Types of Sukuk (Islamic Bonds) and History of Japanese Company Issuance

Bedi Gunter Lackmann
Research Associate,
Nomura Institute of Capital Markets Research

I. Basic structure of sukuk

The size of the global Islamic finance market totaled roughly US$1.7 trillion at end-2013 and is expected to exceed US$2 trillion at some point in 2014. While there is a wide range of Islamic financial products available, the market for sukuk (Islamic bonds) has been growing at a striking pace. Although the sukuk market is still extremely small compared to the conventional bond market, it has been growing quickly, at an average annual pace of about 30% since the global financial crisis[1].

Sukuk refers to bonds issued in accordance with sharia, Islamic law. The rapid spread of sukuk, primarily in the Middle East and Islamic countries in Asia, has made it an important tool for raising funds and asset management. Recently, sukuk have also been attracting attention in non-Islamic countries in Europe, Asia, and Africa. In 2014, sovereign sukuk were issued by the UK in June and by Hong Kong, Luxembourg, and South Africa in September.

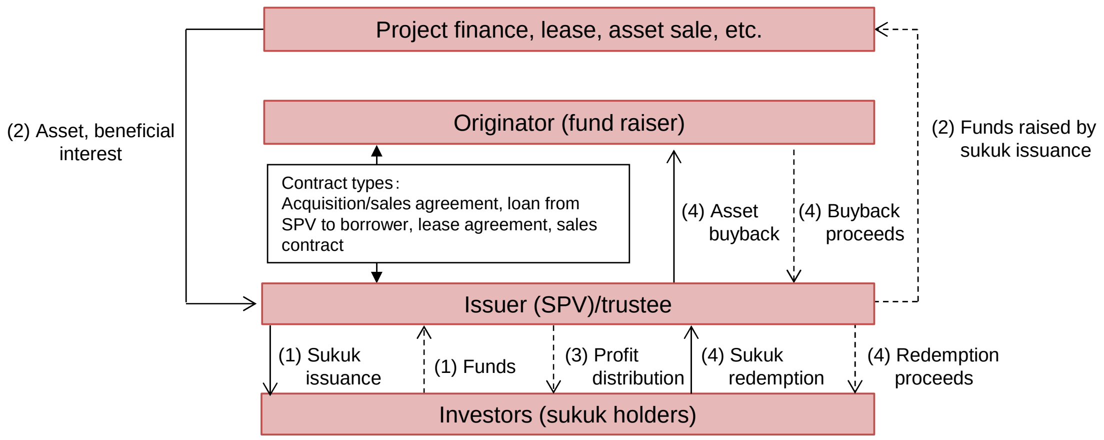
Islamic finance prohibits the payment of interest, but allows in its place the payment to investors of profit distributions and fees generated by transactions and underlying assets. A sukuk is backed by an ownership share in an asset or business project, and the earnings generated by said asset/project are paid to the sukuk holder (investor) in the form of a periodic profit distribution. On the prearranged maturity date, the principal is returned to the sukuk holder using the proceeds from selling the asset either back to the originator (fund raiser) or to a third party. Accordingly, sukuk effectively have the same economic function as a conventional bond, but unlike conventional bonds, which pay interest, sukuk are closer to equity securities. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines sukuk as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or in the ownership of the assets of particular projects or special investment activity."[2]

In the basic structure of a sukuk, the originator establishes a special purpose vehicle (SPV) and issues the sukuk through that SPV to raise funds from investors. The SPV, acting as the investors' trustee, invests those funds in an asset, project or

1 Calculated based on sukuk data from IFIS.
2 Standard Number 2 of the Shariah Standards for Islamic Financial Institutions (2008).

business provided by the originator, and uses the profit generated from the underlying assets to pay dividends to the investors. The originator repurchases the underlying assets at maturity and proceeds are used to redeem the sukuk (Figure 1).

Figure 1: Basic structure of sukuk



1. The originator establishes an SPV and issues sukuk to raise funds.
2. The funds raised by the SPV are used to purchase the underlying assets from the originator.
3. Income/profit generated from the assets are distributed to investors.
4. The originator repurchases the underlying assets when the sukuk matures and the proceeds are used for redemption.

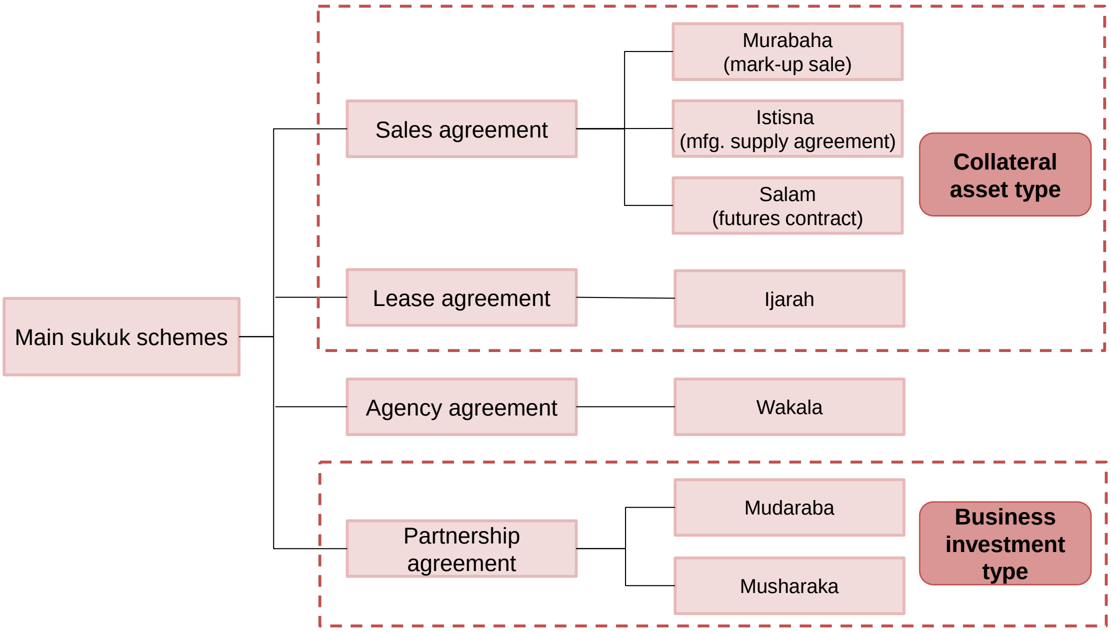
Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

II. Types of sukuk

1. Main types of sukuk

Islamic financial products are becoming increasingly diverse, in part because of the lack of progress in globally standardizing rules in Islamic financial markets. Sukuk schemes can be divided into four basic types: (1) sales-based, (2) lease-based, (3) agent-based, and (4) partnership-based (Figure 2).

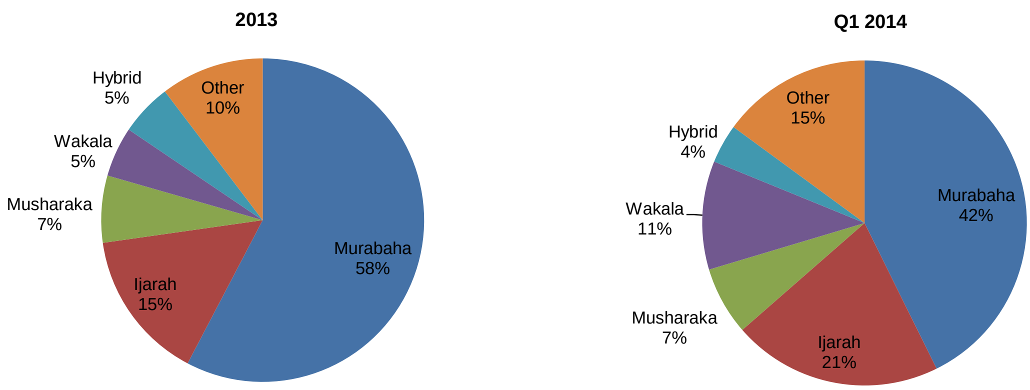
Figure 2: Main types of sukuk



Source: Nomura Institute of Capital Markets Research

The sukuk structure that had the most issuance in 2013 and Q1 2014 was the sales-based murabaha sukuk, which accounted for roughly 60% of global sukuk issuance in 2013. Likewise, the lease-based ijarah sukuk accounted for 15%, the partnership-based musharaka sukuk for 7%, and the agent-based wakala sukuk for 5% (Figure 3).

