Basel III Creates New Opportunities for Sukuk (Islamic Bond) Issuance

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I. Three impacts Basel III will have on the sukuk market

In response to the financial crisis from 2008, the Basel Committee on Banking Supervision significantly strengthened banking regulations to make the banking and financial system more robust by issuing Basel III. Basel III primarily focuses on new capital and liquidity regulations aimed at ensuring the soundness of banks operating internationally. The objective is to require banks to hold more high-quality capital, enough to absorb losses in the event of financial market disruption, and to maintain higher levels of liquidity so that they can cope with the risk of financial markets malfunctioning and also lower their dependence on money markets.

Islamic banks were not directly involved with the factors that triggered the financial crisis nor were they significantly exposed to that crisis, but they will be affected by future reregulation as the regulators in their home jurisdictions apply Basel III. The Islamic Financial Services Board (IFSB), the multilateral organization that issues global standards and guiding principles for institutions offering Islamic financial services (IIFS), announced a set of rules for Islamic banks based on Basel III.

We think Basel III and the rules proposed by the IFSB based on Basel III will affect the global sukuk (Islamic bond) market as follows.

1. The possibility of increased domestic and international issuance by Islamic banks of sukuk that can be counted toward capital so as to meet the increase in capital adequacy ratios relative to Basel II.
2. The possibility of an increase in the issuance of sukuk by highly rated governments and companies aimed at meeting the increased demand for investing in investment-grade sukuk from Islamic banks trying to meet Basel III liquidity requirements.
3. The possibility of a decline in the cost of sukuk issuance via standardization made possible by legislative (including tax law) and regulatory reform in Islamic and non-Islamic countries[1] aimed at facilitating sukuk issuance.

[1] An Islamic country is defined as one where the majority of the population is Muslim.

Next, we overview the trend in Islamic banking regulations at the IFSB and consider the impact that regulatory reform will have on the sukuk market.

II. The IFSB and revised Basel regulations

1. The Islamic Financial Services Board (IFSB)

Regular banks and Islamic banks differ in several aspects, including their systems, concepts, businesses, and contracts. Basel III does not distinguish between regular financial institutions and Islamic financial institutions, however. We think this is explained by the fact that Islamic banking institutions only account for a very small slice of the global financial system.

Given the differences between Islamic finance and regular finance, Basel's failure to distinguish between the two could cause several problems, an example of which is one related to profit-sharing investment accounts (PSIA)[2], an important product for Islamic banks. PSIA deposits are an important source of funding for many Islamic banks, and because account holders bear the risk of losses on investments made with that pool of funds, the banks do not incur any risk. Even if the structure of PSIA were understood to be based on a joint investment between the bank and the account holder, only a portion of the total invested amount would be a risk for the bank. As long as Basel regulations do not recognize that the fund pools within PSIA are different in their calculations of capital adequacy ratios, however, the investment will be treated the same as a regular loan.

Islamic financial assets, growing at an average annual rate of 17.4% over the past four years, reached a total of US$1.8 trillion in 2013 and are generally expected to exceed US$2 trillion in 2014. Of that total, 78% are held in Islamic banks, 16% in sukuk, 4% in Islamic funds, and 1% each in takaful (Islamic insurance) and Islamic micro-finance[3]. In light of its growth potential, we think it will become increasingly important to take Islamic finance into account when designing regulations.

Malaysia established the Islamic Financial Services Board (IFSB) in 2002 to solve this problem. The IFSB acts as a global standard-setting body for Islamic countries and has the following objectives.

- To efficiently monitor and regulate Islamic financial institutions, provide them with suitable guidelines and advice based on global standards (e.g., Basel regulations)[4], and provide leadership on methods for identifying risk, measuring

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2 The funds received from the PSIA deposit holder are invested by the bank in sharia-compliant investments, and the profits and losses from those investments are distributed to deposit holders.

3 Zubair Mughal, "2014 will be promising for Islamic Finance Industry", *Zawya / Thomson Reuters*, 31 Dec 2013.

4 Providing guidelines and advice suitable to Islamic financial institutions means taking into account the requirement for compliance with sharia law.

and managing risk, and standards for disclosing risk so as to support the sound development of the Islamic finance industry.

- Support the stability and soundness of the international monetary and financial systems, and those of the member countries through cooperation with the world's major global standard-setting institutions and financial regulators in each country.
- Develop tools and methods to enable Islamic financial institutions as well as regular financial institutions to efficiently invest and manage risk, and foster growth in the overall financial system[5].

The IFSB cooperates with financial supervisory and regulatory authorities that support the sound development of Islamic finance and proposes regulations and reforms in a broad range of financial sectors, including banking, capital markets, and takaful (Islamic insurance). Since its founding, the IFSB has proposed regulations for Islamic financial institutions and published 22 sets of standards, including in the form of guidance and guiding principles[6]. As of end-2013, the IFSB had 185 members based in 45 jurisdictions, including 58 regulatory and supervisory authorities, eight international institutions, 112 financial institutions, and seven self-regulatory organizations (SROs, which include industry associations and stock exchanges).

2. Basel III and IFSB-15

Like regular banks, Islamic banks are exposed to market risk, credit risk, operational risk, and reputational risk. In addition, in nearly all financial markets Islamic banks must manage a higher level of liquidity risk than regular banks, because the prohibition on receiving interest payments under sharia law limits their ability to use any financial tools that involve interest. Consequently, in countries that do not have sufficiently developed sharia-compliant Islamic capital markets or Islamic financial products, Islamic banks are unable to invest their surplus liquidity (cash) in interest-bearing bonds or lend it to other financial institutions with interest. Additionally, because they are unable to get interest-bearing funding from regular financial institutions or central banks when the market comes under stress, Islamic banks have a harder time managing their liquidity than do regular banks.

To deal with these problems, since 2005 the IFSB has drawn up capital adequacy ratios and guidelines for managing liquidity suitable for Islamic banks and based on Basel regulations. The IFSB also published IFSB-15 at the end of 2013, a proposal for comprehensive regulatory reform aimed at strengthening capital and liquidity requirements for Islamic banks[7].

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5 For details, see IFSB Objectives on the IFSB website (http://www.ifsb.org/objectif.php).
6 For details, see "Published Standards" on the IFSB website (http://www.ifsb.org/published.php).
7 "IFSB-15: Revised capital adequacy standard for Institutions offering Islamic financial services (excluding Islamic insurance (takaful) institutions and Islamic collective investment schemes)."

