

For discussion
on 2 December 2013

Legislative Council Panel on Financial Affairs

Implementation of the Government Bond Programme:

- (a) Legislative Proposal to Enable the Issuance of Islamic Bonds;**
- (b) Liquidity Enhancement Measures**

PURPOSE

This paper briefs Members on the following two initiatives in relation to the implementation of the Government Bond Programme (“GBP”) –

- (a) a legislative proposal to amend the Loans Ordinance (Cap. 61) to enable the raising of funds by the Government under the GBP via the issuance of Islamic bonds (“sukuk”); and
- (b) relevant measures to enhance the liquidity of Government bonds (“GBs”) issued under the institutional part of the GBP.

BACKGROUND

2. The primary objective of the GBP, which was set up following the passage of relevant resolutions by the Legislative Council (“LegCo”) on 8 July 2009, is to promote the further and sustainable development of the local bond market¹. Since its implementation, the GBP has played a key role in providing high-quality bonds issued by the public sector to the local bond market. The current borrowing ceiling of the GBP is HK\$200 billion or equivalent, by virtue of a resolution passed by LegCo under the Loans Ordinance on 22 May 2013.

3. As at 15 November 2013, a total of HK\$107.5 billion worth of GBs (including iBonds of a total amount of HK\$30 billion) have been

¹ Specifically, a resolution (Cap. 61E) passed by LegCo on 8 July 2009 under section 3 of the Loans Ordinance authorises the Government to borrow for the purposes of the Bond Fund, which was set up pursuant to a separate resolution (Cap. 2S) passed on the same day under section 29 of the Public Finance Ordinance (Cap. 2).

issued under the GBP, whereas the total outstanding GBs stood at HK\$90 billion. The issuances under both the institutional and retail parts of the GBP were well received by a wide array of local and foreign investors. That said, the Government remains committed to, through the continuing operation of the GBP, diversifying the types of bonds available in our capital market, broadening the investors' base, and enhancing the liquidity of GBs transacted in the market.

LEGISLATIVE PROPOSAL TO ENABLE THE ISSUANCE OF SUKUK UNDER THE GBP

Justifications

4. Hong Kong is well placed to promote a sukuk market as a first step in developing Islamic finance, which will help diversify the types of financial products and services available in our markets and consolidate our status as an international financial centre and asset management centre. Sukuk are one of the most prominent instruments used in the global capital markets, not only catering for the needs of Muslims but also gaining recognition from among conventional investors and fund raisers as an alternative asset class and funding tool. In 2012, sukuk issuances worldwide reached a new height of some US\$130 billion, three times the amount issued in 2007.

5. The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013, enacted by LegCo on 10 July 2013, has enhanced the competitiveness of Hong Kong in the development of a sukuk market, as the legislation levels the playing field by providing a comparable taxation framework for sukuk vis-à-vis conventional bonds. Coupled with the core edges of our financial markets including our strong presence of international financial intermediaries and well-established market infrastructure, Hong Kong is now on a better footing to promote Islamic finance through encouraging issuers to raise funds by issuing sukuk. We have also witnessed a number of sukuk originated in overseas markets being marketed to institutional investors in Hong Kong, and several international sukuk being listed on the Stock Exchange of Hong Kong².

² These include sukuk issuances of the Government of Malaysia in 2010 and 2011, in the total amount of US\$3.25 billion.

6. To continue to make steady progress on this front, we see the merits of enabling the raising of funds under the GBP via the issuance of sukuk in response to the prevailing market conditions and needs. We envisage that such fund-raising by the Government of Hong Kong SAR, with an excellent credit rating of AAA³, under the GBP, will signal to the markets that our legal, regulatory and taxation frameworks are well established to accommodate sukuk issuances, thereby giving further impetus to other potential sukuk issuers from the public or private sector, both local and international, to raise funds in Hong Kong. We expect that, given the shortage of highly-rated sukuk in the international capital markets, an inaugural sukuk issuance originated by the Government of Hong Kong SAR will draw attention and interest in the global market and attract a new group of investors from the Middle East and other parts of the world to Hong Kong's financial platform.

