

立法會
Legislative Council

LC Paper No. CB(1)966/13-14(02)

Ref: CB1/BC/4/13

Bills Committee on Loans (Amendment) Bill 2014

Background brief

Purpose

This paper provides background information on the Loans (Amendment) Bill 2014 ("the Bill") and a summary of the major views and concerns expressed by Members on related issues.

Background

Government Bond Programme

2. The Financial Secretary ("FS") announced in his 2009-2010 Budget Speech in February 2009 the Government's intention to implement a programme to issue government bonds (i.e. Government Bond Programme, GBP) to promote the further and sustainable development of the Hong Kong bond market. The sums raised from GBP would be credited to a fund (i.e. Bond Fund) to be established which would not be treated as part of the fiscal reserves and would be managed separately from other government accounts.

3. On 8 July 2009, the Legislative Council ("LegCo") passed a resolution under section 29 of the Public Finance Ordinance (Cap. 2) ("PFO") authorizing the Administration to set up the Bond Fund for managing sums raised under GBP, and a separate resolution under section 3 of the Loans Ordinance (Cap. 61) ("LO") authorizing the Administration to borrow a maximum amount of outstanding principal at any time of HK\$100 billion or equivalent for the purposes of the Bond Fund¹. LegCo further passed at its meeting of 22 May 2013 a proposed resolution under section 3(1) of LO authorizing the borrowings by the Government for the purposes of the Bond Fund up to a sum not

¹ The maximum amount of outstanding principal means the principal amount of bonds issued minus that of bonds redeemed.

exceeding in total HK\$200 billion or equivalent. As at 15 December 2013, a total of HK\$107.5 billion worth of government bonds ("GBs") (including inflation-linked retail bonds, i.e. iBonds, of a total amount of HK\$30 billion) have been issued under GBP, whereas the total outstanding GBs stood at HK\$90 billion.

Islamic finance and Islamic bonds

4. The policy initiative of developing Islamic finance (i.e. financial activities that are consistent with the principles of Islamic law, known as Shariah²) in Hong Kong was first unveiled by the former Chief Executive in his 2007-2008 Policy Address and also enshrined in the Policy Addresses and FS's Budgets in the subsequent years. According to the Administration, Islamic finance is among the fastest growing segments in the international financial system while Islamic bonds ("sukuk")³ are among the most prominent instruments used in Islamic finance. As at the end of 2012, the amount of global outstanding sukuk topped US\$240 billion. The Administration considers that the development of Islamic finance in Hong Kong would diversify Hong Kong's financial platform and enhance its competitiveness as an international financial centre.

5. Sukuk have more complex product structures than their conventional bond counterparts. They are usually structured with special purpose vehicles ("SPVs") and multiple asset transfers, which may attract additional profits or property tax exposures, or stamp duty charges when compared with conventional bonds. This has put sukuk in a disadvantaged position from the commercial viability point of view.

6. To remove a major impediment to the development of a sukuk market in the tax regime of Hong Kong, the Administration introduced into LegCo on 9 January 2013 the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012 ("the ABS Bill"), which sought to amend the Inland Revenue Ordinance (Cap. 112) ("IRO") and the Stamp Duty Ordinance (Cap. 117) ("SDO") to provide a comparable treatment for some common types of sukuk vis-à-vis conventional bonds in terms of profits tax, property tax and stamp duty liabilities. A bills committee was formed to study the ABS Bill, which was enacted as the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 ("the ABS Ordinance") by LegCo on 10 July 2013.

² 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).

³ Sukuk are investment certificates economically equivalent to bonds. Unlike conventional bonds, which are debt-based instruments that pay interest, sukuk are asset-based instruments and represent the ownership by the sukuk holders in the underlying pool of assets. Sukuk holders are entitled to an interest-like return in the form of a share in the revenues generated.

The Bill

7. The Administration considers that the issuance of sukuk under GBP will signal to the markets that Hong Kong's 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. The Government's legal advice has suggested that asset transactions involved in sukuk may not be regarded as a "borrowing" in the prevailing context of LO. It is therefore necessary to amend LO to encompass such a situation, in which the Government shall be regarded as "borrowing" moneys from the SPV set up to effect sukuk issuance.

8. The date of First Reading of the Bill is 22 January 2014. The Bill seeks to: (a) amend 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 the Bond Fund; (b) make a related amendment to the Bond Fund Resolution (Cap. 2 sub. leg. S) to allow payments in relation to the alternative bond issued may be made out of the Bond Fund; and (c) amend IRO to exempt from profits tax amounts derived from such alternative bonds and profits on the sale or other disposal of such alternative bonds.

9. The main provisions of the Bill are explained in paragraph 12 of the LegCo Brief (File Ref: B9/33/3C issued on 10 January 2014), and paragraphs 4 to 7 of the Legal Service Division Report on the Bill (LC Paper No. LS23/13-14 issued on 20 January 2014).