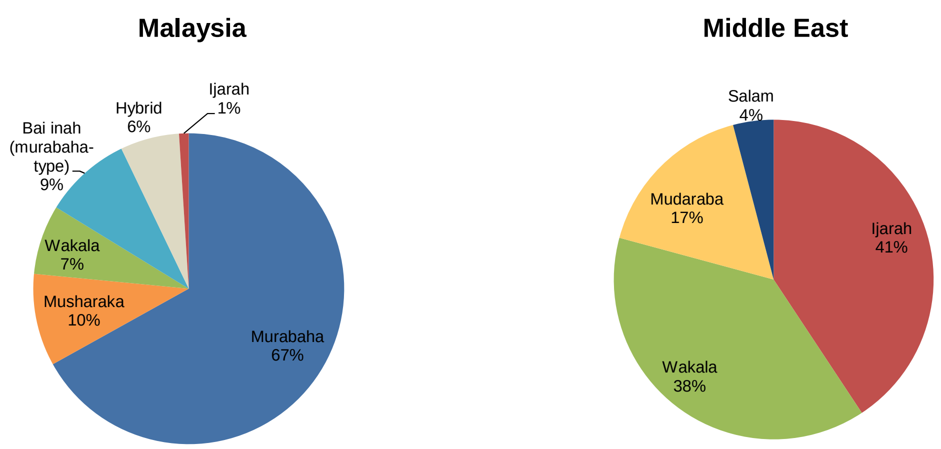
Figure 3: Sukuk issuance in 2013 and Q1 2014, by structure



Source: Nomura Institute of Capital Markets Research, based on data from IFIS, Rasameel Investment Bank Dubai, Bloomberg, and Zawya

The types of sukuk used vary greatly by region (Figure 4), likely for several reasons, including differences in (1) how sharia compliance is interpreted among Islamic scholars, (2) each country's laws related to sukuk, and (3) the originators' assets and funding needs.

Figure 4: Sukuk by region and by structure (Q1 2014)



Source: Nomura Institute of Capital Markets Research, based on Rasameel's Quarterly Global Sukuk Report, April 2014

In the Middle East, most sukuk are either ijarah sukuk, considered the most basic scheme of sukuk, or wakala sukuk, which can be backed by not only specific real assets but also a pool of investment assets[3]. In contrast, most of the sukuk issued in Malaysia are murabaha-type sukuk (primarily commodity murabaha sukuk). Among the reasons why murabaha-type sukuk are widely used in Malaysia are that the scheme can also be used by issuers who do not own assets eligible for backing sukuk and because the simple structure keeps the cost of gaining approval as sharia compliant relatively low. On the other hand, there is almost no issuance of commodity murabaha sukuk in the Middle East, because most Islamic scholars there deem the scheme not sharia-compliant[4]. The interpretation of sharia law thus has a major impact on which sukuk schemes are used.

The trend in global sukuk markets is also changing as a result of changes in the interpretation of sharia. Around the end of 2007, for example, a well-known Islamic scholar serving as the chairman of the AAOIFI's sharia board (Mufti Muhammad Taqi Usmani) made major waves when he stated that 85% of the sukuk that had been issued at the time were not sharia-compliant, casting particularly strong doubt over the

[3] The assets that can back a wakala sukuk are sukuk owned by the borrower, lease agreements, and other sharia-compliant assets that generate profit.

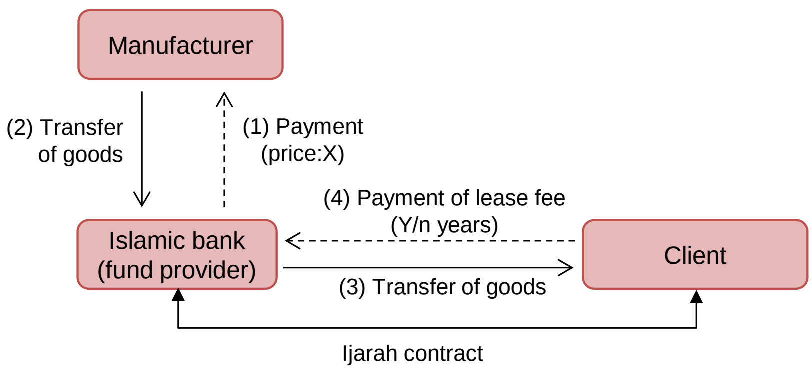
[4] "Wakala and hybrid sukuk volumes rocket, ijarah boost expected later," IFIS, 4 March 2014.

sharia-compliance of musharaka and mudaraba sukuk at the time[5]. Sharia compliance-related issues that carry the risk of causing market turmoil as result of (1) products and contracts previously deemed sharia-compliant being seen as non-compliant as result of a change in interpretation, (2) criticism of an Islamic scholar who has certified the sharia-compliance of a product by another well-known scholar, or (3) a decision that a business that backs a sukuk is not accurately following sharia, is often shortly referred to as sharia risk. Additionally, issuers involved in sharia risk-related market turmoil can be subject to reputational risk in the Islamic world. To avoid sharia risk, international issuers seek to (1) use basic schemes with little risk of being criticized or being affected by a change of interpretation (ijarah, for example), (2) gain approval of sharia compliance from numerous well-known sharia scholars, and (3) urge potential investors to gain approval from sharia scholars they themselves trust at the prospectus stage, before any actual investment is made.

2. Ijarah sukuk

Ijarah is a lease contract in Islamic finance (Figure 5). It is based on a scheme that is similar to that for conventional leases, and thus familiar to issuers and investors in non-Islamic countries.

Figure 5: Basic structure of ijarah



Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

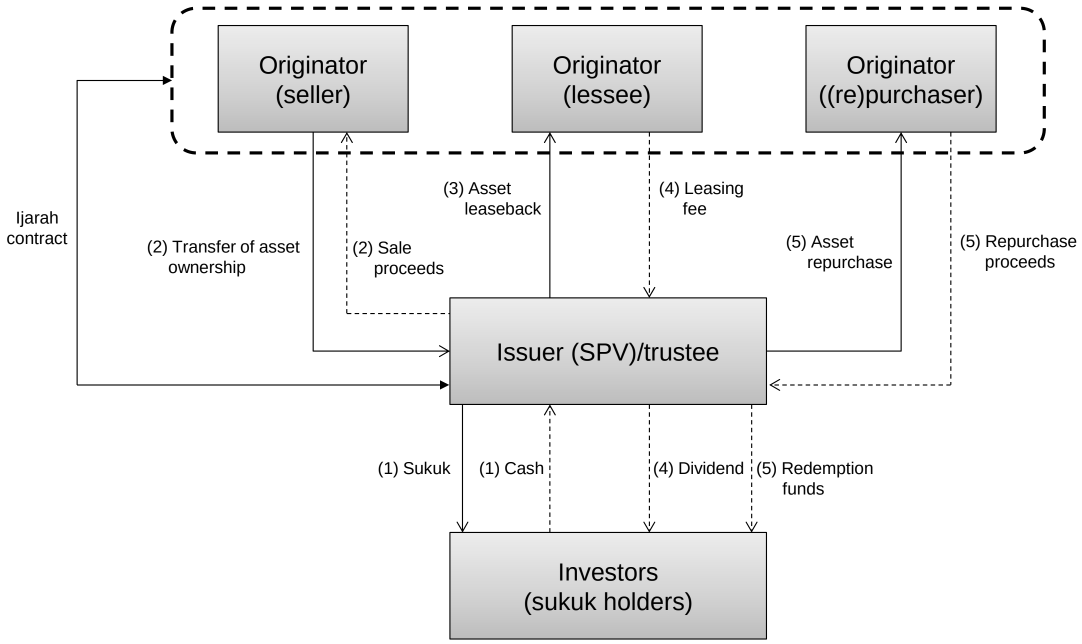
An ijarah sukuk is based on a leasing scheme, and normally an SPV is established to be the issuer. This SPV uses the funds collected from investors to purchase the underlying real assets from the originator, i.e., from the entity raising the funds. The underlying assets can be real estate or industrial machinery, for example, and their purchase price is equal to the amount of sukuk issuance. After the SPV purchased the

