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Report of the Bills Committee on Loans (Amendment) Bill 2014

Purpose

This paper reports on the deliberations of the Bills Committee on Loans (Amendment) Bill 2014 ("the Bills Committee").

Background

Government Bond Programme

2. The Financial Secretary ("FS") announced in the 2009-10 Budget the Government's intention to implement a Government Bond Programme ("GBP") to issue government bonds ("GBs") in order to promote the further and sustainable development of Hong Kong's bond market. On 8 July 2009, the Legislative Council ("LegCo") passed a resolution under section 29 of the Public Finance Ordinance (Cap. 2) authorizing the Administration to set up the Bond Fund ("BF") 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 at any time of HK\$100 billion or equivalent (by way of outstanding principal) for the purposes of BF, i.e. the maximum borrowing ceiling. LegCo further passed at its meeting of 22 May 2013 a resolution under section 3(1) of LO raising the maximum borrowing ceiling of GBP to HK\$200 billion or equivalent.

Development of Islamic finance

3. According to the Administration, Islamic finance (i.e. financial activities that are consistent with the principles of Islamic law, known as Shariah¹) is among the fastest growing segments in the international financial

¹ 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).

system, and Islamic bonds ("sukuk")² are among the most prominent instruments used in Islamic finance.

4. 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 a commercial viability perspective.

5. The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 ("the ABS Ordinance") enacted by LegCo on 10 July 2013 amends the Inland Revenue Ordinance (Cap. 112) ("IRO") and the Stamp Duty Ordinance (Cap. 117) to provide for comparable treatment for some common types of sukuk vis-à-vis conventional bonds in terms of profits tax, property tax and stamp duty liabilities, thus removing a major impediment to the development of a sukuk market in Hong Kong. Sukuk type instrument is referred to in the ABS Ordinance as alternative bond scheme.

6. In order to further promote Islamic finance through encouraging issuers to raise funds by issuing sukuk, the Administration has proposed to allow the issuance of sukuk under GBP in response to market conditions and needs.

The Bill

7. To achieve the purpose in paragraph 6 above, the Administration gazetted the Loans (Amendment) Bill 2014 ("the Bill") on 10 January 2014 which received its First Reading at the LegCo meeting of 22 January 2014.

8. The Bill seeks to: (a) amend LO so that the money raised by the Government by alternative bonds issued under a specified alternative bond scheme³ set up by the Government is treated as money borrowed by the Government and may be credited to BF; (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 BF; and (c) amend IRO to exempt from profits tax amounts derived from such alternative bonds.

² 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.

³ The Bill adopts the same nomenclature for sukuk type instruments as the ABS Ordinance. "Specified alternative bond scheme" is defined by section 4 of Schedule 17A to IRO. An "alternative bond scheme" is defined by section 2 of that Schedule.

9. The Bill, if passed, would come into operation on the day on which it is published in the Gazette.

The Bills Committee

10. At the House Committee meeting on 24 January 2014, members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in the **Appendix**. Under the chairmanship of Hon Kenneth LEUNG, the Bills Committee has held one meeting with the Administration to discuss the Bill. The Bills Committee has also posted a notice at the website of LegCo to invite written views from the public on the Bill. No submissions have been received.

Deliberations of the Bills Committee

11. The Bills Committee supports the Bill in principle. During the scrutiny of the Bill, the Bills Committee has focused on the rationale for introducing amendments to LO, considerations for sukuk issuance under GBP, Hong Kong's competitiveness in the development of a sukuk market, and efforts in promoting Islamic finance and the sukuk market in Hong Kong. The major deliberations of the Bills Committee are summarized in the ensuing paragraphs.

The need to amend LO to accommodate the issuance of sukuk under GBP

12. Members of the Bills Committee have enquired about the need to introduce the Bill given that the ABS Ordinance has already provided the necessary comparable taxation framework to put some common types of sukuk on the same footing as conventional bonds. During the clause-by-clause examination of the Bill, the Bills Committee has studied how the proposed amendments operate in achieving the purpose of the Bill.

13. The Administration has clarified that the purpose of the Bill is to accommodate the issuance of sukuk under GBP. The Administration points out that 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.

14. The Administration has explained that the ABS Ordinance has by the addition of the new Schedule 17A to IRO introduced the concept of "specified alternative bond scheme" to cover sukuk schemes. The Bill (through amendments to section 2 of LO under clause 3 and the addition of a new section

2A under clause 4) will leverage on Schedule 17A to IRO to broaden the meaning of the word "borrow" and introduce the concept of "specified alternative bond scheme" in LO to cover a situation when the Government raises funds by way of sukuk issuance. This will enable the funds so raised to be credited to BF.