Major views and concerns expressed by Members

10. The Administration briefed the Panel on Financial Affairs ("FA Panel") on the framework of GBP and the two proposed resolutions under PFO and LO at the meeting on 4 May 2009. The subject was further discussed at a special meeting of FA Panel on 11 May 2009. A subcommittee has been formed to study the two proposed resolutions ("the Subcommittee"). FA Panel discussed the Administration's proposal to expand the maximum amount of borrowings under GBP at the meeting on 8 April 2013. The Administration and HKMA briefed FA Panel on the legislative proposal of the Bill at its meeting on 2 December 2013. The major views and concerns raised by Members during the meetings of FA Panel and the Subcommittee, as well as those raised during the scrutiny of the ABS Bill, are summarized in the ensuing paragraphs.

Issuance of sukuk under the Government Bond Programme

11. Members sought information about the revenue and expenditure situation of GBP, and the financial impact on GBP arising from the proposal to issue sukuk under GBP. They also enquired whether allowing issuance of sukuk under GBP would bring positive impact on GBP and whether the cost incurred for issuance of sukuk would be higher than that of conventional bonds.

12. HKMA explained that the Bond Fund had been established to manage the sums raised under GBP. Proceeds from bond issuances under GBP were credited to the Bond Fund, which was placed with the Exchange Fund for investment. The Bond Fund had registered net surpluses (i.e. investment income less interest payments and other issuance-related expenses) in all years since its launch in 2009, and a net surplus of around HK\$700 million was recorded in 2010-2011. On the costs for issuing sukuk and conventional bonds, HKMA advised that there was no significant difference on the pricing of both kind of bonds. While it would be difficult to make accurate forecast on the pricing of sukuk to be issued under GBP, it was envisaged that the issuance of sukuk under GBP would have little impact on the sustainability of the Bond Fund. The Government believed that issuing sukuk under GBP would set an example to the market and encourage more local and international issuers from the public and private sector to issue sukuk, thus conducive to the development of the local sukuk market and benefiting the financial services sector.

13. On Members' enquiries about the target investors of the sukuk under GBP and the issuance size, HKMA advised that it was envisaged that investors would be institutional investors given the relatively complex structure of sukuk. On the issuance size of sukuk, this would be determined with regard to the prevailing market conditions and market appetite. The Administration pointed out that the total outstanding GBs stood at HK\$90 billion in mid November 2013. The Administration would be prudent in determining the issuance size of sukuk under GBP. It was envisaged that the initiative would not have significant impact on the issuance of other types of bonds under GBP.

14. In response to Members' concern about how legal disputes relating to sukuk issued under GBP would be handled given that Shariah differed from Hong Kong laws, the Administration advised that Hong Kong could make reference to experience of other jurisdictions in handling sukuk-related disputes. The prevailing international practice was to resolve disputes between issuers and sukuk holders in accordance with the terms and conditions stipulated in the contracts entered between the parties. In issuing sukuk under GBP, the Administration would ensure that the sukuk were structured in a Shariah-compliant manner. The offering documents of the sukuk would specify the proper jurisdiction (i.e. a Hong Kong court or otherwise which would be the appropriate forum to adjudicate a dispute) and the governing law for adjudicating the disputes.

15. Members enquired whether institutional investors purchasing sukuk issued under GBP could split the sukuk for sale to retail investors subsequently and whether such activity was prohibited by laws or the resolutions setting up GBP. HKMA responded that it was unlikely for the institutional investors purchasing sukuk issued under GBP to split the sukuk for subsequent sale to retail investors. In general, there were no additional restrictions imposed on sukuk investors in relation to secondary trading. The trading practices of sukuk were similar to those of conventional bonds.

Development of the local sukuk market

16. Some Members enquired about the forecasted number of international Islamic financial institutions that would establish business in Hong Kong with implementation of the initiative to issue sukuk under GBP, and the jurisdictions the Administration could make reference to in developing Islamic finance.

17. HKMA advised that currently there were two banks in Hong Kong which had set up Islamic windows. Given that the sukuk market in Malaysia was well developed and currently about 60%-70% sukuk in the global market were issued out of Malaysia, the Administration was maintaining close liaison with Malaysia on the development of Islamic finance. For instance, Hong Kong and Malaysia held the first meeting of the Joint Forum on Islamic Finance on 3 December 2013 in Hong Kong to discuss how to advance the development of Islamic finance in Hong Kong.

18. Some Members opined that jurisdictions including Malaysia and Singapore had succeeded in developing Islamic finance because their governments had implemented support measures and maintained strong ties with the Islamic community. In the absence of a close linkage with the Islamic community and given that individual Muslims would not purchase sukuk issued under GBP, they queried whether the Government had put in place sufficient support measures for the development of Islamic finance.