7. In fact, a number of overseas jurisdictions such as Malaysia, Indonesia, Qatar, Dubai, Bahrain and Turkey have issued sovereign sukuk to develop their Islamic financial markets, while the United Kingdom ("UK") and Egypt are contemplating to issue sovereign sukuk.

8. We thus consider that the GBP provides a possible window to promote the sukuk market in Hong Kong through the issuance of sukuk, alongside conventional bonds, targeting global international investors who look for opportunities to diversify their investment portfolios into highly-rated sukuk products.

Legislative Amendments Required

9. Unlike conventional GBs issued under the GBP, sukuk are structured in a Shariah-compliant manner with the use of special purpose vehicles ("SPV") and multiple asset transfers (for example, in the form of purchase and sale as well as leasing between an originator and the SPV)⁴. To illustrate by an example, a schematic diagram showing the arrangements for a sukuk issuance in connection with the GBP in the form of Ijarah (i.e. lease arrangement) is set out in **Annex A**. Legal advice has suggested that this type of asset transactions entered into by the Government may not be regarded as a "borrowing" in the prevailing context of the Loans Ordinance

³ Standard and Poor's, Moody's and Fitch now assign AAA, Aa1 and AA+ long term foreign currency credit ratings respectively to the Government of Hong Kong SAR. So far, Hong Kong is one of the two jurisdictions attaining a credit rating AAA in the Asian region.

⁴ The Shariah prohibition on interest means that the creation of a purely debt-based saleable security is not possible. Sukuk are thus often structured in a way so as to generate the same economic effects as conventional bonds, but in a Shariah compliant manner, through the use of asset transfers and various contractual techniques.

(at **Annex B**). We therefore need to amend the Loans Ordinance to encompass such a situation, in which the Government shall be regarded as “borrowing” moneys from the SPV set up to effect sukuk issuance (i.e. by engaging in necessary asset transactions with the Government as the originator of the sukuk, acting as sukuk issuer to issue sukuk certificates to investors, making periodic distribution payments to sukuk holders, and redeeming the sukuk certificates at the end of the term).

10. To this end, our proposed approach for the legislative amendments is to leverage the newly-added Schedule 17A to the Inland Revenue Ordinance (“IRO”, Cap. 112)⁵ to broaden the meaning of the word “borrow” and introduce the concept of “specified alternative bond scheme” in the Loans Ordinance to cover a situation when the Government sets up a SPV to raise funds by way of sukuk issuance. This will enable the sukuk proceeds so obtained to be credited to the Bond Fund, the moneys of which are to be placed with the Exchange Fund for investment by the Hong Kong Monetary Authority (“HKMA”) under the existing framework of the GBP.

11. In addition, we will envisage consequential amendments to (a) section 26A of the IRO, and (b) the Bond Fund Resolution (Cap. 2S). For (a), we need to allow coupon payments and disposal gains derived from any sukuk issued in connection with the GBP to enjoy the same full tax exemption as that currently applicable to the interest payments and disposal gains in relation to conventional GBs⁶. For (b), we need to pay out of the Bond Fund to settle the coupon payments and redemption payment to sukuk holders through the SPV, mirroring the current arrangement for the Bond Fund to pay interest and redemption payment to conventional GB holders⁷.

Way Forward

12. The Government is contemplating the Loans (Amendment) Bill to address the issues described in paragraphs 9-11 above, and aims to

⁵ Schedule 17A to the IRO provides a taxation framework of sukuk by introducing the concept of “specified alternative bond scheme” to represent sukuk schemes. The Schedule was newly added under the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 to provide for the taxation framework of sukuk.

⁶ Section 26A(1)(b) of the IRO provides that interest paid or payable on a bond issued under the Loans Ordinance shall be exempt from profits tax. Likewise, under section 26A(1)(c), any profit on the sale or other disposal or on the redemption on maturity or presentment of such a bond shall be exempt from profits tax.

