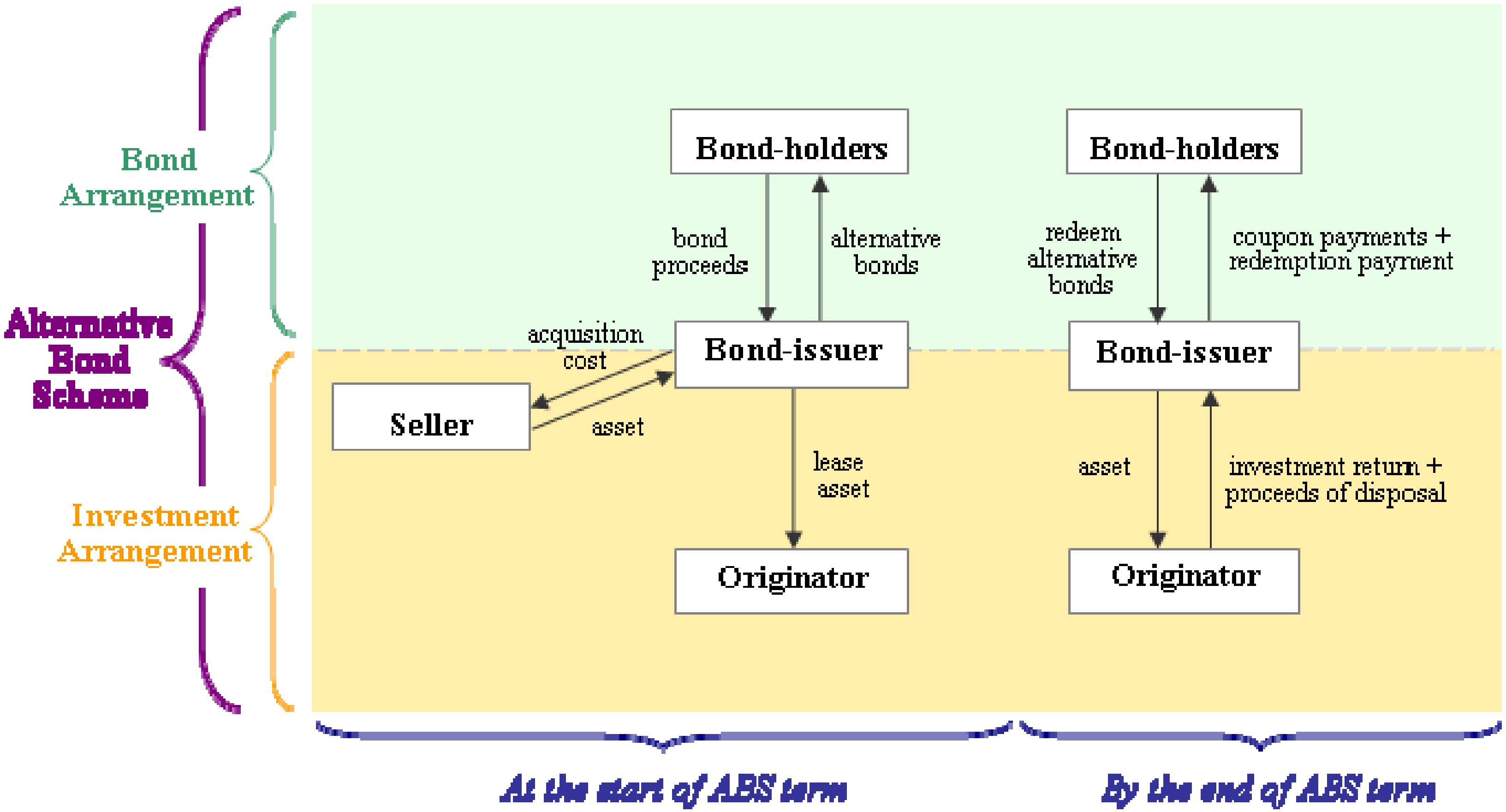
- Malaysia, the UK, Singapore, Japan and France have amended tax laws to provide the necessary clarity to facilitate issuance of sukuk and to level the playing field between comparable instruments in terms of tax treatments

Coverage of the Bill

- Cover 5 most common types of sukuk in the global market, which accounted for around 95% of global sukuk issuances in 2011 and first half of 2012
  - Lease arrangement (Ijarah)
  - Profits sharing arrangement (Musharakah and Mudarabah)
  - Purchase and sale arrangement (Murabahah)
  - Agency arrangement (Wakalah) (suggested by market during public consultation)

- The Bill will empower Financial Secretary to expand the coverage of eligible "alternative bond schemes" ("ABS") to respond to evolving market developments, by way of subsidiary legislation in future

Example: Lease arrangement (Ijarah)



Qualifying conditions

- We need to ensure –
  - A prospective ABS is economically equivalent to a typical conventional bond structure, hence its eligibility for the proposed tax treatment under Hong Kong tax laws
  - Reasonable safeguards are put in place to minimise tax avoidance
  - The proposed taxation framework would encourage the sukuk benefitted thereunder would have a nexus with Hong Kong, hence directly promoting our financial market development

Qualifying conditions

- Prescribe a set of qualifying conditions
  - Limit on return
  - ABS as financial liability
  - Maximum term length
  - Arrangements performed according to tenor
  - Bond-issuer as conduit
  - Connected with Hong Kong

Proposed tax treatment

- The underlying principle is to treat a prospective ABS that meets the qualifying conditions as a conventional bond arrangement for the purposes of the IRO and SDO, and to apply comparable tax treatments accordingly

- Exempt additional profits or property tax exposures, or stamp duty charges for the purposes of establishing an ABS

Proposed tax treatment

- Bond arrangement
  - Bond proceeds paid by bond-holders to a bond-issuer are to be regarded as money borrowed by the bond-issuer from the bond-holders, and coupon payments payable by the bond-issuer to the bond-holders are to be regarded as interest payable on such money borrowed

- Investment arrangement
  - The acquisition cost of assets is to be regarded as the money borrowed by an originator from the bond-issuer. The investment return is to be regarded as interest payable on the money borrowed by the originator from the bond-issuer

Public consultation

- Public consultation on draft provisions to be included in the Bill conducted between March and May

- 15 responses were received from a broad range of interested stakeholders and a large majority of respondents welcomed the legislative proposals

- Taken on board many useful comments and suggestions in contemplating the draft provisions in respect of coverage, qualifying conditions, other procedural matters and obligations

- Consultation Conclusion issued on 29 October to address suggestions and comments

Public consultation

- Expand the coverage to include agency arrangement (Wakalah)
- Relax the "maximum term length" condition by changing the maximum term length requirement for a qualified bond arrangement from 10 to 15 years
- Increase the flexibility of the "connected with Hong Kong" condition
  - Allow sukuk issue which is lodged with and cleared by the Central Moneymarkets Unit operated by HKMA to satisfy the condition
- Remove the "diverse holding condition"
- Relax the proposed record-keeping requirement
  - IRO – "3 years after the end of the sukuk term" or "7 years after the relevant transaction", whichever is longer
  - SDO – "1 year after the end of the sukuk term"

Way forward

- Finalising the "Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill"

- Aim to introduce the Bill to the Legislative Council in early 2013