19. The Administration advised that Hong Kong enjoyed certain edges in the development of Islamic finance. Firstly, the well-established market infrastructure in Hong Kong was able to support the issuance and listing of different types of bonds. Besides, the ABS Ordinance 2013 enacted by LegCo in July 2013 had removed a major impediment to the development of a sukuk market by providing a comparable taxation framework for sukuk vis-à-vis conventional bonds. The Administration would also encourage local and foreign bond issuers to issue sukuk in Hong Kong. The legislative proposal enabling the issuance of sukuk under GBP could demonstrate that Hong Kong possessed well established market infrastructure, including sound legal, regulatory and taxation frameworks accommodating issuance of sukuk. It

further pointed out that some non-Muslim countries like the United Kingdom were contemplating to issue sovereign sukuk. HKMA supplemented that a number of Islamic finance seminars had been organized in Hong Kong in collaboration with international organizations such as the Islamic Financial Services Board to boost the knowledge and awareness of market practitioners on sukuk.

Protection for sukuk investors

20. Noting that sukuk were complex financial instruments, Members were concerned about protection for sukuk investors, including regulation over sukuk issuers and investor education on risks involved in investment of sukuk. They also considered it important for Hong Kong to nurture adequate professionals with knowledge of Shariah in Hong Kong to support the development of Islamic finance and handle sukuk-related disputes. The Administration was urged to step up its efforts in promoting exchange and co-operation with other financial centres in the development of Islamic finance and diversification of Islamic finance instruments besides sukuk.

21. On the investor protection front, the Administration explained that similar to other financial products, sukuk would be subject to the prevailing regulatory regime in respect of product offering, marketing, disclosure and intermediaries requirements in accordance with the relevant provisions of the Securities and Futures Ordinance (Cap. 571) ("SFO") and the Companies Ordinance (Cap. 622) ("CO"). A number of statutory requirements⁴ were in place so that product issuers were required to make adequate disclosure and thus afforded protection to investors. While global sukuk transactions were generally carried out at an institutional level, investors would be informed of the risks of sukuk products through the current conduct regulation of intermediaries selling securities products. The Administration would work with the regulators on enhancing investor education on sukuk and Islamic finance. The Administration also advised that it fully appreciated the importance in nurturing professionals and market practitioners with expertise in Islamic finance, as well as maintaining continuous dialogue with relevant parties in major Islamic financial markets in order to better understand the latest global developments.

Expense chargeable to, investment and management of the Bond Fund

22. In considering the two proposed resolutions in 2009, some Members expressed concern whether the sums in the Bond Fund would be used for financing public projects, or for public expenses. Members were also concerned about FS's power in determining the expense and investment of the

⁴ For instance, issuers were required under SFO to seek authorization from the Securities and Futures Commission on the issuance of any advertisement, invitation or document, which was or contained an invitation to the public to enter into or offer to enter into an agreement to acquire the relevant sukuk products, unless an exemption applied.

Bond Fund and whether the proposed resolution under section 29 of PFO in 2009 should restrict FS's power in making investments of the Bond Fund.

23. The Administration advised that according to paragraph (g) of the proposed resolution under section 29 of PFO, surplus funds, if any, in the Bond Fund may be transferred to the general revenue only after all financial obligations and liabilities are met in relation to the loans borrowed under GBP and LegCo has given the necessary approval. To address Members' concern on FS's power, the Administration agreed to adjust paragraph (e)(ii) of the proposed resolution under section 29 of PFO to provide that the Bond Fund would be invested in the manner FS considered "appropriate for the prudent management of the Fund". Besides, FS would indicate the intended investment arrangement of the Bond Fund in his speech for moving the motion regarding the proposed resolution.

24. In response to a Member's enquiry about whether the Administration would introduce new initiatives in the management and utilization of the Bond Fund, the Administration advised that the objective of the Bond Fund was to promote the further and sustainable development of the bond market in Hong Kong as set out in the resolution for setting up the Bond Fund passed in 2009. It would be important to manage the Bond Fund prudently and appropriate to continue placing the Bond Fund with the Exchange Fund for investment. Given that the Bond Fund had been set up since 2009, more time should be taken to observe its operation and management before considering any ground for changes.

Considerations for the launch of bonds

25. Some Members enquired about the Government's considerations in determining the timing for issuance of individual bonds under GBP, and the possible impact of such bond issuance on the securities market. Members were also concerned whether a fair and transparent mechanism was put in place for issuance and distribution of GBs.