⁷ Section (e)(i) of the Bond Fund Resolution prescribes that the Financial Secretary may expend money from the Bond Fund for the purposes of repaying or, if appropriate, paying the principal of, interest on, and expenses incurred in relation to, any sums that have been borrowed under section 3 of the Loans Ordinance for the purposes of the Fund.

introduce the Bill to LegCo in the first quarter of 2014. In the meantime, HKMA, as Government's representative under the GBP, is examining other practicality issues in order to formulate a possible sukuk issuance plan for implementation after the legislative exercise, with regard to prevailing market conditions and market needs.

LIQUIDITY ENHANCEMENT MEASURES

13. To achieve the primary objective of the GBP as set out in paragraph 2 above, GBs are issued in a systematic and consistent manner under the institutional part of the GBP. As at 15 November 2013, the amount of outstanding institutional GBs is HK\$60 billion. In running this part of the GBP, HKMA has engaged primary dealers ("PDs") to act as intermediaries and market-makers to facilitate sale and purchase of GBs⁸. As the size of the market and the number of issuances continue to grow, market players and PDs have reflected to us that GBs need to be reasonably liquid such that investors can adjust their holdings more efficiently as necessary.

14. By benchmarking some sovereign issuers in other financial centres, and in discussion with the appointed PDs, HKMA will introduce the following two liquidity enhancement measures for the institutional part of the GBP in the coming months –

- (a) **Switch tender**: It aims to address any lasting supply-demand mismatch of institutional GBs by allowing PDs to permanently switch GBs of different tenors or remaining maturities. To illustrate the operation of a switch tender, HKMA may, in response of market demand, initiate a tender to switch a certain amount of an off-the-run GB that has 8 years of remaining maturity into another recently-issued GB of a tenor of 10 years. This operation will help increase the supply of the GBs in greater demand and reduce the supply of those with less market appetite, thus optimising the structure and enhancing the overall liquidity of the GBP; and

⁸ The institutional part of the GBP has adopted a PD system, under which eleven banks are currently appointed to make market for GBs by quoting executable bid-offer prices upon request. PDs act as intermediaries to provide secondary market liquidity and help lubricate the market by bridging any mismatch of demand and supply for GBs. This is to say, an institutional investor can approach a PD to get a bid price to sell or an offer price to buy a GB. The PD is obliged to provide an executable quote. As the PD may not necessarily be able to find another institutional investor to buy or sell the relevant bond at the same time, the PD needs to take and hold some GBs on their book as market-making inventory, and wait for an opportunity to unload it.

- (b) **Bond swap facility**: It aims to address temporary supply-demand mismatch by allowing PDs to temporarily swap certain amount of an institutional GB into another GB based on prevailing market prices through HKMA. In so doing, HKMA will, in response to a PD's request, arrange temporary issuance of the requested GBs to the PD for cash, while early-redeeming the same monetary value of different GBs (i.e. cash neutral transactions). When the swapping term ends, the earlier transactions will be reversed, again in a cash-neutral manner, by early-redeeming the exact amount of the requested GBs that were issued to the PD previously, and by re-issuing the exact amount of GBs that have been redeemed early in the first place. This bond swap facility will help bridge any temporary supply-demand mismatch among individual GB issuances, and enable a PD to quickly obtain from HKMA a particular GB for sale to a requesting institutional investor, and then return that GB when the PD acquires it from the market later.

15. We expect that market players will welcome the above arrangements, as these will enhance the effectiveness of market-making activities and liquidity management on the part of PDs, and encourage end-investors to trade more actively in the GB market. Since the arrangements will entail issuances and redemption of GBs, whether on a permanent or temporarily basis, we will record and reflect such transactions in the published audited accounts of the Bond Fund, and make suitable provisions or revised provisions in the Estimates. That said, since any issuance and redemption of GBs under a switch tender in principal amounts or a bond swap facility in market value will offset each other, the total amount of outstanding GBs at any time will remain essentially the same, and within the borrowing ceiling approved by LegCo.