15. The Administration has further advised that in order to allow payment from BF to settle the sums which are used to meet (a) the coupon and redemption payments to alternative bond holders, mirroring the current arrangement for BF to pay interest and redemption payment to conventional GB holders; and (b) the expenses incurred in relation to the issuance of alternative bond under GBP, the new paragraph (ea) is added to the Bond Fund Resolution (Cap. 2 sub. leg. S) to set out such arrangements (clause 7)⁴. Moreover, section 26A of IRO is amended (clauses 8 and 9)⁵ to allow coupon payments and disposal gains derived from any alternative bond issued in connection with GBP to enjoy the same profits tax exemption as that currently applicable to the interest payments and disposal gains in relation to conventional GBs.

Arrangements for issuance of sukuk under GBP

16. As issuance of sukuk under GBP may have implications on other types of bonds issued under GBP and the local bond market, the Bills Committee has enquired about the Administration's considerations in launching sukuk under GBP, the target investors and offering mechanism involved, as well as the management of sukuk proceeds.

17. In respect of the considerations for issuance of sukuk, the Administration has advised that the timing and actual issuance size will be determined with regard to the prevailing market conditions and needs. The preliminary thinking for the inaugural sukuk issuance under GBP might be in the size equivalent to around US\$500 million or more. While conventional bonds issued under GBP were denominated in Hong Kong dollar, the Administration will make reference to international practice in deciding whether the inaugural sukuk issuance should be denominated in Hong Kong dollar or US dollar.

18. Regarding the target investors of sukuk, the Administration has pointed out that institutional investors are the major players in the global sukuk market. It is envisaged that the investors of the inaugural sukuk issuance under GBP would be institutional investors. Depending on market interest and

⁴ Paragraph (e)(i) of the Bond Fund Resolution prescribes that FS may expend money from BF 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 LO for the purposes of the Fund.

⁵ Section 26A(1)(b) of IRO provides that interest paid or payable on a bond issued under LO 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.

developments, consideration may be given to whether retail investors should be included in sukuk issuances under GBP in future. As far as the offering mechanism is concerned, the Administration may engage financial institutions and legal advisers in arranging the deal through a SPV, although conventional institutional GBs are issued by the Government by way of tender.

19. On the management of sukuk proceeds, the Administration has responded that under the existing framework of GBP, proceeds from bond issuances under GBP will be placed with the Exchange Fund ("EF") for investment by the Hong Kong Monetary Authority ("HKMA"). Investment return for BF is calculated based on the average annual rate of return of EF's investment portfolio over the past six years or the average annual yield of three-year Exchange Fund Notes for the previous year, whichever is the higher.

Hong Kong's competitiveness in the development of a sukuk market and Islamic finance

20. While recognizing the benefits for Hong Kong in developing a sukuk market and Islamic finance, which include diversification in financial products and services available to Hong Kong financial markets and reinforcing Hong Kong's status as a major international financial centre and asset management center, the Bills Committee has expressed concern about the competitiveness of Hong Kong's sukuk platform vis-à-vis those of other jurisdictions in attracting international sukuk issuers and investors. In particular, it is observed that major Islamic financial centres, such as Malaysia, have well-developed sukuk markets, and Hong Kong lacks ties with Islamic communities.

21. The Administration has advised that the ABS Ordinance has enhanced the competitiveness of Hong Kong in the development of a sukuk market by providing a comparable taxation framework for some common types of sukuk vis-à-vis conventional bonds. Coupled with the core strengths of Hong Kong financial markets, including a transparent regulatory framework, a low and simple tax regime, the strong presence of international financial intermediaries and the 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. Moreover, given Hong Kong's role as Mainland's gateway to the global financial market, Hong Kong has the advantage of matching the needs of fund raisers and investment demand of investors between Mainland and the Middle East.

22. The Administration envisages that sukuk issuance 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. Furthermore,

given the shortage of highly-rated sukuk in the international capital markets, an inaugural sukuk issuance originated by the Hong Kong Government, with an excellent credit rating of AAA, 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 who look for opportunities to diversify their investment portfolios into highly-rated sukuk products. The Administration further points out that a number of overseas jurisdictions, such as Malaysia, Indonesia, Qatar, Dubai, Bahrain and Turkey have issued sovereign sukuk to develop their Islamic financial markets. The United Kingdom and Egypt are contemplating to issue sovereign sukuk. Hong Kong should make reference to the experience of these jurisdictions and use GBP as a window to promote the local sukuk market.

Efforts in enhancing the development of Islamic finance in Hong Kong

Promoting Hong Kong's sukuk platform

23. In view of increasing competition from other financial centres in developing the sukuk market and Islamic finance, the Bills Committee has stressed the need for the Administration to make concerted efforts with relevant parties in promoting Hong Kong's sukuk platform. Members have sought information on the Administration's plans and measures in this regard.