In response to Basel III, IFSB-15 aims to introduce a framework for capital ratio and liquidity requirements that ensures effective risk management in the Islamic banking industry. It also offers sharia-compliant guidelines related to the components of regulatory capital (including Tier 1 and Tier 2). In addition, it analyzes the risk exposure of Islamic financial products (like PSIA and sukuk) and services, and proposes capital ratio requirements and other rules to match. IFSB-15 also prescribes rules on the capital preservation buffer and leverage ratios.

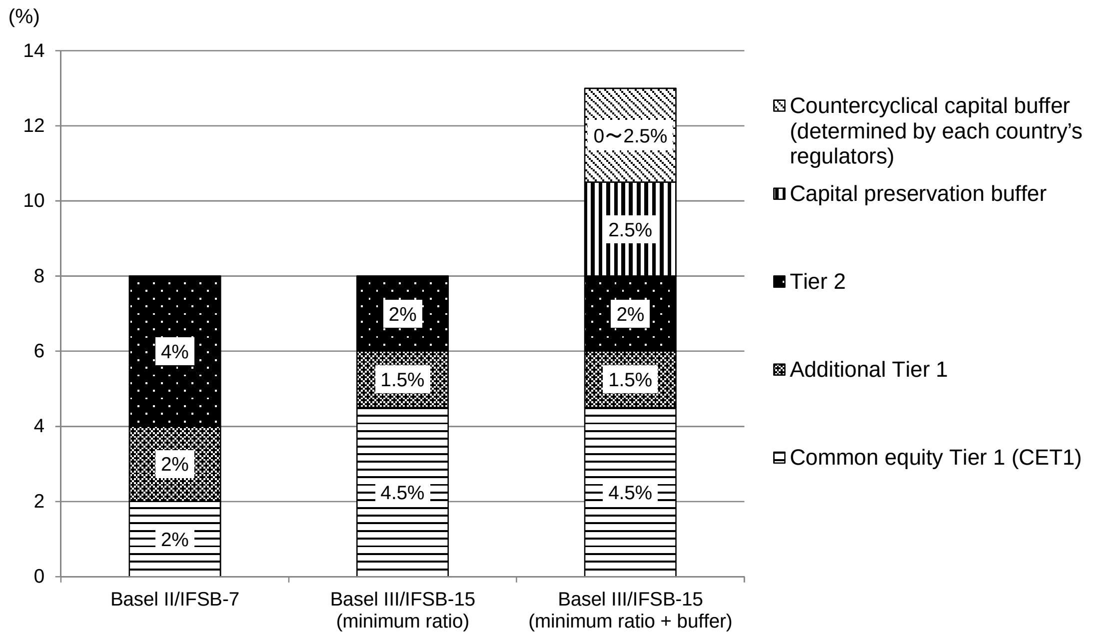
Islamic countries will not necessarily implement the regulations drawn up by the IFSB. Because none of the IFSB's regulations are legally binding, their actual implementation is at the discretion of each country's regulatory institutions.

III. Impact from changes in capital ratio requirements on the sukuk market

1. Growth in sukuk issuance by Islamic banks

Under Basel III, the 8% minimum capital ratio is padded with a capital conservation buffer of 2.5% plus another 0-2.5% countercyclical capital buffer at the discretion of regulators in each country (Figure 1). The new rules also tightened up the requirements for counting Tier 1 capital, comprised of common equity Tier 1 (CET1) capital and additional Tier 1 capital (including preferred stock and hybrid securities), as well as Tier 2 capital.

Figure 1: Capital strengthening under Basel III/IFSB-15



Note: Capital requirements will be incrementally raised to the levels shown in the graph by 2019.
Source: Nomura Institute of Capital Markets Research, based on Basel III and documented IFSB-15 rules

Many of the financial products offered by Islamic banks are backed by commodities or physical assets (such as real estate), and thus exposed to market risk. This is why the IFSB has emphasized the importance to Islamic banks of the countercyclical capital buffer proposed under Basel III, and especially for Islamic banks operating in developing countries, of maintaining a countercyclical capital buffer on top of the capital conservation buffer[8].

The IFSB set its capital requirements at the same percentages as under Basel III. On the other hand, taking into account the sharia-imposed limits on the funding tools that Islamic banks can use as capital, IFSB-15 allows a portion of Tier 1 or Tier 2 capital to consist of sukuk issuance based on Islamic bank assets. More specifically, perpetual musharaka sukuk can be included in additional Tier 1 capital, while sukuk with a maturity of at least five years (mudaraba sukuk and wakala sukuk) can be included in Tier 2 capital[9] (Figure 2).

Figure 2: Capital instruments that can be counted toward capital under Basel III and IFSB

Basel III		IFSB-15	
Core Tier 1 (CET1)	Common stock	**Core Tier 1 (CET1)**	Common stock
Other Tier 1	Preferred stock	**Other Tier 1**	Preferred stock
	Hybrid securities		Musharaka sukuk
Tier 2	Subordinated bonds	**Tier 2**	Mudaraba sukuk and wakala sukuk (with an initial maturity of at least five years)
	Subordinated loans		

Note: 1. According to the IFSB, the distribution ratio to sukuk holders must be set irrespective of the issuing bank's credit rating.
2. Preferred shares in Islamic structures are only accepted in some countries.

Source: Nomura Institute of Capital Markets Research, based on Basel III and documented IFSB-15 rules

The rules basically treat perpetual musharaka sukuk issued by Islamic banks the same as hybrid securities issued by regular banks, and likewise treat sukuk with a maturity of at least five years the same as subordinated debt issued by a regular bank. Of course, in some respects these sukuk do not have the same capital characteristics as the tools for raising capital used by conventional banks, but the IFSB recognizes a similarity in light of the nature of Islamic financial contracts and customary practices in the sukuk market (see appendix).

2. Sukuk issuance to manage capital

In response to the above, Islamic banks worldwide have started using sukuk issuance to raise their capital ratios up to the levels required under Basel III. Specific examples include a US$1 billion sukuk issued by Abu Dhabi Islamic Bank to raise Tier 1 capital in 2012[10], a US$1 billion sukuk issued by Dubai Islamic Bank to raise

8 According to IFSB-15, regulators in each country can add a countercyclical capital buffer of 2.5% or more when necessary.