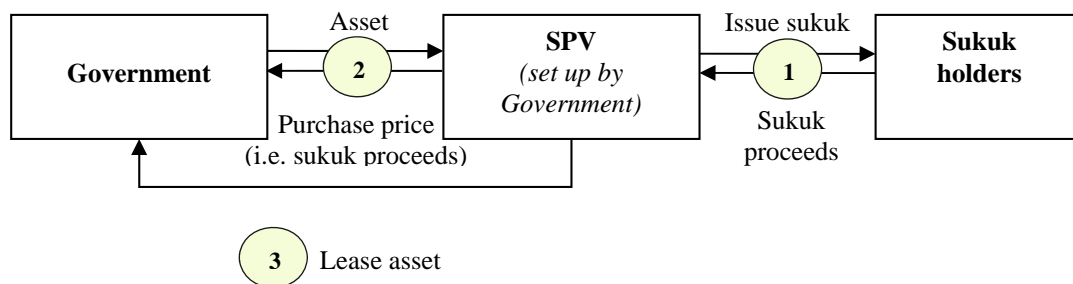
ADVICE SOUGHT

16. Members are invited to note and comment on the content of this paper.

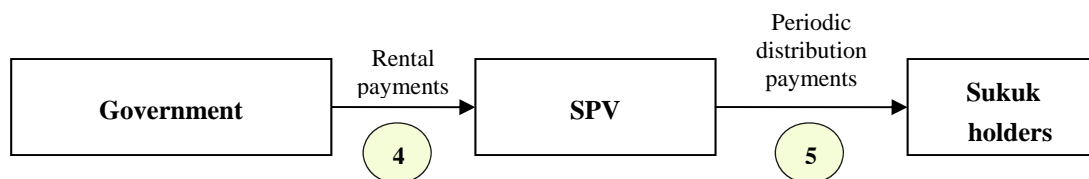
**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
November 2013**

**A schematic illustration
showing the arrangements for a sukuk issuance
in the form of Ijarah (i.e. lease arrangement)**

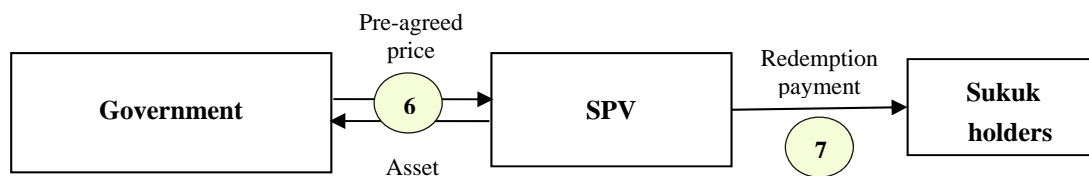
Upon formation



During the sukuk term



Upon maturity



Under an Ijarah sukuk structure, the Government (as the originator) will set up a special purpose vehicle (“SPV”) solely for the purpose of the sukuk scheme. The SPV will issue sukuk instruments to sukuk holders, and will use the sukuk proceeds obtained from sukuk holders to acquire an asset from the Government. Upon the acquisition, the SPV will lease the asset to the Government for a consideration (“rental payments”) which will be used by the SPV for periodic distribution payments to sukuk holders. Upon the maturity of sukuk, the SPV will dispose of the asset to the Government at a pre-agreed price, and the proceeds of disposal of the asset will be used to redeem the sukuk.

Chapter:	61	LOANS ORDINANCE	Gazette Number	Version Date
		Long title		30/06/1997

To make provision for the raising of loans and for matters connected therewith.

[23 May 1975]

(Originally 39 of 1975)

Section:	1	Short title		30/06/1997
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This Ordinance may be cited as the Loans Ordinance.

