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**Panel on Financial Affairs**

**Meeting on 5 November 2012**

**Background brief on the proposed legislation to facilitate  
development of an Islamic Bond market in Hong Kong**

**Purpose**

This paper provides background information on the proposed legislation to facilitate development of an Islamic Bond market in Hong Kong and summarizes the major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") during discussions in 2009-2010 to 2011-2012 sessions.

**Background**

Islamic finance and Islamic bonds

2. Islamic finance refers to the financial activities that are consistent with the principles of Islamic law, known as Shariah. Shariah is based on the text of Quran (considered by Muslims as the revealed word of God) and the Sunnah (the sayings and practices of Prophet Muhammad). Shariah provides guidance or principal rules governing all aspects of the day-to-day activities of Muslims, including religion, politics, finance, business and family. Major principles of Shariah that are applicable to Islamic finance include Riba (prohibition on receipt and payment of interest) and Haram (prohibition on dealing in banned activities e.g. alcohol and pork). According to the Administration, Islamic financial industry has grown into a global business of

an estimated US\$1 trillion in recent years, and is accepted by both Muslims and non-Muslims.

3. Islamic bond ("Sukuk") is a common type of financial instrument used for Islamic financing. Sukuk are investment certificates economically equivalent to bonds. Unlike bonds, which are debt-based instruments that pay interest, Sukuk are asset-backed or asset-based instruments and represent the ownership by the Sukuk holders in the underlying pool of tangible assets. Sukuk holders are entitled to a share in the revenues generated and the capital appreciation of the assets involved. Sukuk can be issued by governments or private companies.

### **Proposed development of Islamic finance in Hong Kong**

#### Legislative proposal to facilitate the development of a Sukuk market

4. The policy initiative of developing Islamic finance in Hong Kong was first unveiled by the Chief Executive ("CE") in his 2007-2008 Policy Address and also enshrined in the Policy Addresses and the Financial Secretary's Budgets in the subsequent years. According to the Administration, the development of Islamic finance in Hong Kong could help diversify Hong Kong's financial platform and enhance its competitiveness as an international financial centre.

5. The development of a local Sukuk market would serve as the first step of promoting the development of Islamic finance in Hong Kong. According to the Administration, the existing tax regime of Hong Kong is a major impediment to the development of a Sukuk market. This is because the structuring of Sukuk often involved transfer of underlying assets and setting up of special purpose vehicles, such that the launch and transactions of Sukuk in Hong Kong may attract additional tax implications when compared with conventional bonds and hence putting Sukuk in a disadvantaged position from the commercial viability point of view. The Administration therefore considers it necessary to introduce amendments to the Inland Revenue Ordinance (Cap. 112) ("IRO") and Stamp Duty Ordinance (Cap. 117) ("SDO") to level the playing field for common types of Sukuk vis-à-vis conventional bonds in terms of profit tax, property tax and stamp duty liabilities.

6. Under the Administration's proposal, the legislative exercise will cover four relevantly common types of Sukuk, viz. *Ijarah*<sup>1</sup>, *Mudarabah*<sup>2</sup>, *Murabahah*<sup>3</sup> and *Musharakah*<sup>4</sup> and be implemented through a prescriptive approach in line with that adopted in the United Kingdom. The legislative amendments will set out, inter alia, the qualifying criteria/features for the relevant types of Sukuk, circumstances under which the tax neutrality treatments will be disapplied or revoked, the authority to waive or amend in future (by order or regulation) the qualifying criteria/features to accommodate new types of Islamic financial products, tax treatments for the originator, Sukuk issuer and Sukuk holders under different types of Sukuk arrangements, etc.

#### Interim Administrative arrangements

7. The Administration has advised that pending implementation of the legislative amendments to the IRO and the SDO, market players can make use of the administrative mechanisms available under section 87 of the IRO<sup>5</sup> as well as section 52 of the SDO<sup>6</sup> to apply for profits tax, property tax and stamp duty exemption for Sukuk issuance and transactions. Applications made under these two provisions will be considered on a case-by-case basis. The Administration issued a package of relevant reference materials for the industry in November 2009.

#### Public consultation on the proposed amendments to the IRO and SDO in 2012

8. On 29 March 2012, the Administration launched a two-month consultation on the proposed amendments to the IRO and the SDO to gauge market views on the proposed legislative amendments. The major proposals of the consultation are as follows:

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<sup>1</sup> *Ijarah* is a leasing contract, where the bank buys and leases out the asset required by the client for a rental fee.

<sup>2</sup> *Mudarabah* is a form of partnership where one party provides the capital while the other provides its expertise to invest the capital and manage the associated investment project. Profits so generated are shared between the partners according to a pre-determined ratio, whereas losses accrued are borne by the capital provider only.

<sup>3</sup> *Murabahah* is a form of asset financing where an Islamic bank purchases a tangible asset at the request of its client and resells it to the client with a mark-up.

<sup>4</sup> *Musharakah* is a form of partnership where all parties must contribute capital. While profits are shared in a pre-determined ratio, losses are shared in proportion to the capital contributed.

<sup>5</sup> Under section 87 of the IRO, the CE in Council may by order exempt any person, office or institution from payment of the whole or any portion of any tax chargeable under the IRO on a case-by-case basis.

<sup>6</sup> Under section 52 of the SDO, the CE can remit or refund wholly or in part the stamp duty paid or payable in respect of any instruments chargeable with stamp duty on a case-by-case basis. The CE has delegated the relevant approving authority to, inter alia, the Secretary for Financial Services and the Treasury.

