

## **LEGISLATIVE COUNCIL BRIEF**

Loans Ordinance  
(Chapter 61)

### **Loans (Amendment) Bill 2014**

#### **INTRODUCTION**

At the meeting of the Executive Council on 7 January 2014, the Council **ADVISED** and the Chief Executive **ORDERED** that the Loans (Amendment) Bill 2014 (“the Bill”), at **Annex A**, should be introduced into the Legislative Council (“LegCo”) to accommodate the issuance of Islamic bonds (“sukuk”<sup>1</sup>) under the Government Bond Programme (“GBP”).

#### **JUSTIFICATIONS**

##### **Development of the local bond market**

2. The primary objective of the GBP, which was set up following the passage of relevant resolutions by LegCo on 8 July 2009, is to promote the further and sustainable development of the local bond market<sup>2</sup>. 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 borrowing ceiling of the GBP was increased from HK\$100 billion to HK\$200 billion or equivalent, by virtue of a resolution passed by LegCo under the Loans Ordinance on 22 May 2013.

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<sup>1</sup> Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform with the principles of Islamic laws (“Shariah”). The Shariah prohibition on interest means that the creation of a purely debt based saleable security is not possible. Sukuk are often structured in a way so as to generate the same economic effects as conventional bonds, but in a Shariah-compliant manner. This is achieved through the use of assets and various contractual techniques to conform with Shariah.

<sup>2</sup> 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).

3. As at 15 December 2013, a total of HK\$107.5 billion worth of Government Bonds (“GBs”) (including iBonds of a total amount of HK\$30 billion) have been 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, and broadening the investors’ base.

### **Development of Islamic finance**

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 strengths of our financial markets including the strong presence of international financial intermediaries and our 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 Kong<sup>3</sup>.

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 the issuance of sukuk 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

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<sup>3</sup> These include sukuk issuances of the Government of Malaysia in 2010 and 2011, in the total amount of US\$3.25 billion.

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, with an excellent credit rating of AAA<sup>4</sup>, 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 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 institutional investors who look for opportunities to diversify their investment portfolios into highly-rated sukuk products.

### **Proposed legislative amendments**

9. We propose introducing amendments to the Loans Ordinance to accommodate the issuance of sukuk under the GBP. 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)<sup>5</sup>. 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 B**. 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. 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 the SPV 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

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<sup>4</sup> 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.

<sup>5</sup> 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.

certificates at the end of the term).

10. To this end, we propose leveraging the newly-added Schedule 17A to the Inland Revenue Ordinance (“IRO”, Cap. 112)<sup>6</sup> 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 raises funds by way of sukuk issuance. This will enable the sukuk proceeds so obtained to be credited to the Bond Fund, which would 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 propose making related amendments to (a) the Resolution of LegCo establishing the Bond Fund (Cap. 2S) (“Bond Fund Resolution”), and (b) section 26A of the IRO. For (a), we need to pay out of the Bond Fund to settle the sums which are used to meet the coupon and redemption payments to sukuk holders, mirroring the current arrangement for the Bond Fund to pay interest and redemption payment to conventional GB holders<sup>7</sup>. We also need to enable the use of Bond Fund to pay the expenses incurred in relation to the issuance of sukuk under the GBP. For (b), we need to allow coupon payments and disposal gains derived from any sukuk issued in connection with the GBP to enjoy the same profits tax exemption as that currently applicable to the interest payments and disposal gains in relation to conventional GBs<sup>8</sup>.

## THE BILL

12. The main provisions of the Bill are as follows –

- (a) **Clause 3** amends section 2 of the Loans Ordinance to expand the meaning of the term “borrow” to include a borrowing within the meaning of the new section 2A in clause 4 (paragraphs 9 and 10 above

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<sup>6</sup> 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.

<sup>7</sup> 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.