[5] See Tetsuya Kamiyama, *Isuramu Shouken Bijinesu—Mareeshia Shijo wo Chuushin ni* (Islamic securities business – Focus on the Malaysian market), Fall 2008 edition of Capital Market Quarterly (in Japanese).

underlying assets, they are leased back to the originator, who pays a leasing fee to the SPV during the lease period, which is passed on to the sukuk holders in the form of a dividend payment. Upon maturity, the originator repurchases the assets from the SPV (at a pre-agreed upon price) and the proceeds are used to redeem the sukuk (Figure 6). The proceeds from the repurchase are the same amount as the sukuk issuance.

It should be noted that the amount of ijarah sukuk issuance is constrained by the market price of the originator's real asset, and according to the sukuk guidelines published by the Securities Commission Malaysia, must not exceed 1.51 times the market value of the underlying asset[6].

Figure 6: Basic structure of ijarah sukuk



1. The originator establishes an SPV and issues sukuk to raise funds.
2. Acting as a trustee for the investors, the SPV uses the collected funds to purchase the underlying assets, paying to the originator the purchase price, which is the same as the amount of sukuk issuance.
3. Said assets are leased back to the originator based on the initially signed ijarah contract.
4. The leasing fee generated by the assets is the source of funds for the dividends paid to sukuk holders via the SPV.
5. The originator repurchases the underlying assets when the sukuk matures and the proceeds are used for redemption.

Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

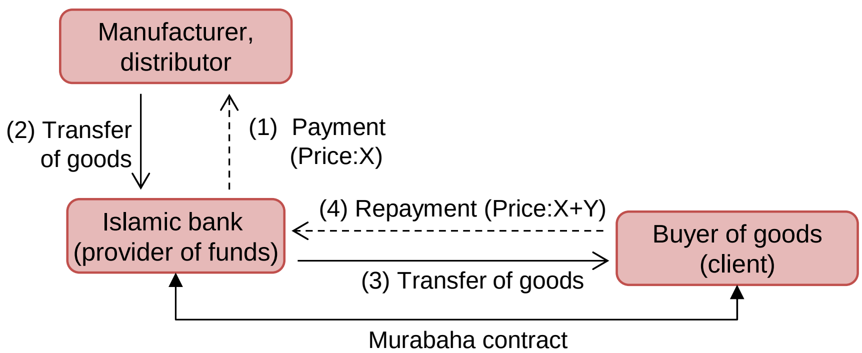
6 Securities Commission Malaysia, "Guidelines on Sukuk," 6 January 2014, p. 11. ("In cases where the market value of a particular asset cannot be ascertained, a fair value or any other value must be applied.")

Ijarah is one of the widely used basic schemes for sukuk, ranking second in recent years behind murabaha sukuk. Additionally, because the ijarah scheme is similar to a conventional lease scheme, it is also used for corporate and sovereign sukuk issuance in non-Islamic countries as well as in Islamic countries lacking legislation on Islamic finance. The sukuk issued by Nomura Holdings in Malaysia in 2010, the sovereign sukuk issued by the UK in June 2014 and by Hong Kong, Luxembourg, and South Africa in September were all based on the ijarah scheme[7]. We therefore expect future growth in sovereign sukuk issuance to increase the issuance volume of ijarah sukuk.

3. Murabaha sukuk

Murabaha is a scheme often used for purchasing equipment, products, and other goods under an installment sales contract (Figure 7). When a client needs to purchase a good, the fund provider purchases that good on behalf of the client and then resells it to the client on an installment basis[8]. The key is to clearly disclose details of the transaction between the parties, setting all terms in advance, including the initial purchase price, resale price, fees, and number of installments. The transaction to purchase/sell the goods is conducted after agreement is reached. The basic structure for murabaha sukuk is shown in Figure 8.

Figure 7: Basic structure of murabaha

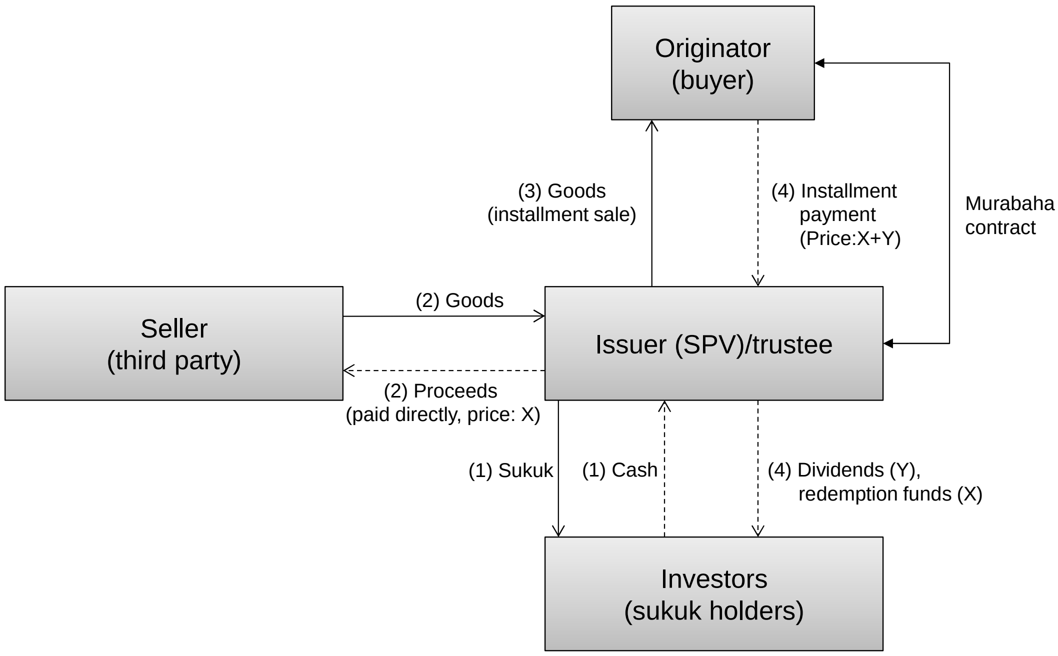


Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

7 See Bedi Gunter Lackmann, *Kakudai suru Soburin Sukuuku (Isuramu Kokusai)—Eikoku to Hong Kong no Hakkou Jirei* (Growth of Sovereign Sukuk (Islamic Government Bond)—Examples of Issuance in the UK and Hong Kong), the online Fall edition of the Nomura Capital Market Quarterly (in Japanese).