- (a) to adopt a prescriptive and religion-neutral approach and to cover four types of sukuk, viz. *Ijarah*, *Mudarabah*, *Murabahah* and *Musharakah*;
- (b) to adopt a tripartite structure, comprising an originator, a bond-issuer and bond-holders, as the basis for the framework of the proposed legislative amendments;
- (c) to introduce a new term known as alternative bond scheme containing two arrangements, namely, bond arrangement and investment arrangement. Under each of the aforesaid arrangements, a set of essential features and qualifying conditions must be satisfied in order for the parties involved to enjoy the special tax treatment and stamp duty treatment / relief applicable to that arrangement; and
- (d) to empower the Financial Secretary to amend certain parts of the legislation by subsidiary legislation, which will be subject to negative vetting by the Legislative Council, to extend the special tax regime to additional types of Sukuk.

### **Discussion at the Panel on Financial Affairs**

9. At the meeting on 3 May 2010, the Administration briefed the FA Panel on the proposed framework and schedule of the legislative exercise to amend the IRO and the SDO. Members in general expressed support on the Administration's initiative to develop the local Islamic financial market. The major concerns/views expressed by members and the Administration's responses are summarized in the ensuing paragraphs.

10. Some members considered that the Administration should formulate a strategy for the development of Islamic finance in Hong Kong which would facilitate the development of Islamic financial products apart from bonds as well as the provision and training of professionals with knowledge of the Shariah. There was also concern about the absence of a uniform regulatory regime for Islamic finance in Hong Kong resulting in difficulties for investors to seek remedy in default cases involving Islamic financial institutions/products.

11. Regarding the Government's strategy to develop Islamic finance, the Administration explained that given the small Islamic population in Hong Kong, the Administration would concentrate on the development of a wholesale

capital Islamic financial market instead of retail Islamic services in order to provide a platform for investors from the Middle East to invest in the financial markets of Hong Kong, the Mainland and neighboring areas. The Government was pressing ahead with the development of Islamic finance in Hong Kong on various fronts. Efforts included visits paid by senior government officials to Islamic economies to enhance cooperation between Hong Kong and such economies as well as to raise Hong Kong's profile as an Islamic financial platform. The Administration further advised that measures had been and would be taken in collaboration with the financial sectors concerned to enhance training of professionals on Islamic financial services, including training courses for professionals on the operation of the Islamic financial market jointly organized by the Treasury Markets Association and the universities in Hong Kong. Besides, the Hong Kong Monetary Authority had arranged exchange programme with the Islamic experts in the Mainland. On the concern about the regulatory regime for Islamic finance, the Administration advised that the Islamic Financial Services Board, to which Hong Kong is an associate member, had laid down standards and guidelines for participants in the Islamic financial industry.

12. Some members opined that the Government should assess the economic benefits brought by the development of Islamic finance, and requested the Administration to provide information on the number and results of applications for profits tax, property tax and stamp duty exemption for Sukuk issuance and transactions made under section 87 of IRO and section 52 of SDO under the interim arrangements (paragraph 7 above) pending implementation of the proposed legislative amendments. The Administration advised that since the exemption applications involved private commercial information, it would not be appropriate for the Government to disclose the relevant details.

### **Questions raised at Council meetings**

13. At the Council meeting on 9 December 2009, Hon Jeffrey LAM raised a written question on the impact of Dubai World's debt problem on financial institutions in Hong Kong, including the Administration's assessment on the impact of the economic situation in Dubai on the development of Islamic bond market in Hong Kong and the latest progress of the development of Islamic bond market in Hong Kong. Hyperlinks on the details of the question and the Administration's reply are in the **Appendix**.

### **Recent developments**

14. The Administration will brief the FA Panel on the proposed legislation to facilitate development of a Sukuk market in Hong Kong at the meeting on 5 November 2012.

### **Relevant papers**

15. A list of relevant papers is in the **Appendix**.

Council Business Division 1  
Legislative Council Secretariat  
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## Appendix

### List of relevant papers

<b>Date</b>	<b>Event</b>	<b>Papers/Minutes of meeting</b>
9 December 2009	Hon Jeffrey LAM raised at the Council meeting a written question on the impact of Dubai World's debt problem on financial institutions in Hong Kong	<a href="#">Hansard</a>
3 May 2010	The Panel on Financial Affairs ("FA Panel") discussed the proposed amendments to the Inland Revenue Ordinance (Cap. 112) and Stamp Duty Ordinance (Cap. 117) in relation to Islamic finance	<a href="#">Discussion paper</a> (LC Paper No. CB(1)1728/09-10(04)) <a href="#">Fact sheet</a> on overview of Islamic finance (FS19/09-10) <a href="#">Minutes of meeting</a> (LC Paper No. CB(1)2143/09-10) <a href="#">Follow-up paper</a> (LC Paper No. CB(1)1902/09-10(01))
29 March 2012	The Administration launched a consultation on the proposed legislative amendments to facilitate the development of Islamic bond market in Hong Kong	<a href="#">Press release</a> <a href="#">Consultation paper</a>
21 May 2012	Briefing by the Hong Kong Monetary Authority to FA Panel on its work	<a href="#">Power-point presentation materials by HKMA</a> (LC Paper No. CB(1)2080/11-12(01))