24. The Administration has advised that the strengths of Hong Kong's bond market, including sukuk market and the listing platform, have been one of the key features in the promotional work targeting international investors in recent years in promoting the opportunities and advantages presented by Hong Kong as an international financial centre. The Administration assures the Bills Committee that it will take every possible opportunity to promote Hong Kong's bond market, including the sukuk platform, when meeting with institutional investors, issuers and asset managers. The Administration has been collaborating with relevant parties such as Hong Kong Economic and Trade Offices and the market in promoting Hong Kong's sukuk platform overseas and keeping a close contact with the industry to encourage them to issue sukuk in Hong Kong. The inaugural sukuk issuance under GBP will be useful in building interest and momentum in Islamic finance activities in Hong Kong.

Effective regulatory regime and sufficient investor protection

25. Given that sukuk are innovative financing instruments and have more complex structures than conventional bonds, the Bills Committee has expressed concern about protection for sukuk investors, and stressed the importance for the Administration to ensure a robust regulatory regime over sukuk issuers.

26. The Administration has explained that, similar to other financial products, sukuk are 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). For instance, issuers are required under SFO to seek authorization from the Securities and Futures Commission ("SFC") on the issuance of any advertisement, invitation or document, which is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire the relevant sukuk products, unless an exemption applies. As institutional investors will be the target investors of sukuk issued under GBP, certain exemptions under SFO will apply.

27. As regards international co-operation in the regulation of Islamic financial products, the Bills Committee notes that SFC and the Securities Commission Malaysia ("SCM") signed a Declaration of Mutual Cooperation on Development of Islamic Capital Market and Islamic Collective Investment Schemes in November 2009 which provides the framework for SFC's and SCM's mutual recognition of Islamic collective investment schemes offered to the public. SFC has so far authorized one Malaysia-based Islamic equity fund under the mutual recognition framework. SFC and SCM will continue to maintain dialogue on the regulation of Islamic funds.

Cooperation with other Islamic financial centres and development of human capital

28. The Bills Committee has urged the Administration to increase exchanges with other financial centres in fostering co-operation and keeping abreast of latest developments in the global sukuk market. Members also consider that an adequate supply of professionals and market practitioners with expertise in sukuk issuance and Islamic finance is vital to the development of the sukuk market and Islamic finance in Hong Kong.

29. On the promotion of market awareness and knowledge of Islamic finance, the Administration has advised that HKMA has been in close collaboration with overseas central banks (such as Bank Negara Malaysia ("BNM")), international organizations (such as the Islamic Financial Services Board and the International Centre for Education in Islamic Finance) and local industry bodies (such as the Treasury Markets Association) to offer training for market practitioners. Over the past few years, HKMA has organized a series of Islamic finance seminars and workshops covering a wide range of topics (e.g. Islamic capital markets, Islamic money markets, Islamic equity funds and indices, Islamic banking, etc.) which received enthusiastic market response. To continue the efforts, the Bills Committee notes that HKMA is planning to organize an Islamic finance conference jointly with BNM in April 2014 in Hong Kong. This will provide a good opportunity for Hong Kong market

practitioners to interact with their Malaysian counterparts to exchange views on issues concerning structuring sukuk and for Hong Kong corporates to understand more about the potential of sukuk issuance as a viable funding option.

30. As regards cooperation with key Islamic financial markets, such as Malaysia and Dubai, the Administration has informed the Bills Committee that HKMA has been maintaining a close partnership with these markets. For instance, HKMA and BNM set up a private sector-led Joint Forum on Islamic Finance in 2013 which aims to promote closer collaboration between the private sector in Hong Kong and Malaysia by offering a platform for market players in both places to discuss practical and pertinent issues in the area of Islamic finance. SFC has also been working closely with its counterparts from major Islamic markets. For example, in April 2008, SFC signed a Memorandum of Understanding with the Dubai Financial Services Authority for mutual co-operation on capacity building and human capital development in Islamic finance, as well as the promotion and development of the Islamic capital market.

Committee Stage amendments

31. The Bills Committee and the Administration will not propose Committee Stage amendments to the Bill.

Resumption of Second Reading debate

32. The Bills Committee supports the resumption of the Second Reading debate on the Bill at the Council meeting of 26 March 2014.

Consultation with the House Committee

33. The Bills Committee reported its deliberations to the House Committee on 14 March 2014.

Bills Committee on Loans (Amendment) Bill 2014

Membership list

Chairman Hon Kenneth LEUNG

Members Hon James TO Kun-sun
Hon WONG Ting-kwong, SBS, JP
Hon Starry LEE Wai-king, JP
Hon Alan LEONG Kah-kit, SC
Hon Charles Peter MOK

(Total : 6 members)

Clerk Ms Connie SZETO

Legal Adviser Mr KAU Kin-wah