8 Settlement can be in a lump sum cash payment or installment payments, depending on the agreement, but normally is done in installments.

Figure 8: Basic structure of murabaha sukuk



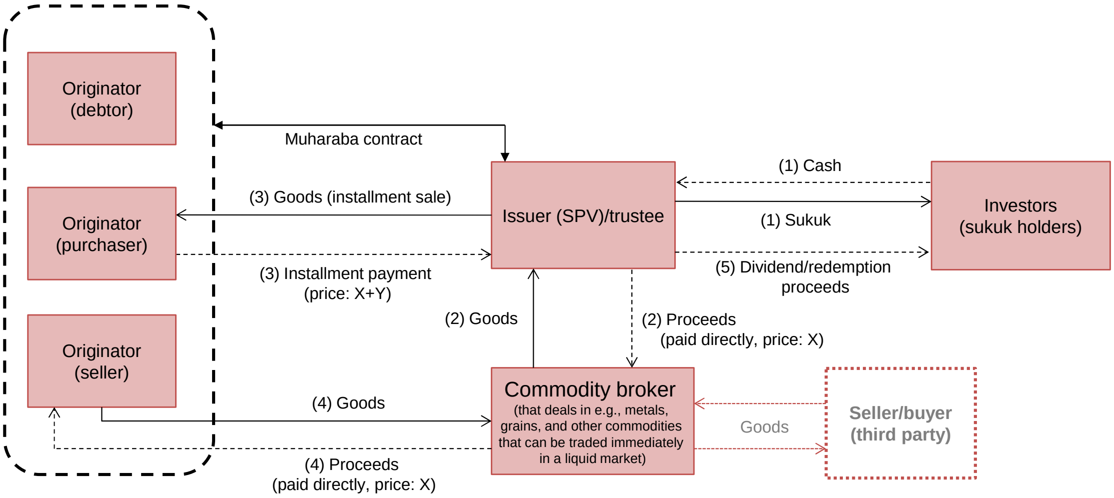
Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

Usually in the case of a murabaha sukuk, an SPV is established and a murabaha contract is signed with the originator wanting to buy a product. All of the terms of the murabaha contract, including the repayment period, the number of payments, and the amount of markup, are determined ahead of time. The sukuk is issued afterward, and the SPV, acting as a trustee for investors, uses the funds thus obtained to purchase the product wanted by the originator with cash and then resells it to the originator at the predetermined markup, which in turn funds the dividends paid to investors. This dividend is not interest generated by a debt, but profit generated from the sale of a product, and thus sharia compliant.

A commodity murabaha sukuk, a type of murabaha primarily used in Malaysia recently, is structured as shown in Figure 9. The basic flow is the same as that of a plain murabaha sukuk, but because the originator's purpose in issuing a commodity murabaha sukuk is not to purchase a product, as soon as the originator gets possession of the product it sells it to a third party to raise cash. Consequently, this scheme is often used for products in markets with low volatility and high liquidity, such as metals and grains[9]. There are few restrictions on what can be used as underlying assets for a commodity murabaha sukuk, and products like metals that are broadly traded on the London Metals Exchange (LME) offer flexibility in issuance amount.

9 Gold and silver are excluded, because both are considered money under Islamic law, and sharia sees trading money for money at differing amounts and values as having the same effect as riba (interest). Currency exchange is allowed under sharia because no differences are assigned to the actual values of the currencies being exchanged. The commissions paid in a currency exchange transaction are also in keeping with sharia.

Figure 9: Basic structure of a commodity murabaha sukuk



1.	The originator establishes an SPV and issues sukuk to raise funds.
2.	Acting as a trustee for the investor, the SPV uses the collected funds to purchase the requested commodity.
3.	The SPV then resells the purchased commodity to the originator at a markup.
4.	Once the originator obtains the commodity, it immediately sells it to a third-party in order to obtain cash.
5.	The compensation paid on transactions between the SPV and originator is what funds the dividends and redemption proceeds paid to the sukuk holder.

Notes: 1. The black dotted-line arrows indicate cash flow.
2. Sometimes, the commodity's initial seller and final buyer is the same entity. Such a transaction is referred to as "Bai al Inah" and deemed not sharia compliant in most jurisdictions.

Source: Nomura Institute of Capital Markets Research

On the other hand, although structured as a sales transaction, because the originator's intention in using this scheme is to buy and instantly convert a highly liquid product into cash, some Islamic scholars view commodity murabaha as a transaction that directly creates the effect of interest and therefore not sharia compliant[10].

4. Musharaka sukuk

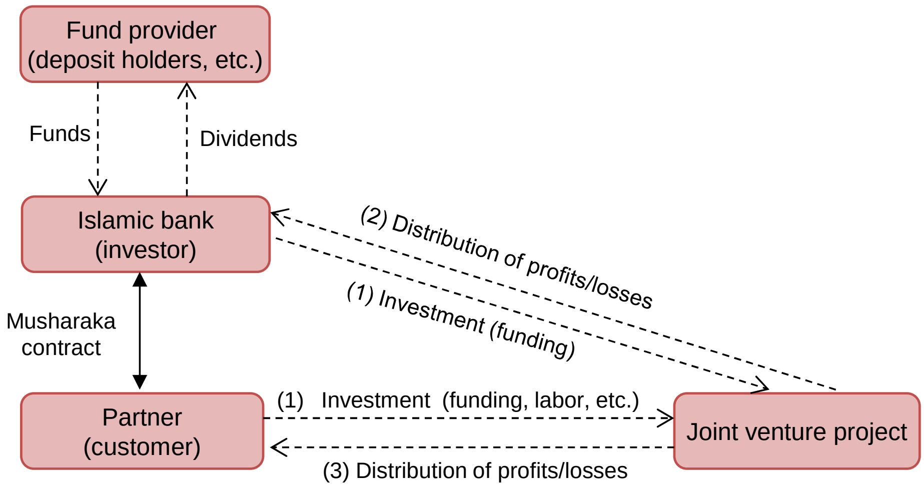
Musharaka could be viewed as a partnership created through a joint investment. It is an equity-based contract similar to a partnership agreement under Japan's Civil Code. Being structured so that an Islamic bank (investor) can jointly invest with a business operator in need of funding, it is similar to a venture capital financial service. It differs, however, from its conventional equivalent as it is based on the concepts of prohibiting interest and sharing risk and return, where the percentage allocation

10 There are also some sharia scholars, however, who see commodity murabaha as allowable only for short-term issuance that is necessary to strengthen the issuer's liquidity.

among investors of profits and losses from said business is determined ahead of time (Figure 10).

Although the business invested in jointly by the provider of funds (investor) and the business operator is managed jointly, the musharaka contract agreed to at the outset often establishes the fund provider as a silent partner, i.e., one without any say in managing the business.