9 See the appendix for further details on each type of sukuk.

10 Exposure drafts of IFSB-15 had already been published in 2012.

Tier 1 capital in 2013[11], and a 1.4 billion riyal (roughly US$373 million)[12] sukuk issued by Saudi Hollandi Bank to raise Tier 2 capital in 2012. The order books for the sukuk issued by Abu Dhabi Islamic Bank and Dubai Islamic Bank each totaled over US$14 billion, evidence of strong demand from fund managers, individual investors, and Islamic banks[13]. Outside of the Persian Gulf region, Malaysia's AmIslamic Bank, RHB Bank, and Public Bank have all received approval from Securities Commission Malaysia to issue sukuk to meet the Basel III capital ratio requirements, and have announced plans to raise Tier 2 capital through incremental sukuk issuance totaling 3 billion ringgit (about US$970 million), 1 billion ringgit (about US$325.8 million), and 5 billion ringgit (about US$1.5 billion)[14], respectively[15]. AmIslamic has already issued 200 million ringgit (about US$60.9 million) of Basel III-compliant sukuk, the first Basel III sukuk issued in East Asia.

As the IFSB continues to make incremental increases in its capital requirements in step with Basel III, we expect Islamic banks to meet the resulting need to raise capital by increasing their issuance of sukuk.

IV. Introduction of liquidity requirements increases demand for sukuk

1. Growing demand for sukuk with strong credit rating

We expect the phased-in introduction of the liquidity coverage ratio (LCR), one of the Basel III liquidity requirements, to increase the need for high-quality liquid assets among Islamic banks[16].

As already noted, because global Islamic banks face a number of sharia restrictions on how they can manage liquidity, unlike regular banks they are unable to hold the sovereign bonds issued in large quantities by the US, UK, German, and Japanese governments. Issuance of sovereign sukuk is limited, because those Islamic governments with sound government finances, like the Gulf states, have no need to issue sukuk internationally in large quantities, whereas Islamic governments in Africa are unable to issue sufficient quantities of sukuk owing to liquidity constraints and their lack of credit worthiness. Consequently, not enough high-quality liquid assets compliant with Islamic finance are being supplied to the global financial markets, and this creates a risk that Islamic banks will be unable to meet rising LCR standards.

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11 In the UAE, raising Tier 1 capital requires mudaraba sukuk, and the sukuk issued by Abu Dhabi Islamic Bank and Dubai Islamic Bank are of the mudaraba variety. For details, see 4. Mudaraba sukuk in the appendix.

12 The exchange rate on 26 November 2012 was US$1/3.74536 riyals.

13 This information comes from "The Current Prospects for Risk-Sharing Sukuk," published by HSBC Amanah on 11 September 2013.

14 The exchange rate on 15 February 2014 was US$1/3.30354 ringgit.

15 Al-Zaquan Amer Hamzah, "Malaysia's AmIslamic plans region's first Basel III sukuk," *Reuters*, 13 February 2014 and Al-Zaquan Amer Hamzah, "Malaysia's Public Bank seeks approval for $1.5bln Basel III sukuk," *Reuters*, 26 February 2014.

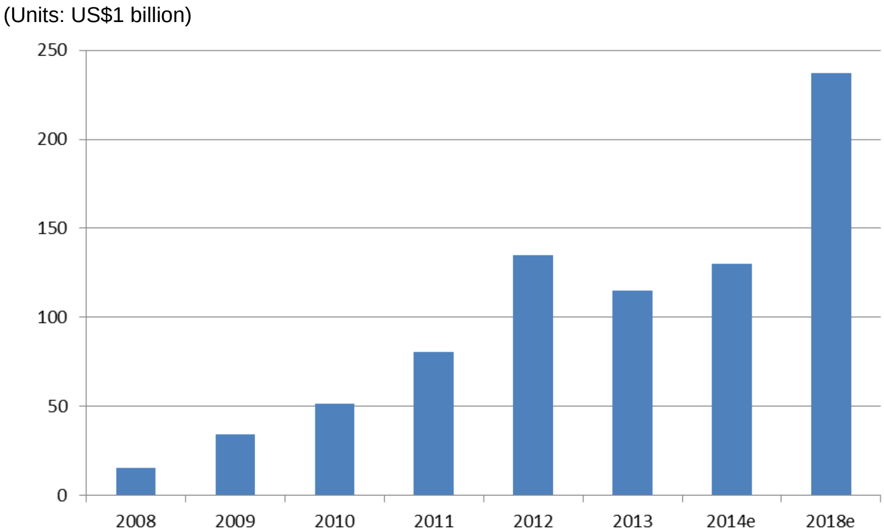
16 The minimum LCR in 2015 is set at 60%, after which it steps up by 10 percentage points each year until it reaches 100% in 2019.

Recent data on the global sukuk market shows total sukuk issuance hit a record-high US$135 billion in 2012, but fell back to about US$115 billion in 2013, partly due to the effects of tapering by the US Federal Reserve Bank (FRB) on global markets. We expect investor demand for sukuk to continue to outstrip supply because of growth in Islamic financial assets and the increased need for high-quality sharia-compliant liquid assets[17].

As clear from the size of the order books for the sukuk issued by Abu Dhabi Islamic Bank (Fitch: A+) and Dubai Islamic Bank (Fitch: A), there are growing opportunities for highly rated governments and corporations to issue sukuk.

Summarizing the above, we think the implementation of IFSB-15 will increase demand for issuing sukuk as a way to raise capital and increase demand for investing in sukuk as a high-quality liquid asset, and this should encourage growth in the global sukuk market. Reuters expects global sukuk issuance to resume growth from 2014, to US$130 billion in 2014 and to US$237 billion in 2018[18], (Figure 3). Ernst and Young estimates global demand for sukuk will reach US$900 billion in 2017.

Figure 3: Forecast global sukuk issuance



Note: Data for 2014-2018 are Reuters forecasts.
Source: Nomura Institute of Capital Markets Research, based on data from Zawya, Bloomberg, and KFH Research

V. Global growth in handling of Islamic finance

In response to this growth in Islamic banking assets and the size of the sukuk market, a number of non-Islamic governments and corporations in non-Islamic jurisdictions as well as multilateral institutions have announced plans to issue sukuk.

[17] Bernardo Vizcaino, "Global sukuk supply/demand gap to peak in 2014," *Reuters*, 26 February 2014 and "Global demand for Sukuk to reach US$900bn by 2017," *Ernst & Young*, 9 September 2012.

[18] Bernardo Vizcaino, "Birth of new sovereign sukuk sources to broaden market," *Reuters*, 22 January 2014.