Section:	2	Interpretation		30/06/1997
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In this Ordinance, unless the context otherwise requires-

"borrow" (借入) includes the power to draw upon a credit facility;

"issue" (發行), in relation to a bond, promissory note or other instrument in the form described in section 4(1A)(b), means registering the holding of such bond, note or instrument by the person to whom it is issued by entering the relevant information or data into the relevant record; (Added 47 of 1991 s. 2)

"lender" (貸款人) means any person from whom the Government borrows money under this Ordinance.

Section:	3	Power to borrow		30/06/1997
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(1) The Government may, in such manner and on such terms and subject to such conditions as may be agreed between the Government and any person, borrow from such person such sum or sums and for such purposes as may be approved by resolution of the Legislative Council.

(2) Any agreement between the Government and a lender in respect of sums borrowed under the powers conferred by subsection (1) shall be made in the name of the Government of Hong Kong and may be signed on behalf of the Government by the Financial Secretary, or by any person authorized by him in writing.

(3) Subject to subsection (4), as soon as practicable after the execution of an agreement under this section, the Financial Secretary shall cause a copy of the agreement to be laid on the table of the Legislative Council. (Amended 47 of 1991 s. 3)

(4) The Financial Secretary may, in his absolute discretion, exclude from the application of subsection (3) any agreement, or any part thereof, which relates to the issue of any bond, promissory note or other instrument issued under section 4. (Added 47 of 1991 s. 3)

Section:	4	Power to issue instruments including bonds		30/06/1997
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(1) The Government may issue such bonds, promissory notes or other instruments on such terms and conditions as may be necessary for the purpose of giving effect to the terms of any agreement which may be entered into by it with a lender in respect of any borrowing under this Ordinance.

(1A) A bond, promissory note or other instrument issued by the Government under subsection (1) may take the form of-

- (a) a written document; or
- (b) information or data which is recorded (whether by means of a computer or otherwise) in a non-legible form but is capable of being reproduced in a legible form. (Added 47 of 1991 s. 4)

(2) Any bond, promissory note or other instrument issued by the Government under subsection (1) may, where it is the form of a written document, be signed on behalf of the Government by the Financial Secretary or by any person authorized by him in writing. (Amended 47 of 1991 s. 4)

Section:	5	Appropriation and charge of loans		30/06/1997
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(1) Any sums borrowed by the Government under this Ordinance shall, except in the case of sums borrowed for the purposes of the general revenue, be applied and are appropriated to the purposes for which they were borrowed:

Provided that any part of such a sum which cannot be applied to those purposes may be applied to such other purposes as may be approved by the Financial Secretary.

(2) Where sums borrowed under this Ordinance are not immediately available and expenditure in respect of the purpose for which they were borrowed must be met, such expenditure shall be charged as an advance pending reimbursement and the maximum amount which may be so advanced in any financial year in connection with any purpose shall be approved by resolution of the Legislative Council.

(3) Any sum borrowed under this Ordinance and all interest and other charges thereon are hereby charged upon and shall be payable out of the general revenues and assets of Hong Kong.

(4) Any expenses of or incidental to the raising of a loan may be defrayed from the sums borrowed.

Section:	6	Implementation of obligations under agreements	68 of 1999	01/07/1997
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Remarks:

Adaptation amendments retroactively made - see 68 of 1999 s. 3

(1) Notwithstanding anything contained in any other law, an agreement concluded with a lender in respect of any borrowing under this Ordinance and any bond, promissory note or other instrument issued pursuant to any such agreement and any undertaking given in respect of any such agreement, bond, promissory note or instrument by the Government shall be valid and enforceable and have full force and effect in accordance with their respective terms.

(2) The Chief Executive may, by order published in the Gazette, provide for the remission of any tax, duty, charge or fee payable under any Ordinance in respect of any agreement, bond, promissory note or instrument concluded with a lender or issued in connection with any borrowing under this Ordinance or in respect of any payment of interest or otherwise under any such agreement, bond, promissory note or instrument. (Amended 68 of 1999 s. 3)