<sup>8</sup> 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.

refer);

- (b) **Clause 4** adds a new section 2A to the Loans Ordinance to set out how the terms “borrow”, “interest” and “principal” under the Loans Ordinance are to be construed in the circumstances in which money is raised by the issue of alternative bonds under a “specified alternative bond scheme” set up by the Government (paragraphs 9 and 10 above refer);
- (c) **Clause 5** preserves the current discretion of the Financial Secretary in relation to the arrangement of tabling relevant agreements relating to the issuance of bonds under the Loans Ordinance before LegCo for any relevant agreements relating to a “specified alternative bond scheme” under the GBP;
- (d) **Clause 7** adds a new subsection to the Bond Fund Resolution to set out the arrangement for paying out of the Bond Fund payment to the SPV for the purposes of making the relevant coupon and redemption payments to holders of alternative bonds, as well as the expenses in relation to the borrowing under a specified alternative bond scheme (paragraph 11 above refers); and
- (e) **Clauses 8 to 9** amend section 26A of the IRO to set out the proposed profits tax exemption for alternative bonds issued under a specified alternative bond scheme under the GBP (paragraph 11 above refers) and deals with the consequential amendment to Schedule 17A to IRO.

## LEGISLATIVE TIMETABLE

13. The legislative timetable will be –

Publication in the Gazette	10 January 2014
First Reading and commencement of Second Reading debate	22 January 2014
Resumption of Second Reading debate, committee stage and Third Reading	To be notified

## IMPLICATIONS OF THE PROPOSAL

14. The Bill has economic and financial implications as set out at **Annex C**. The Bill is in conformity with the Basic Law, including the provisions concerning human rights. It has no family, productivity, environmental, sustainability or civil service implications. The amendment proposed in the Bill will not affect the current binding effect of the Loans Ordinance, IRO and the Bond Fund Resolution.

## **PUBLIC CONSULTATION**

15. We briefed the LegCo Panel on Financial Affairs on the legislative proposal at the meeting on 2 December 2013. The Panel noted, and generally raised no objection to, the Administration's plan to introduce legislative amendments to accommodate the issuance of sukuk under the GBP. Questions were raised in relation to the parameters of the proposed sukuk issuance, the possible demand for those instruments, the impact on the overall operation and performance of the GBP, and the efforts in promoting Islamic finance. We explained that an inaugural sukuk issuance originated by the Government under the GBP would draw international investors' attention to the capability of Hong Kong's financial platform to accommodate sukuk issuances and transactions, leveraging the recent amendments to the IRO and Stamp Duty Ordinance to provide for a market-friendly tax framework for sukuk. We would take a gradual approach to assess market conditions to consider the size in any inaugural sukuk issuance under the GBP. Given the established size of the Bond Fund, we did not anticipate that any kick-off sukuk issuance under the GBP would cause any significant impact on the performance of the Bond Fund. We have also been cultivating a market-friendly environment, through manpower training and cooperation with other financial markets, to support and promote Islamic financial activities in Hong Kong.

## **PUBLICITY**

16. We will issue a press release upon the gazettal of the Bill and arrange a spokesperson to answer media enquiries.

## **ENQUIRIES**

17. Enquiries relating to the brief can be directed to Mr Jackie Liu, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) at 2810 2067.

**Financial Services and the Treasury Bureau**  
**10 January 2014**

# A BILL

## To

Amend the Loans Ordinance so that 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 into the Bond Fund; to make a related amendment to the Resolution of the Legislative Council establishing the Bond Fund; and to amend the Inland Revenue Ordinance to exempt from profits tax certain amounts derived from those bonds.

Enacted by the Legislative Council.

### Part 1

#### Preliminary

1. **Short title**

This Ordinance may be cited as the Loans (Amendment) Ordinance 2014.

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### Part 2

#### Amendments to Loans Ordinance

2. **Loans Ordinance amended**

The Loans Ordinance (Cap. 61) is amended as set out in sections 3, 4 and 5.

3. **Section 2 amended (interpretation)**

Section 2, definition of *borrow*—

**Repeal the semicolon**

**Substitute**

“, and includes to borrow within the meaning of section 2A(2);”.

4. **Section 2A added**

After section 2—

**Add**

“2A. **Meanings of *borrow*, *interest* and *principal* in case of specified alternative bond scheme**

(1) This section applies if—

(a) a specified alternative bond scheme is set up—

(i) with the Government as the originator under the specified investment arrangement in the scheme; and

(ii) with a special purpose vehicle, established by the Government, as the bond-issuer under the scheme;