1. Europe

Luxembourg's government (Fitch: AAA) submitted a bill to its legislature authorizing sukuk issuance, and announced plans to issue a €200 million (US $275 million) sovereign sukuk in 2014 (whether the sukuk will be denominated in euros or in US dollars is to be determined). Although it will probably take another 2 to 5 months before the legislation is passed, the real estate that will back the sukuk has already been identified[19]. Meanwhile, the Luxembourg Stock Exchange has listed a total of 16 sukuk issues since 2002[20]. Much of the investment from Gulf countries into Europe has been done through Luxembourg corporations for tax and legal reasons, and it appears the Luxembourg government wants to maintain its status as the gateway to Europe for Islamic financial assets by participating in the sukuk issuance market[21].

The UK government announced plans to issue a £200 million sovereign sukuk in 2014[22]. The UK implemented its own liquidity requirements for the amount of domestically held liquid assets, and the sovereign sukuk scheduled for issuance in September 2014 is aimed at enabling the 25 Islamic banks in the UK to manage their liquidity[23]. The government has also created an Islamic finance task force[24] to encourage regular banks to develop sharia-compliant financial products, and aims to make the UK the hub for Islamic finance in the West[25].

There are already more Islamic banks operating in the UK than in any other Western European country, and more than a dozen universities and business schools offer courses on Islamic finance. Nevertheless, George Osborne, the UK's Chancellor of the Exchequer, says the UK must do even more "to reap all the benefits of Islamic finance." The government plans to introduce lending schemes, including student loans, housing loans, and business startup loans, as well as entrepreneurial support programs

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19 Abhinav Ramnarayan and Bernardo Vizcaino, "Luxembourg moves closer to debut sukuk," *Reuters*, 7 January 2014.

20 Bernardo Vizcaino, "Luxembourg bill for debut sukuk to take 2-5 months to pass," *Reuters*, 16 February 2014.

21 "EU GCC Invest Report 2013", *EU GCC Invest*, April 2013, Andy Sambidge, "GCC investments in Europe jump to $78.9bn," *Arabian Business Publishing*, 5 July 2010, and Abhinav Ramnarayan and Bernardo Vizcaino, "Luxembourg moves closer to debut sukuk," *Reuters*, 7 January 2014.

22 The UK government issued the mentioned £200 million sovereign sukuk on 25 June 2014. The sukuk received very strong demand, with orders totaling around £2.3 billion, and will mature on 22 July 2019. The profit rate has been set at 2.036%.(Source: HM Treasury. This report was originally published in Japanese on April 18, 2014. This footnote was added to the English translation on July 23, 2014)

23 Matthew Amlôt, "UK Sukuk slated for September launch," *CPI Financial*, 20 February 2014.

24 The UK's Islamic task force was established in March 2013 to increase the UK's importance to the global Islamic finance market, including by promoting growth of the domestic Islamic finance market and encouraging inbound investment from Islamic countries. For details, see the UK government press release "Government launches first Islamic Finance Task Force," 11 March 2013. (https://www.gov.uk/government/news/government-launches-first-islamic-finance-task-force--2).

25 "London steps up Islamic finance ambitions," *Reuters*, 18 September 2013.

like its Enterprise Allowance Scheme, that comply with sharia law. This is because "Islamic finance will not only create jobs in the UK, it will bring in investment"[26].

Efforts by the UK's government are already bearing fruit. Examples of construction projects financed by Islamic investors include London's Shard Building[27] and the athletes' village for the 2012 London Olympics. Islamic finance is also an important source of funding for the UK's infrastructure investments. A £400 million investment from Malaysia[28] helped pay for the redevelopment of the Battersea power station[29], and Dubai invested £150 million in the London Gateway deep-water port project[30]. Another result from these efforts was that London became the first non-Islamic country to host the World Islamic Economic Forum in 2013. The UK's sovereign sukuk, which has already captured the interest of global Islamic investors, is also gaining broader attention.

2. Africa

A number of non-Islamic countries in Africa are also planning on issuing sovereign sukuk. South Africa's government is now looking at funding through a sukuk, and its Ministry of Finance announced plans to issue its first sovereign sukuk in 2014[31]. Additionally, the governments of Kenya, Tanzania, and Nigeria have long considered issuing sukuk, and should move forward depending on the results of South Africa's sukuk issuance[32].

3. US

Over 2.6 million Muslims now live in the US, where the world's highest rate of growth in the number of followers of the Muslim religion was recorded from 2000 until 2010[33]. The US is behind in the development of Islamic finance, however, and we primarily attribute this to issues with the image of Islam in the country.

Despite this, a number of major US corporations have issued sukuk overseas, and some US banks have been the arranger or manager of global sukuk issuances (Figure

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[26] George Osborne, "London can lead the world as an Islamic finance hub," *Financial Times*, 28 October 2013 and "UK government pushes Islamic finance in the country, introduces a Shariah compliant mortgage aid scheme," *Islamic Finance News (IFN)*, 12 February 2014.

[27] The Shard and the Shard London Bridge are super high-rises built on the southwest side of London Bridge station.

[28] According to Reuters, Malaysia is the second largest source of investment in UK real estate behind the US. "London steps up Islamic finance ambitions," *Reuters*, 18 September 2013.

[29] Jeremy Grant, "Battersea project brings Malaysia's UK investments into focus," *The Financial Times*, 1 July 2013.

[30] Andrew Critchlow, "DP World open to more UK investment after London Gateway," *The Telegraph*, 29 March 2014.

[31] "Debut Sukuk for South Africa could be issued as soon as March this year," *IFN*, 27 February 2014.

[32] Mirna Sleiman, "South Africa's debut sukuk seen in first-quarter 2014," *Reuters*, 25 November 2013.

[33] "The Future of the Global Muslim Population," *PEW Research Center*, 27 January 2011.

4). There are also some US companies considering the issuance of sukuk to raise capital domestically. For example, Washington based investment bank Taylor-DeJongh set up a research division to investigate the possibility of using sukuk for energy and infrastructure project financing, and is currently studying ways for the railway company Continental Rail to raise funds using sukuk. If the project succeeds, it will become the flagship case of a domestic US firm using sukuk financing[34].