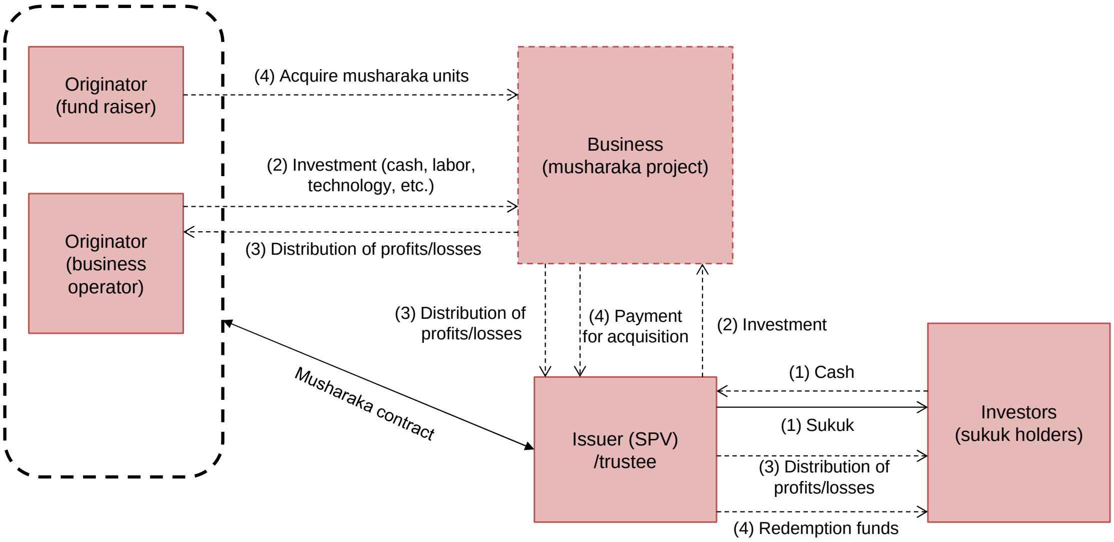
Figure 10: Basic structure of musharaka



Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

In the case of a musharaka sukuk, first an SPV is established to issue the sukuk, and that SPV enters into a musharaka contract in order to operate the joint business together with the originator. The originator supplies the equipment, technology, and management expertise to operate the business, and the SPV invests the funds obtained from issuing the sukuk into the business backing the sukuk. Profit distributions to the sukuk holders are made from the income generated by the musharaka business. The originator acquires the underlying business at maturity, and the proceeds are used to redeem the sukuk (Figure 11).

Figure 11: Basic structure of musharaka sukuk



1.	The originator establishes an SPV and issues sukuk to raise funds.
2.	The SPV, acting as trustee for the investor, enters into a musharaka contract with the originator, and invests the collected funds into the project.
3.	The profits/losses generated by the project are shared with the sukuk holders.
4.	When the sukuk matures, the originator acquires the musharaka business, and the proceeds are used to fund redemption.

Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

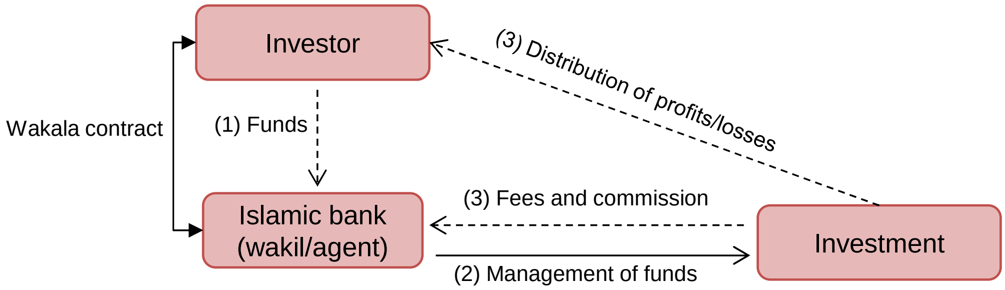
Unlike ijarah sukuk, the amount of a musharaka issuance is not limited by the market value of specific assets, since it is based on a joint venture. This relative freedom in the sukuk issuance amount provides the advantage that explains the widespread use of musharaka sukuk for large issues.

Theoretically musharaka sukuk holders are exposed to both profits and losses generated from the underlying joint business. In practice, however, there are several mechanisms that have been developed to fix the yield for investors. For example, in addition to the musharaka contract between the originator and the SPV, a business consignment agreement is signed to allow the originator to operate the musharaka business. Under this consignment agreement, the business operator (originator) receives, in addition to a fixed consignment fee, an incentive payment equal to the amount by which profits exceed a specified “expected” amount. Conversely, if the business operator is unable to generate the “expected” amount of profit, it must make up the difference, which is subsequently repaid with an incentive payment due to profits exceeding the expected amount going forward. In some cases any incentive payments received by the business operator are held in a segregated account until the sukuk matures, and when profits from the musharaka business fall short of the “expected” amount, funds from that account are used to supplement dividend payments until the sukuk matures. Opinions of Islamic scholars are split regarding whether this method of fixing the yield is sharia compliant. Another way to fix the yield is for the SPV to purchase the equipment that the originator invests in the musharaka business and lease them back to the originator until the sukuk's maturity date. More Islamic scholars view this method of fixing the dividend payment as sharia compliant. The sukuk issuance program launched in 2008 by UMW Toyota Capital, the Malaysian subsidiary of Toyota Financial Services, uses the musharaka scheme.

5. Wakala sukuk

Wakala are agency agreements and basically structured the same as an asset management business in conventional finance. The investor provides funds to the agent, called a wakil, and the wakil invests the funds on behalf of the investor (Figure 12).

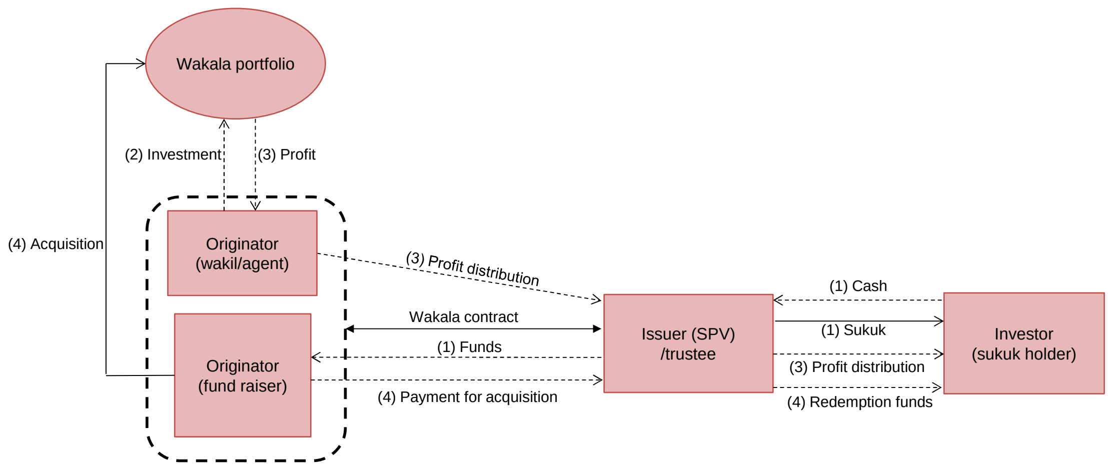
Figure 12: Basic structure of wakala



Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

Wakala sukuk are based on an agency agreement and backed by investment assets, unlike ijarah sukuk, which require real assets. This makes them a scheme by which originators lacking real assets can act as an issuer. Under the usual structure, an SPV is established to act as the trustee for investors and enter into a wakala agreement with the originator. Acting as the wakil, the originator takes the funds collected from the sukuk holders and invests them in sharia-compliant assets, which can include for example sukuk owned by the originator, claims based on murabaha contracts, and ijarah contracts. In this case, the resulting portfolio is also referred to as a wakala portfolio. Earnings from the wakala portfolio are paid to the sukuk holder as dividends. At maturity, the wakala portfolio is either purchased directly by the originator or sold to a third party, with the resulting cash paid to the sukuk holder as redemption proceeds (Figure 13).

Figure 13: Basic structure of wakala sukuk



1. The originator establishes an SPV and issues a sukuk to raise funds.
2. The SPV, acting as trustee for investors, signs a wakala agreement with the originator, naming the originator the wakil. The wakil invest the collected funds in a wakala portfolio made up of sharia-compliant investment assets.
3. Earnings generated by the wakala portfolio are paid to the sukuk holder as dividends.
4. When the sukuk matures, the wakala portfolio is either purchased directly by the originator or sold to a third party, and the proceeds are used to fund the redemption.

Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

Wakala sukuk were not widely used up until 2010, but it has been one of the fastest-growing schemes in recent years. Growth in wakala sukuk has been driven not only by Malaysia's domestic issuers but also by global financial institutions and other international issuers. Examples include a US$300 million issue by Dubai Investment Park, a US$1.35 billion issue by International Islamic Liquidity Management Corporation (IILM), and a US$1.5 billion issue by the Islamic Development Bank (IDB). Use of wakala sukuk is particularly widespread in the Middle East, primarily because of the flexibility they offer. Wakala sukuk are unconstrained by the market price of the specific real assets backing them, and can be backed by a combination of various sharia-compliant investment assets.

III. Examples of sukuk issuance by Japanese companies

Actual sukuk issuances by Japanese companies are still few. Aeon Credit Service Malaysia became the first Japanese company to issue sukuk in 2007, and Toyota Financial Services' Malaysian subsidiary, UMW Toyota Capital (UMWTC, now called Toyota Capital Malaysia) was next with a sukuk issuance in 2008. Both of those issues used a musharaka scheme. Nomura Holdings issued an ijarah sukuk backed by aircraft leases in 2010. More recently, in September 2014, The Bank of Tokyo-Mitsubishi UFJ issued the world's first yen-denominated sukuk raising ¥2.5 billion, and a US$-denominated sukuk raising US$ 25 million of funding (Figure 14)[11].

Figure 14: Sukuk issued by Japanese companies

Issuer	Aeon Credit Service	UMW Toyota Capital (now Toyota Capital Malaysia)	Nomura Holdings	The Bank of Tokyo-Mitsubishi UFJ (Malaysia)
Year issued	2007	2008	2010	2014
Scheme	Musharaka	Musharaka	Ijarah	Wakala
Issuance amount	400mn ringgit (total for CP and MTN)	1bn ringgit (total for CP and MTN)	US$100mn	¥2.5bn US$25mn
Years to maturity	7	7	2	1
Yield	-	-	LIBOR + 1.6%	-
Listing	None	None	Bursa Malaysia	-
Underwriter	BTMU Malaysia, CIMB Investment Bank, ASEAN Bankers Malaysia (an investment bank subsidiary of Maybank)	BTMU Malaysia, CIMB Investment Bank	Kuwait Finance House (KFH, Malaysia)	CIMB Investment Bank

Note: Further details of The Bank of Tokyo-Mitsubishi UFJ's sukuk issuances were unknown when this report was written.
Source: Nomura Institute of Capital Markets Research

Aeon and UMWTC's intent in issuing sukuk in Malaysia was likely in order to (1) diversify their funding methods, (2) obtain funding in local currency, (3) fund sharia-compliant businesses[12], and (4) increase their acceptance by, and expand their customer base among, local Islamic consumers.

On the other hand, global financial institutions like Nomura Holdings and BTMU are motivated to enter this market to (1) diversify their funding sources by region and currency, (2) raise funds aimed at providing sharia-compliant financial services to the local market, (3) improve their image and name recognition in the Islamic world, (4) gain access to investors in Southeast Asia and the Middle East, (5) assume the role of an arranger for future Japanese sukuk issuances (a longer-term objective of accumulating expertise and helping other Japanese companies obtain funding through sukuk), and (6) strengthen their relationships with governments seeking to develop Islamic financial markets and with major market players.

In this section, we look in detail at three relevant examples of sukuk issued by Japanese companies: Aeon Credit Service, UMW Toyota Capital, and Nomura Holdings.

[11] "After landmark sukuk, Japan's BTMU seeks to offer Islamic ringgit loans," Reuters, 25 September 2014.

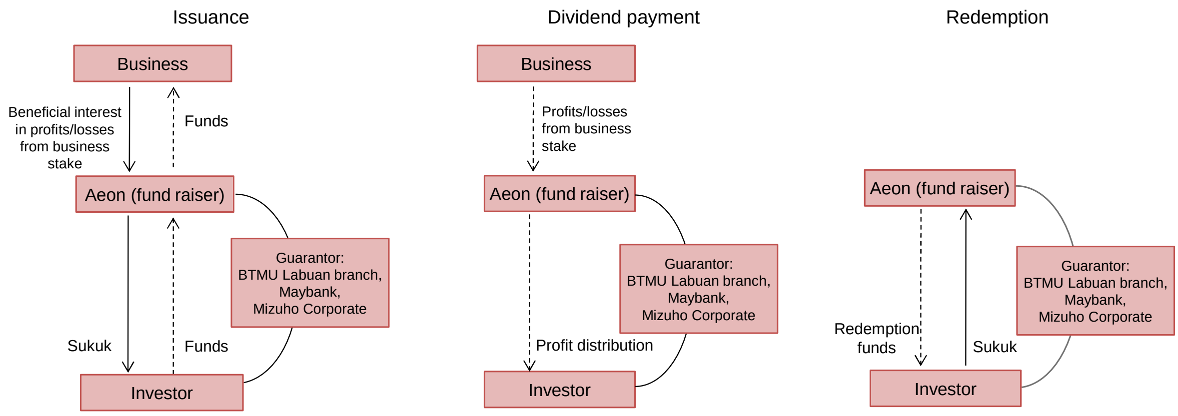
[12] When issuing a sukuk, the purposes for which the funds are raised and the business of the issuer must be sharia compliant. For example, a manufacturer of alcoholic beverages cannot issue a sukuk.

1. Aeon Credit Service's musharaka sukuk

In 2007, Aeon structured a seven-year, 400 million ringgit (about ¥13.6 billion) sukuk issuance program. It used the funds raised for investments, including to expand its credit card system and ATM network as well as increase its number of branches and sales offices, and also for working capital[13]. The sukuk were meant to satisfy Aeon's demand for short- to medium-term funds and were in the form of commercial papers (CP) with a maximum term of 12 months and medium-term notes (MTNs) with a maximum term of five years.

Aeon's sukuk issuance was based on the musharaka scheme and structured as shown in Figure 15. One use of the funds it raised with this sukuk was for investing in expanding the sharia-compliant consumer finance business it started in 2002 in Malaysia.

Figure 15: Structure of Aeon Credit Service's sukuk



1. Aeon issues sukuk to raise funds.
2. The funds are used to develop Aeon's business, and earnings from that business are distributed to sukuk holders based on a predetermined share of the profits.
3. When the sukuk matures, a previously agreed upon sale/purchase agreement is executed, the musharaka notes are bought back, and the proceeds paid to investors for redemption.

Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

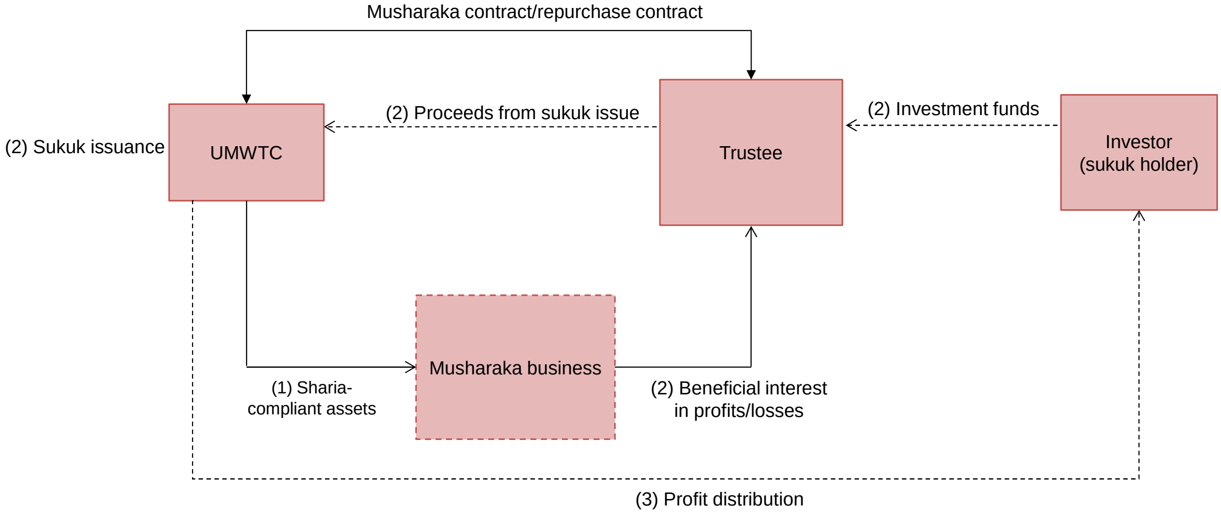
2. UMW Toyota Capital's (UMWTC's) musharaka sukuk

Another example that is well known, even in Japan, is UMWTC's sukuk issuance. In 2008, UMWTC structured a 1 billion ringgit (about ¥32 billion) sukuk issuance program. Like Aeon's sukuk, it was based on a musharaka scheme (Figure 16).

Because it was privately placed, 100% of the investors were institutional investors, about half of those from outside of Malaysia[14].

13 "AEON's Sukuk Frenzy Begins," Islamic Finance News, 19 January 2007.
14 "Toyota's US$14 million Musharakah ICP and IMTN," Islamic Finance News, 1 August 2008.

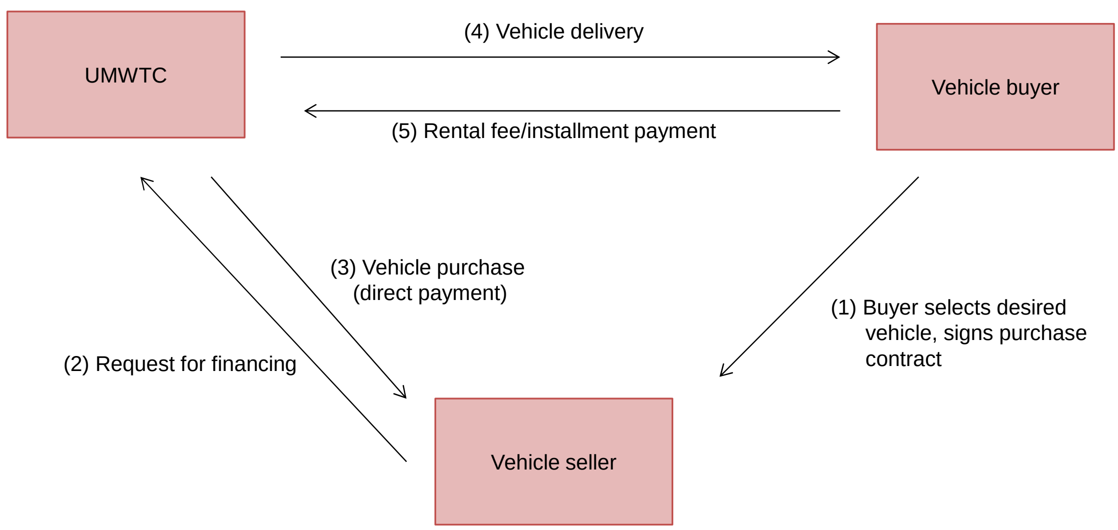
Figure 16: Structure of UMWTC's sukuk



Source: Nomura Institute of Capital Markets Research based on Toyota Capital Services, UMW Toyota Capital SDN BHD "Offering Circular"

The sharia-compliant assets supplied to the trustee by UMWTC were sharia-compliant auto loan claims written by UMWTC in Malaysia in one of two formats: Al-Ijarah Thumma Al-Bai, which is hire purchase financing, or Toyota Drive, which is leasing (Figure 17). Thus the funds raised by the sukuk are used to provide sharia-compliant auto financing to Muslim consumers. The earnings generated by these assets are the source of funds for the dividends paid to sukuk holders.

Figure 17: Structure of Al-Ijarah Thumma Al-Bai



Source: Nomura Institute of Capital Markets Research

The reasons that UMWTC gave for choosing Malaysia as its issuance jurisdiction were (1) it needed ringgit-based funding for its Malaysian business, (2) Malaysia has clear laws related to sukuk and the most advanced sukuk market, and (3) it is a very cost-effective way to raise funds because of various tax incentives offered by the government.

The reasons that both Aeon and UMWTC chose the musharaka scheme were that they owned sharia-compliant businesses and assets suitable for musharaka, and at the time of issuance, musharaka were accepted and commonly used worldwide[15].

3. Nomura Holdings' ijarah sukuk

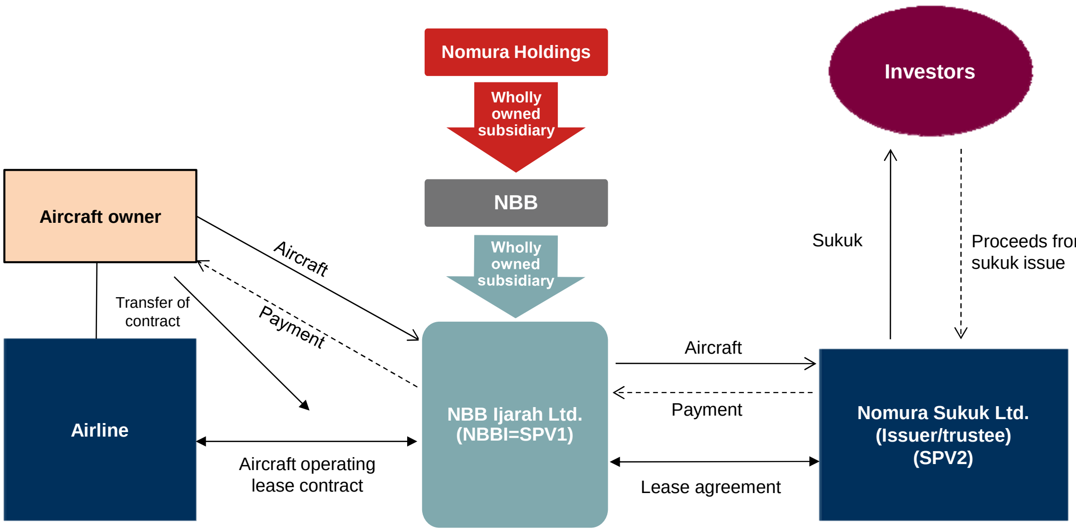
In 2010, Nomura Holdings became the first Japanese company to issue a dollar-denominated sukuk in Malaysia. It was a US$100 million ijarah sukuk with a term of two years, and the funds raised were used in the aircraft leasing business operated by Nomura's subsidiary, Nomura Babcock & Brown (NBB).

We think it likely that Nomura Holdings chose an ijarah scheme for its sukuk because it is a basic scheme that appeals to global investors, and is seen as having low sharia risk.

Figure 18 shows the structure of Nomura Holdings' sukuk.