- (b) alternative bonds are issued by the bond-issuer under the bond arrangement in the scheme;
  - (c) bond proceeds from the issue of alternative bonds are received by the bond-issuer under the bond arrangement;
  - (d) the Government receives a sum representing the bond proceeds (whether directly from the bond-issuer or otherwise) under the specified investment arrangement;
  - (e) the Government agrees to pay certain sums under the specified investment arrangement, which sums are—
    - (i) to be received by the bond-issuer (whether directly from the Government or otherwise); and
    - (ii) to be used by the bond-issuer for payment of the redemption payment and additional payments payable under the bond arrangement; and
  - (f) the bond arrangement is a qualified bond arrangement and the specified investment arrangement is a qualified investment arrangement.
- (2) In this Ordinance—
- (a) the sum received by the Government as mentioned in subsection (1)(d) is regarded as a sum borrowed by the Government from the bond-issuer; and
  - (b) references to borrow and principal are to be construed accordingly.
- (3) In this Ordinance—
- (a) the sums agreed to be paid by the Government as mentioned in subsection (1)(e), if they are to be

used for payment of the additional payments concerned, are regarded as interest agreed to be paid by the Government on the sum regarded under subsection (2) as being borrowed; and

- (b) a reference to interest is to be construed accordingly.
- (4) In this section, an expression specified below has the same meaning as it has in Schedule 17A to the Inland Revenue Ordinance (Cap. 112)—
- additional payments* (額外付款)
  - alternative bond* (另類債券)
  - bond arrangement* (債券安排)
  - bond-issuer* (發債人)
  - bond proceeds* (發債所得)
  - originator* (發起人)
  - qualified bond arrangement* (合資格債券安排)
  - qualified investment arrangement* (合資格投資安排)
  - redemption payment* (贖債付款)
  - special purpose vehicle* (特定目的工具)
  - specified alternative bond scheme* (指明另類債券計劃)
  - specified investment arrangement* (指明投資安排)”。

## 5. Section 3 amended (power to borrow)

Section 3(4)—

### Repeal

everything after “, which relates”

### Substitute

“to—

- (a) the issue of any bond, promissory note or other instrument under section 4; or
  - (b) a borrowing within the meaning of section 2A(2).”
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## Part 3 Related Amendments

### Division 1—Enactments Amended

**6. Enactments amended**

The enactments specified in Divisions 2 and 3 are amended as set out in those Divisions.

### Division 2—Amendment to Resolution of the Legislative Council Establishing Bond Fund (Cap. 2 sub. leg. S)

**7. Paragraph (ea) added**

After paragraph (e)—

**Add**

“(ea) for sums borrowed in the manner mentioned in section 2A of the Loans Ordinance (Cap. 61), the power under paragraph (e) includes—

- (i) paying the sums referred to in subsection (1)(e) of that section; and
- (ii) paying the expenses incurred in relation to the borrowing;”.

### Division 3—Amendments to Inland Revenue Ordinance (Cap. 112)

**8. Section 26A amended (exclusion of certain profits from tax)**

(1) After section 26A(1)(c)—

**Add**

“(ca) additional payments paid or payable on an alternative bond issued in connection with a borrowing by the Government within the meaning of section 2A(2) of the Loans Ordinance (Cap. 61);

(cb) any profit on the sale or other disposal of, or on the receipt of redemption payment for, such an alternative bond;”.

(2) Section 26A(2), Chinese text, definition of ~~證監會~~—

**Repeal the full stop**

**Substitute a semicolon.**

(3) Section 26A(2)—

**Add in alphabetical order**

“*additional payments* (額外付款) has the same meaning as it has in Schedule 17A;

*redemption payment* (贖債付款) has the same meaning as it has in Schedule 17A;”.

9. **Schedule 17A amended (specified alternative bond scheme and its tax treatment)**

Schedule 17A—

**Repeal**

“[ss. 5B(7), 14A(6), 15(3A), 16(4A), 20AC(7), 26A(4)]”

**Substitute**

“[ss. 5B(7), 14A(6), 15(3A), 16(4A), 20AC(7), 26A(2) & (4)]”.

### Explanatory Memorandum

A fund known as the “Bond Fund” was established by a resolution made and passed by the Legislative Council under section 29 of the Public Finance Ordinance (Cap. 2) on 8 July 2009 (*Bond Fund Resolution*). Another resolution was made and passed by the Legislative Council under section 3 of the Loans Ordinance (Cap. 61) (*Loans Ordinance*) to authorize the Government to borrow for the purposes of the Bond Fund. The main purpose of this Bill is to amend the Loans Ordinance so that money raised by the Government by alternative bonds issued under a specified alternative bond scheme set up by the Government (*the scheme*) is treated as money borrowed by the Government and may be credited into the Bond Fund.