Figure 4: Issuance of international sukuk by US companies

Issuance /maturity	Issuer	Borrowers	Borrower's origin	Sector	Issuance amount	Status	Type of sukuk	Listings	Arrangers	Managers	Rating agencies	Ratings
2009--2014 (60 months)	GE Capital	General Electric	US	Electronics	US$500mn	Outstanding	Ijarah (lease)	London, Dubai, Malaysia	Citigroup, Goldman Sachs International	Citigroup, Goldman Sachs International, NBAD, LMH	Moody's, S&P	Aa2. AA+
2009--2014 (60 months)	Hilal Sukuk	International Finance Corporation (IFC)	US	Financial	US$100mn	Outstanding	Ijarah (lease)	Bahrain, Dubai	HSBC Amanah, KFH, LMH, Dubai Islamic Bank	HSBC Amanah, KFH, LMH, Dubai Islamic Bank	Moody's	Aaa
2006--2019 (156 months)	East Cameron Gas Company	East Cameron Partners, LP	US	Energy	US$167mn	Nonperformance	Musharakah (partnership)	Vienna	Merrill Lynch. BSEC S.A.	Merrill Lynch	S&P	CC
2005--2010 (60 months)	World Bank (International Finance Corporation (IFC))	International Finance Corporation (IFC)	US	Financial	US$200mn	Redeemed	BBA (deferred payment sale)	Unlisted	ABN Amro Bank (Malaysia), CIMB Islamic	ABN Amro Bank (Malaysia), CIMB Islamic	Moody's	Aaa
2004--2007 (36 months)	World Bank (International Finance Corporation (IFC))	International Finance Corporation (IFC)	US	Financial	US$131mn	Redeemed	BBA (deferred payment sale)	Unlisted	HSBC Amanah, CIMB Islamic	HSBC Amanah, CIMB Islamic	Moody's, S&P	Aaa, AAA

Source: Nomura Institute of Capital Markets Research, based on data from the Islamic Finance Information Service (IFIS)

4. Asia

Within Asia recently, activity in Hong Kong is particularly worth noting. The Hong Kong government is more actively courting Islamic finance and investment, aiming to become an important Islamic financial hub in Asia and narrow its gap with Malaysia and Singapore. The Hong Kong government submitted the Loans (Amendment) Bill 2014 in January 2014 to issue sovereign sukuk under its government bond issuance program. If the legislation passes, it would be the second reform to promote Islamic finance in Hong Kong. In October 2013, it implemented legislation[35] providing a taxation framework for sukuk similar to regular bonds[36].

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34 Nathaniel Popper, "Islamic Banks, Stuffed With Cash, Explore Partnerships in West," *New York Times*, 25 December 2013.

35 "Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013."

36 "Hong Kong Gazettes new laws to make way for Sukuk issuances," *IFN*, 13 January 2014.

Hong Kong is clearly committed to becoming an Islamic financial center. The Hong Kong Stock Exchange already lists international sukuk issuance, including sovereign sukuk from Malaysia, totaling US$3.25 billion[37], and through a further easing of domestic issuances plans to build a new market to facilitate local sukuk.

There was also an important announcement regarding sukuk in Asia made by the Asian Development Bank (ADB). The ADB is currently strengthening its ties with Islamic finance and is considering issuing sukuk as early as in 2014. There is a possibility that the ADB will not stop with just one issue but set up a scheme for periodic issuance[38]. There is also the potential that sukuk issuance by the ADB, which has a AAA credit rating, could encourage sukuk issuance by ADB member nations.

Japanese companies have also become active in Islamic finance recently. The Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad announced at the Islamic Finance News Asia Forum 2013 that it was planning on issuing a sharia-compliant securitization scheme “soon”[39]. BTMU Malaysia was a co-lead manager for the 11 ringgit-denominated sukuk issued by Toyota Capital since 2008, and is the first Japanese bank set up an internal sharia committee.

Following the first US dollar-denominated sukuk issued by a Japanese company, a deal from Nomura Holdings in 2010, Japan's financial institutions have shown continuing interest in Islamic finance.

VI. Summary

Islamic financial institutions worldwide are looking to increasingly use securities markets for Islamic finance in step with their investment diversification and growth. We think the strengthening of capital requirements and introduction of LCR (Liquidity Coverage Ratio) requirements under Basel III and IFSB-15 will increase demand for sukuk and could drive future growth in the market.

Furthermore, numerous countries in Europe, Africa, and Asia plan to issue sovereign sukuk in 2014, which we expect to be an important year for growth of the global sukuk market. A large number of countries, including non-Islamic countries, issuing sukuk would contribute greatly to the globalization and growth of a sukuk market that is now heavily weighted toward the Gulf states and Islamic countries in Asia, primarily Malaysia.

There still are some regulatory barriers in non-Islamic countries and in some Islamic countries, however. Issuing sukuk in markets without the right legal framework, accounting expertise, knowledge of sharia, and credit worthiness winds up costing more than issuing a regular bond, and makes sukuk issuance less attractive.

37 From the Legislative Council Commission (LegCo), Loans (Amendment) Bill 2014.
38 Bernardo Vizcaino, “ADB considering Islamic bond, sovereign insurance product,” *Reuters*, 16 December 2013.
39 Lauren Mcaughtry, “Islamic Securitization: An Overview,” *IFN Supplements*, November 2013 Issue.

This is why it is essential for the regulatory authorities to make extra efforts to accommodate Islamic finance.

The UK, Luxembourg, and Hong Kong are already actively reforming their laws and promoting the listing of sukuk on their securities exchanges. They are also developing domestic Islamic finance products and services to make their markets more attractive to investors from Islamic countries.

There are voices within the Hong Kong government who argue that Hong Kong's very small Islamic population compared with Malaysia and Singapore makes issuing sovereign sukuk less attractive. Given Hong Kong's strong credit rating[40], however, for market participants in a global issuance, factors like the yield and credit strength are more important to non-Islamic investors than whether the product is a sukuk or a regular bond, and the size of the domestic Muslim population will not have much impact. The even more compelling reason for their decision is that the increased investment needs among the world's Islamic banks brought by Basel III rules provide a good opportunity to issue sovereign sukuk with an investor-grade rating[41].

Japan's growth strategy includes a number of different measures aimed at making Japan Asia's top financial and capital market. In light of the rapid growth of Islamic emerging markets, the increased demand for sukuk brought by regulatory reforms, and the diverse needs of Islamic investors, strengthening the country's standing in Islamic finance can be an important means to further internationalize the domestic financial and capital markets. Furthermore, it is possible for creditworthy Japan, like the UK, Luxembourg, and Hong Kong, to attract investment from Islamic countries in the Middle East and Southeast Asia with an abundance of surplus capital by developing products and instituting reforms to allow the listing of sukuk and issuance of sovereign sukuk.