26. The Administration advised that the prevailing market conditions were crucial in determining the timing for issuance of individual tranches of GBs. Relevant considerations included the financial market conditions, investor demand and expected pricing of the bonds which would be taken into account in deciding the size and timing for launching individual tranches of government bonds. As regards the impact on the securities market, given the relatively modest amount of bond issuance under GBP each year, the impact on the market was not expected to be significant. The Administration further advised that it was necessary to allow sufficient flexibility for it in determining the exact offering mechanism for specific types of bonds targeting different investors under GBP. As for issuance of retail GBs, to facilitate access by individual investors, bonds would be distributed through an extensive network of placing

institutions which will include placing banks, the Hong Kong Securities Clearing Company and securities brokers.

Types of bonds to be issued under the Government Bond Programme

27. On Members' concern about the types of bonds to be issued under GBP and whether bonds denominated in other currencies, such as Renminbi ("RMB"), would be considered under GBP, the Administration advised that while its plan was to issue conventional fixed rate HK Dollar-denominated bonds with shorter tenors within the range of two to ten years at the initial stage of the GBP implementation, it would monitor the market needs and demand, draw reference from experience gained under GBP in considering whether, and if so, when to add more variety to GBP by issuing other types of bonds. The Administration added that the resolutions in both 2009 and 2013 would not place a restriction on the currency denomination of government bonds. The Administration was aware of the substantial increase in RMB-denominated bond issuances in Hong Kong and would take into account the development of RMB-denominated bonds in taking forward GBP in future.

Council Questions

28. Members raised three written questions at the Council meetings on 28 October 2009, 8 May 2013 and 17 July 2013 on issuance of GBs and measures to promote the development of the bond market. Members have also raised three written questions on the issuance of iBonds at the Council meeting of 26 October 2011, 23 May 2012 and 11 December 2013. Details of the LegCo questions and the Administration's replies are given in the hyperlinks in **Appendix**.

References

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

List of relevant papers

Date	Event	Papers/Minutes of meeting
4 May 2009 and 11 May 2009	The Panel on Financial Affairs discussed the Government Bond Programme (GBP)	<p><u>Discussion Paper</u> (LC Paper No. CB(1)1469/08-09(01))</p> <p><u>Legislative Council Brief</u> (G6/123/5C)</p> <p><u>Administration's supplementary information</u> (LC Paper No. CB(1)1507/08-09(02))</p> <p>Minutes for meetings on <u>4 May 2009</u> (LC Paper No. CB(1)2092/08-09) and <u>11 May 2009</u> (LC Paper No. CB(1)2519/08-09)</p>
May to June 2009	The Subcommittee on Proposed Resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61) scrutinized the proposed resolutions concerned	<p><u>Proposed resolution under Section 29 of the Public Finance Ordinance (Cap.2)</u></p> <p><u>Proposed resolution under Section 3 of the Loans Ordinance (Cap.61)</u></p> <p><u>Legislative Council Brief</u> (G6/123/5C)</p> <p><u>Report of the Subcommittee</u> (LC Paper No. CB(1)2049/08-09)</p>
8 July 2009	The Legislative Council ("LegCo") passed the proposed resolutions under Section 29 of the Public Finance Ordinance (Cap. 2) and Section 3 of the Loans Ordinance (Cap. 61) moved by the Financial Secretary	<u>Hansard</u>

Date	Event	Papers/Minutes of meeting
28 October 2009	Hon Mrs Regina IP raised a written question regarding the issuance of government bonds	Hansard
26 October 2011	Hon Frederick FUNG raised a written question regarding the review of the issuance of iBond	Hansard
23 May 2012	Hon Mrs Regina IP raised a written question regarding the issuance of iBond	Hansard
8 April 2013	FA Panel discussed the proposal to raise the maximum amount of borrowing under GBP	<p>Discussion paper (LC Paper No. CB(1)781/12-13(07))</p> <p>Administration's supplementary information (LC Paper No. CB(1)953/12-13(02))</p> <p>Minutes (LC Paper No. CB(1)1654/12-13)</p>
8 May 2013	Hon James TIEN raised a written question regarding the issuance of government bonds	Hansard
22 May 2013	LegCo passed the proposed resolution under Section 3(1) of the Loans Ordinance (Cap. 61) moved by the Secretary for Financial Services and Treasury	Hansard
10 July 2013	LegCo passed the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Bill 2012	<p>Hansard</p> <p>Bill passed</p> <p>Report of the Bills Committee</p>

Date	Event	Papers/Minutes of meeting
17 July 2013	Hon Kenneth LEUNG raised a written question regarding measure to promote the development of the bond market	Hansard
2 December 2013	FA Panel discussed the legislative proposals of the Bill	Discussion paper (LC Paper No. CB(1)390/13-14(05))
11 December 2013	Hon SIN Chung-kai raised a written question regarding iBonds Issued by Government	Hansard
22 January 2014	The Loans (Amendment) Bill 2014 was introduced into the Legislative Council	The Bill Legislative Council Brief Legal Service Division report (LC Paper No. LS 23/13-14)