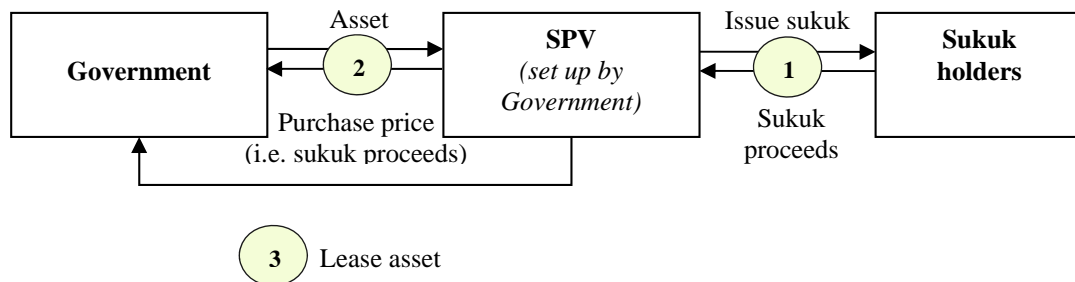
2. Part 1 of the Bill contains a preliminary provision. Clause 1 sets out the short title. The Loans (Amendment) Ordinance 2014 comes into operation on the day on which it is published in the Gazette.
3. Part 2 of the Bill amends the Loans Ordinance. The main provision is clause 4 which adds a new section 2A to the Loans Ordinance. Under that new section, money raised by the Government by alternative bonds issued under the scheme is regarded as money borrowed by the Government. Any sum paid or payable by the Government that is to be used for payment of additional payments payable under the scheme is regarded as interest paid or payable by the Government on the money so borrowed.
4. Part 3 of the Bill contains related amendments to the Bond Fund Resolution and the Inland Revenue Ordinance (Cap. 112) (*Inland Revenue Ordinance*).
5. The amendment to the Bond Fund Resolution in Division 2 of Part 3 of the Bill enables the Financial Secretary to expend money from the Bond Fund for making redemption payment and additional

payments under the scheme and paying the expenses in relation to the borrowing.

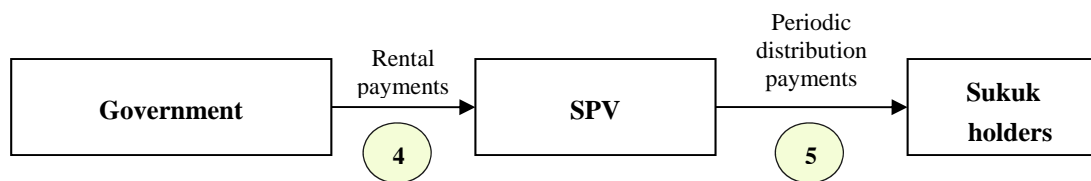
6. The amendments to the Inland Revenue Ordinance are contained in Division 3 of Part 3 of the Bill. Additional payments received under the scheme, and profits on the sale or other disposal of, or on the receipt of redemption payment for, any alternative bond under the scheme, will be exempt from profits tax under that Ordinance.

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

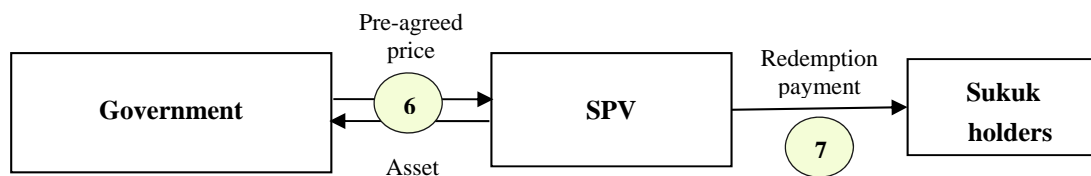
Upon formation



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.

*Economic implications*

The proposal will accommodate the issuance of sukuk under the GBP, thereby broadening the product types and investors' base and promoting the further and sustainable development of the local bond market. This will also give impetus to other potential sukuk issuers to raise funds in Hong Kong, thereby helping to reinforce Hong Kong's status as an international financial centre and asset management centre.

*Financial implications*

2. The Bill seeks to apply the same profits tax exemption to holders of sukuk as it applies to holders of conventional bonds issued under the GBP. The amount of tax to be exempted should not be regarded as revenue foregone as they should not be charged in any way under a level-playing field.