In this regard, one possible step for Japan, as was done in the UK, is to set up a task force made up of domestic Islamic finance experts who could cooperate with regulatory authorities and the FSA to better understand the potential for Islamic finance with Japan. In tandem with this, there is probably a need to cooperate with global institutions like the IFSB to further promote regulatory reform to enable Islamic finance in Japan. It is important, however, that subsequent measures go beyond just encouraging overseas investors to participate in Japan's Islamic finance market. They should include attracting funding, talent, technology, and expertise to the market, turning loose motivated individuals and aggressively developing new products to create an industry capable of providing job opportunities and a new growth engine for the Japanese economy.

Such market-building efforts could conceivably be broadened to include the funding of construction projects for the 2020 Tokyo Olympics and a diversification of funding sources for a variety of domestic infrastructure projects, as occurred in the UK.

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40 S&P: AAA, Moody's: Aa1, Fitch: AA+.

41 Enoch Yiu, "Hong Kong's Islamic finance goal boosted by Basel III rules," *South China Morning Post*, 16 December 2013.

Appendix: Sukuk as equity capital

IFSB-15 recognizes sukuk as a means for Islamic banks to raise capital. Musharaka sukuk count as additional Tier 1 capital, and mudaraba sukuk and wakala sukuk as Tier 2 capital.

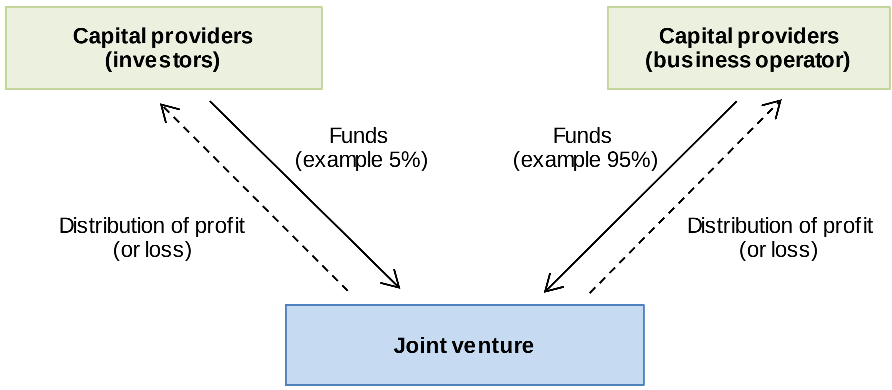
Sukuk are more equity-like than regular bonds, and backed by sharia compliant assets and usufruct. Investors in musharaka and mudaraba sukuk own a partial interest in actual assets associated with the bank, but because the funds are invested in the bank's entire business, they are not actually limited to the value of said assets. This gives the issuing bank flexibility in raising funds. In other words, because the banks are not limited by the value of the underlying assets, they can raise a large volume of funds in response to investor demand.

We provide a simple explanation of how these sukuk are structured below.

1. Musharaka

Musharaka is a partnership-based form of Islamic finance allowing the investor and business operator to jointly invest in a single project. The invested capital can be liquid assets (like cash) or fixed assets (like a building). Each investor owns a part of the business in proportion to the share of its investment. Depending on the terms of the agreement, the business can be operated either jointly or by one side. Additionally, the profits generated by the business must be allocated in accordance with the predetermined distribution ratio. If losses are incurred, they must also be allocated based on the same distribution ratio (Figure 5).

Figure 5: Structure of musharaka

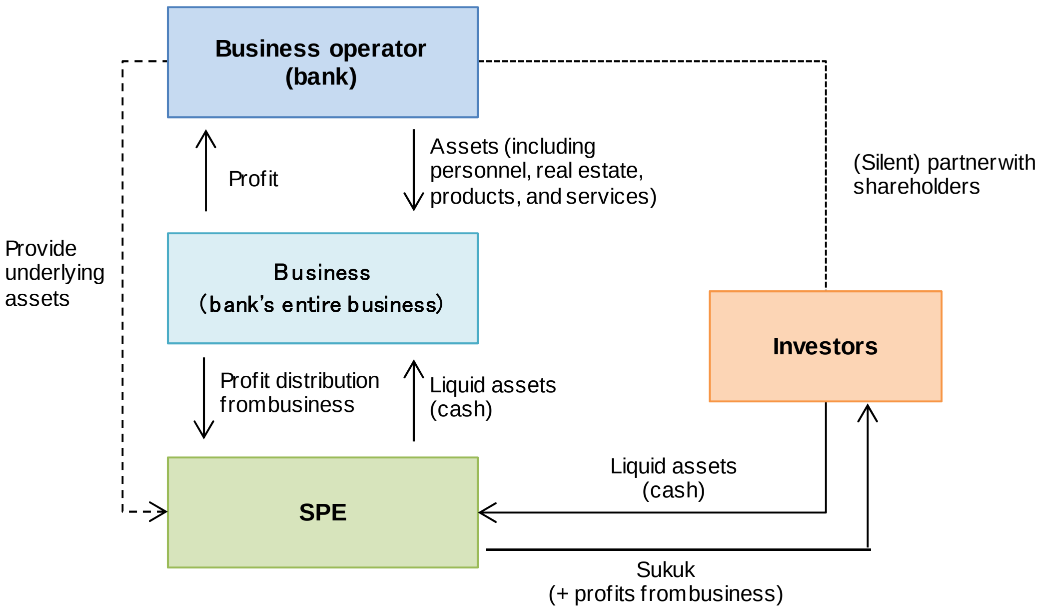


Source: Nomura Institute of Capital Markets Research

2. Musharaka sukuk

With a musharaka sukuk that qualifies for additional Tier 1 capital, an Islamic bond is issued using the bank's entire business as the underlying asset, and the sukuk holder can receive profit distributions from the bank, just like shareholders[42], although they are partial owners who are not involved with operations or management (Figure 6).

Figure 6: Musharaka sukuk



Source: Nomura Institute of Capital Markets Research

The criteria that musharaka sukuk must meet or exceed under IFSB-15 in order to be counted as additional Tier 1 capital are shown in Figure 7.

Figure 7: Criteria for counting musharaka sukuk as additional Tier 1 capital

Loss absorbency
1. Sharia compliant Islamic banks can issue musharaka sukuk (with the bank's entire business as underlying assets) that are able to absorb losses. Sukuk holders are bank stakeholders similar to common shareholders and share in the bank's risks and rewards.
2. They are subordinate to bank deposit holders and general creditors.
Issuance process and procedure
3. The instrument is issued and paid-up.
4. Neither the bank nor a related party over which the bank exercises control or significant influence can purchase the instrument.
5. The bank cannot fund the purchase of the capital raising instrument, either directly or indirectly.
6. Repayment of principal through repurchase or buy-back is allowed subject to supervisory approval without any expectation of repayment being created by the bank.

