

Presence of an Islamic Bond Market

A. Current Status of the Islamic Bond Market in Hong Kong, China

The tax laws in Hong Kong, China were amended in 2013 to provide a taxation framework for *sukuk* (Islamic bonds) comparable to conventional bonds. The government also issued two *sukuk* in 2014 and 2015 to play a lead role to the market. These measures have helped create a conducive environment for the *sukuk* market to grow in Hong Kong, China.

B. The Nature of Sukuk

In its simplest form, *sukuk* are certificates of equal value that represent an undivided interest (proportional to the investor's interest) in the ownership of an underlying asset (both tangible and intangible), usufruct, services, or investments in particular projects or special investment activities. Unlike conventional debt securities that mirror debts or loans on which interest is paid, *sukuk* can be structured based on innovative applications of Islamic principles and concepts. Nonetheless, *sukuk* share some similarities with conventional debt securities in that they are similarly structured based on the ability of the issuer to pay the periodic distribution and principal repayment.

A prerequisite for *sukuk* is the compliance with Islamic, or Shariah, principles that prohibit the charging of interest. A *sukuk* is structured so that it involves an exchange of Shariah-compliant assets for financial consideration that allows investors to earn profits and rentals from transactions in the future.

There are various types of *sukuk* since different Shariah principles are used for the creation of Islamic securities. The more prominent ones are the sale and purchase of an asset based on deferred payment, the leasing of specific assets, and a profit- and loss-sharing scheme.

C. Legal Implications for Investors

Sukuk represent ownership claims on a pool of assets or rights to receivables or participation. *Sukuk* may be issued as public offers or via private placements.

The various transaction contracts that form the genesis for a *sukuk* issue have different legal implications for investors. *Sukuk* investors should, therefore, be fully apprised of and knowledgeable about their rights and obligations under the various underlying Islamic concepts and principles, which are explained hereafter.

1. Rights to Underlying Asset and Its Cash Flow

For *sukuk* that represent ownership of assets, their usufruct or services (the underlying asset), the claim embodied in the *sukuk* is not just a claim on the underlying asset used in the *sukuk* transaction, but also the right to the cash flow and proceeds from the sale of the asset.

2. Rights to Cash Flow from the Contract of Exchange but Not the Asset

For *sukuk* issued as evidence of indebtedness arising from the sale of the asset based on contracts of exchange, the claim is on the obligations stemming from the applied contract of exchange, and not ownership of the physical asset as ownership has been transferred to the obligor.

3. Rights to Undivided Interest in Specific Investments

For special investment activities funded through a loss-sharing scheme, the *sukuk* represent the holders' undivided interests in the specific investments. This structure is used to raise funds for projects on the basis of partnership contracts. *Sukuk* holders or investors then become the owners of the project in proportion to their respective shares. Profits are distributed according to a pre-agreed proportion while losses are prorated according to their equity share.

D. *Sukuk* Issuance in Hong Kong, China

The government successfully issued two *sukuk* under its Government Bond Programme in September 2014 and June 2015. The two *sukuk* were well-received by global investors, achieving multiple times oversubscriptions and setting a benchmark for the market. The first *sukuk* used an *ijarah* (leasing) structure and the second *sukuk* used an asset-light *wakalah* (agency) structure in which only 34% of the underlying assets were fixed assets, compared to 100% for the *ijarah* structure. The two *sukuk* issuances have demonstrated the viability and flexibility of Hong Kong, China's platform.

E. Regulations for *Sukuk*

The current regime of the SFO and CWUMPO—in terms of public offering of securities and the prospectus registration and disclosure requirements for debt securities, conduct regulations of intermediaries, and other investor protection provisions—apply to mainstream *sukuk* as they apply to conventional debt instruments. The product structure of the *sukuk* and the way it is marketed needs to be examined to exactly determine the application of the relevant legislation in any particular case.

F. Basic Market Infrastructure Required to Facilitate Islamic Finance

Enhancements have been made to the US dollar and euro RTGS systems as well as the CMU to facilitate participating members to identify transactions related to Islamic finance and to segregate Islamic-related funds from others.

G. Tax-Related Issues for Islamic Finance in Hong Kong, China

The more complicated structure of *sukuk*, which involves the setting up of a special purpose vehicle and multiple transfers of underlying assets, has led to additional tax liability for *sukuk* issuers in the past.

The enactment of the Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 in July 2013 has overcome this obstacle by removing the additional profits tax and stamp duty charges incurred when issuing *sukuk*, thus leveling the playing field and providing a comparable taxation framework between *sukuk* and other conventional bonds.

The legislation adopts a prescriptive and religion-neutral approach, introducing the Alternative Bond Scheme to denote the *sukuk* arrangements. It covers five common types of *sukuk* in the global market: *ijarah* (lease arrangement), *musharakah* and *mudarabah* (profits sharing arrangement), *murabahah* (purchase and sale arrangement), and *wakalah* (agency arrangement).