42 There is no requirement for the bank to always distribute profits, and the non-distribution of profits shall not constitute a default event.

Maturity and callability
7. It has no maturity date, i.e., no date for repayment of principal , and it cannot have step-up features or any other incentive to the issuer to redeem it.
8. If the sukuk is callable, the issuer is permitted to exercise a call option only after five years, subject to certain requirements: (a) prior supervisory approval, (b) no call expectation is created by the bank, and (c) the ability to replace the called instruments with the same or better quality of capital. Such replacement of capital must meet the condition of sustainability based on said bank's ability to generate profit. The bank must successfully exhibit that its capital position is above the regulatory capital requirements after the call option is exercised.
9. If a sukuk is issued out of a special-purpose entity (SPE), proceeds must be immediately available without limitation to the bank.
Distribution of profits
10. The non-distribution of profits shall not constitute a default event.
11. The instrument should not be designed so that its distributions are linked to the credit rating of the IIFS, i.e., the distribution ratio cannot be periodically reset based on the bank's credit, either wholly or in part.
Unsecured in nature
12. The amount paid at issuance is neither secured nor guaranteed by the IIFS or any related entity. In addition, there should not be any arrangement that legally or economically increases the seniority of the instrument's claim relative to the bank's creditors.

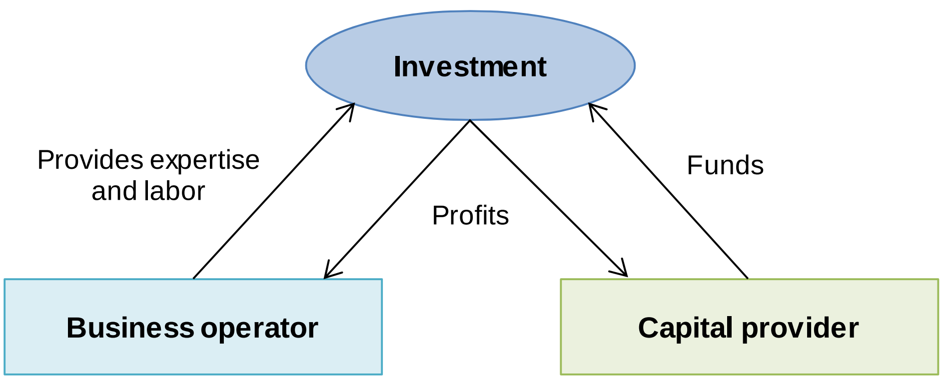
Note: This references in part a draft translation into Japanese by the Japan Bankers Association (JBA) of "Basel III: A global regulatory framework for more resilient banks and banking systems" as well as the original English version.

Source: Nomura Institute of Capital Markets Research, based on IFSB-15 regulations

3. Mudaraba

With mudaraba, the business operator does not have to invest money, but instead must have business expertise and the capacity to operate the business. Mudaraba is thus a scheme to entrust operations to others. The investor provides capital to the business operator, who then manages the funds received in a sharia-compliant manner. The profits or losses that result from investing the funds are shared between the operator and the capital provider based on the predetermined distribution ratio (Figure 8).

Figure 8: Structure of mudaraba



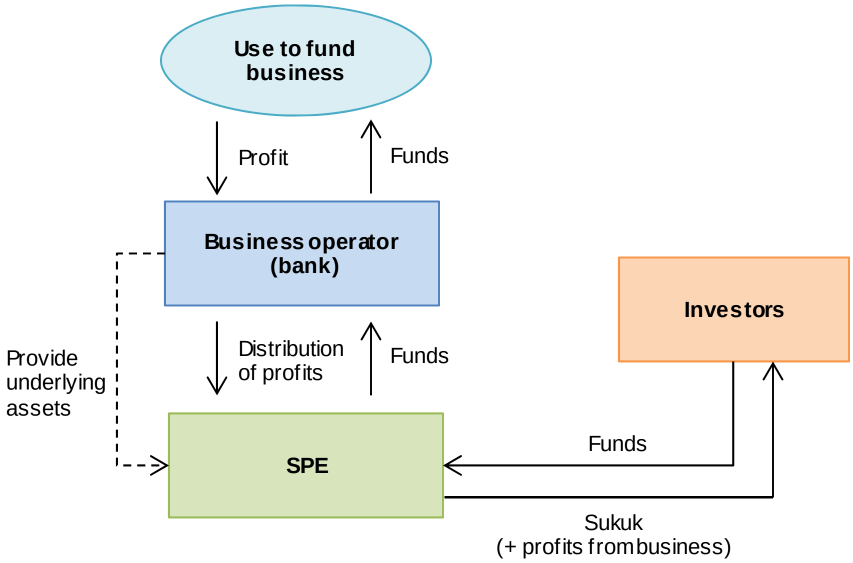
Source: Nomura Institute of Capital Markets Research

4. Mudaraba sukuk

Mudaraba sukuk count toward Tier 2 capital under IFSB-15, but in some countries, such as the UAE, can also be used for additional Tier 1 capital. We think this is because UAE's regulators use a different definition of mudaraba sukuk than the IFSB, which defines mudaraba sukuk with loss absorbency as actually a type of musharaka sukuk[43]. As already noted, implementation of the rules drawn up by the IFSB is at the discretion of each country's regulators. Examples of mudaraba sukuk being used for Tier 1 capital include a US$1 billion issue from Abu Dhabi Islamic Bank in 2012 and a US$1 billion issue from Dubai Islamic Bank in 2013.

Holders of mudaraba sukuk are silent partners who can receive a distribution of profits from the invested funds but cannot participate in running the business (Figure 9).

Figure 9: Mudaraba sukuk



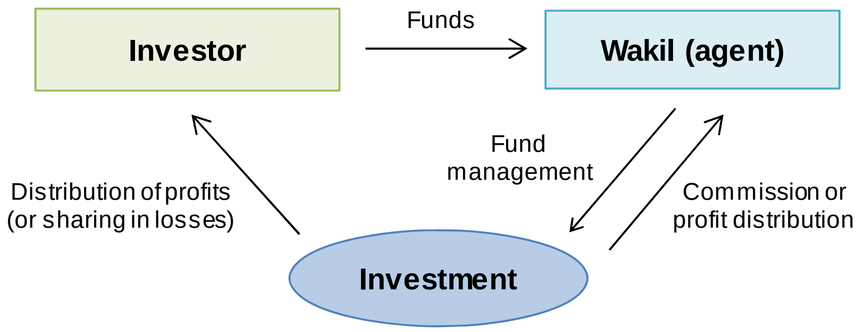
Source: Nomura Institute of Capital Markets Research

5. Wakala

Wakala are basically structured like asset management and other fee businesses typical of the finance sector. The investor provides funds to the Wakil (agent, i.e., bank) and the bank invests the funds on behalf of the investor. The bank takes a commission, a management fee, and/or a portion of the profits from the investment, and the investor is paid a profit distribution. Any losses incurred are borne by the investor (Figure 10).

[43] See footnote 12 on page 8 of the IFSB-15 rules for the IFSB's definition. See 1. in Figure 12 for the reason why general mudaraba and wakala sukuk are not approved for raising Tier 1 capital.

Figure 10: How wakala are structured

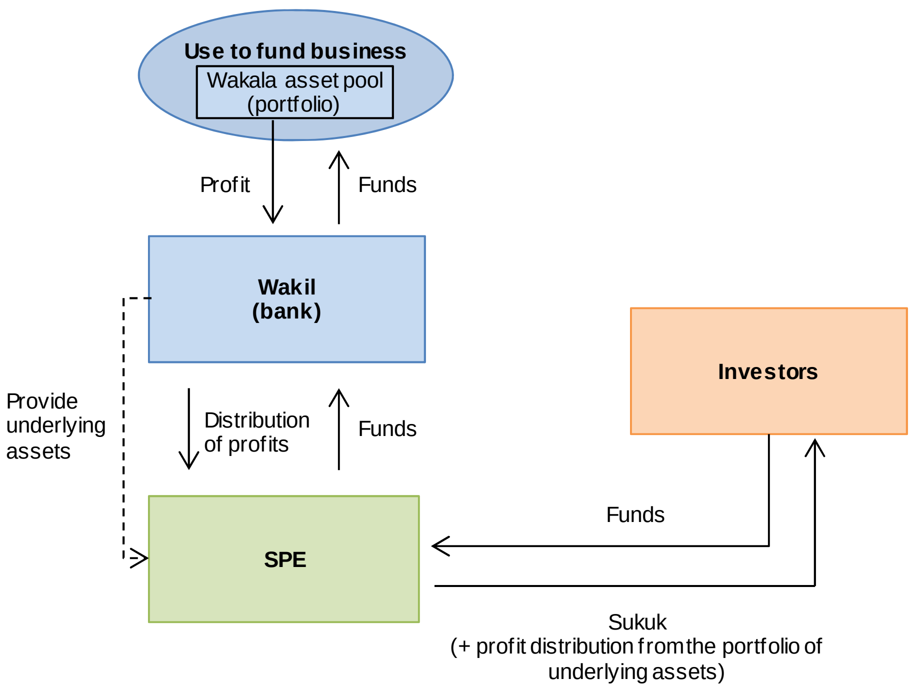


Source: Nomura Institute of Capital Markets Research

6. Wakala sukuk as equity capital

Wakala sukuk are securitizations of such underlying assets as ijarah (lease) agreements, accounts receivable based on murabaha transactions (commodity resale agreements), and portfolios of stock and other sukuk. Income from the portfolio to be used as the underlying asset is distributed to the sukuk holder after deducting the portfolio management fee set prior to issuance.

Figure 11: Wakala sukuk



Source: Nomura Institute of Capital Markets Research

The criteria that wakala sukuk must meet or exceed under IFSB-15 in order to be counted as Tier 2 capital are shown in Figure 12.

Figure 12: Criteria for mudaraba and wakala sukuk to be included in Tier 2 capital

Loss absorbency
1. Sharia compliant Islamic banks can issue mudaraba sukuk and wakala sukuk that are able to absorb losses. To avoid the gharar (uncertainty) prohibited by sharia law, the conversion rate between sukuk and common shares in the event that the issuing bank fails must be established in advance. If the bank fails, prior to converting the sukuk to common shares the assets underlying the sukuk, because they are contractually owned by the sukuk holder, cannot be used in claims against the bank's shareholders and other creditors. After the sukuk are converted to common shares, the original sukuk holders are bank stakeholders similar to common shareholders and share in the bank's risks and rewards. Accordingly, after conversion the funds raised via sukuk become Tier 1 capital.
2. They are subordinate to bank deposit holders and general creditors.
Issuance process and procedure
3. The instrument is issued and paid-up.
4. Neither the bank nor a related party over which the bank exercises control or significant influence can purchase the instrument.
5. The bank cannot fund the purchase of the capital raising instrument, either directly or indirectly.
6. Repayment of principal through repurchase or buy-back is allowed subject to supervisory approval without any expectation of repayment being created by the bank.
7. If the sukuk is issued through a special purpose entity (SPE), proceeds must be immediately available without limitation to the bank.
Maturity and callability
8. The initial maturity is a minimum of five years, after which the instrument becomes callable by the issuer, subject to certain requirements: (a) prior supervisory approval, (b) no call expectation is created by the bank, and (c) the ability to replace the called instruments with the same or better quality of capital. Such replacement of capital must meet the condition of sustainability based on said bank's ability to generate profit. The bank must successfully exhibit that its capital position is above the regulatory capital requirements after the call option is exercised.
9. Principal shall be redeemed using the straight-line method over the redemption period set in above-noted condition (8).
10. There are no step-up provisions or other repayment incentives.
Distribution of profits
11. Investors do not have the right to accelerate future scheduled payments except in the case of bankruptcy and liquidation.
12. The instrument should not be designed so that its distributions are linked to the credit rating of the IIFS, i.e., the distribution ratio cannot be periodically reset based on the bank's credit, either wholly or in part.
Unsecured in nature
13. The amount paid at issuance is neither secured nor guaranteed by the IIFS or any related entity. In addition, there should not be any arrangement that legally or economically increases the seniority of the instrument's claim relative to the bank's creditors.

Note: This references in part a draft translation into Japanese by the Japan Bankers Association (JBA) of "Basel III: A global regulatory framework for more resilient banks and banking systems" as well as the original English version.
Source: Nomura Institute of Capital Markets Research, based on IFSB-15 regulations