Figure 18: Structure of Nomura Holdings' sukuk

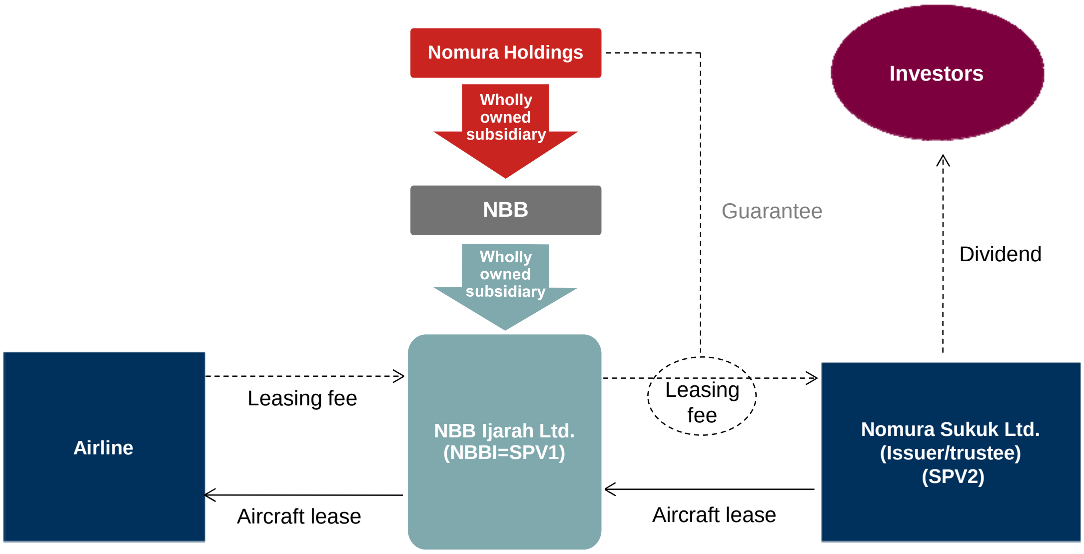
((1) Issuance)



1. SPVs were set up to issue a sukuk backed by aircraft.
2. Both the aircraft and the existing lease contract owned by the original owner are sold and transferred to SPV1. (In principle, sharia requires the transfer of not only the rights to the asset but also the legal title.)

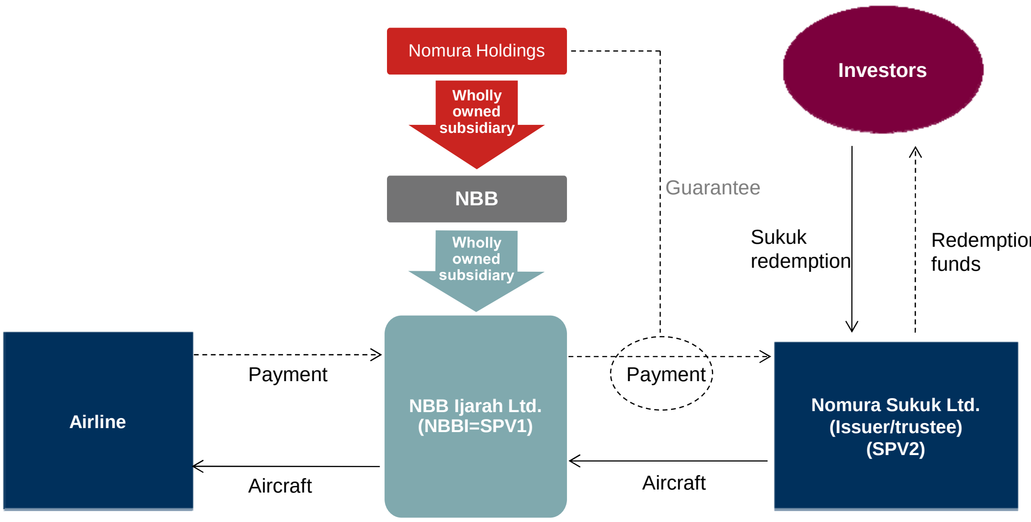
15 "Toyota's US$15 million Musharakah ICP and IMTN," Islamic Finance News, 1 August 2008.

((2) Dividend payment)



3. Investors do not receive interest payments from SPV2, but instead receive dividends funded by the income generated by the aircraft lease agreement underlying the sukuk.
4. Because sharia does not permit the fund raiser (Nomura) to directly guarantee dividend payments to the investor, Nomura instead guarantees any debt that SPV1 has to SPV2, including the lease fee.

((3) Redemption)



5. When the sukuk matures, the aircraft is sold to SPV1 by executing the previously signed purchase/sale agreement, and the proceeds from the sale fund the redemption of proceeds paid through SPV2 to the investors.
6. Here as well, because Nomura is not allowed under sharia to directly guarantee repayment of the sukuk's principal, it instead guaranteed the payment of funds by SPV1 to SPV2.

Note: The dotted-line arrows indicate cash flow.
Source: Nomura Institute of Capital Markets Research

IV. Future trends and issues

As already noted, it is estimated that Islamic financial assets worldwide will grow to exceed US$2 trillion during 2014, with approximately 78% of these assets held by Islamic banks, and 16% in the form of sukuk[16]. This growth in Islamic finance can be explained primarily by the economic growth of Islamic countries, growth in the average incomes of their citizens, and the rising interest in Islamic finance from non-Islamic countries.

Growth in the sukuk market can be explained by (1) growth in the number of both Islamic investors and non-Islamic investors (for purposes of returns, portfolio diversification, socially responsible investing (SRI) via Islamic finance, and avoiding the impacts of the global financial crisis and European debt crisis); (2) increased investments by sovereign wealth funds (SWF) and pension funds in Islamic countries; (3) the progress many countries have made in building market infrastructure and implementing reforms, including tax reforms that make it easier to issue sukuk; (4) growth in sovereign sukuk; and (5) the increased use of sukuk as a way to fund large-scale infrastructure construction and development projects in Islamic countries. Furthermore, in certain respects the implementation of Basel III has encouraged sukuk issuance[17].

Critical steps to enabling sukuk issuance in non-Islamic countries are (1) legally recognizing sukuk issuance and ensuring the stability of laws regarding sukuk and (2) lowering sukuk-related costs to competitive levels by taxing them at the same rate as conventional bonds.

Although Japanese companies are becoming more interested in sukuk, there has yet to be a sukuk issued in Japan, despite domestic sukuk (J-sukuk) issuance having been legally possible since April 2012. Possible reasons for this are (1) when using a basic scheme such as ijarah, the issuance amount is limited by the market value of the underlying assets; (2) not many companies own the sharia-compliant assets needed to back a sukuk issuance; (3) there is a lack of companies with the necessary expertise (legal, accounting, and sharia-compliance assessment) to issue a sukuk or to provide consulting services (in Japanese) on issuing sukuk; (4) sukuk have higher issuance costs than conventional bonds, and their issuance process takes longer (generally 12 to 20 weeks) [18]; and (5) domestic investors have no incentive to invest if sukuk yields are not set higher than conventional bond yields because the dividends received from a J-

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16 Also 4% in Islamic funds, and 1% each in takaful (Islamic insurance) and Islamic micro-finance. (Source: Zubair Mughal, “2014 will be promising for Islamic Finance Industry,” AlHuda Centre of Islamic Banking & Economics (CIBE), 31 December 2013.)

17 For more on the impact that Basel III has on the sukuk market, see Bedi Gunter Lackmann, “New opportunities for sukuk (Islamic bond) issuance brought by Basel III,” Summer 2014 edition of the Nomura Journal of Capital Markets.

18 The process of verifying the sharia compliance of the scheme, the underlying assets, and the business content is said to cost fees ranging from US$20,000 to US$150,000. (Source: Frank Stocker, “*Wie Islamgelehrte am Finanzmarkt Reibach machen* (How shariah scholars make big money in financial markets),” Die Welt, 14 August 2014.)

sukuk get the same tax treatment as the interest on a bond[19], and thus issuers who want to raise yen funds with a sukuk wind up being reliant on finding Islamic investors overseas with a desire to invest in a yen-denominated sukuk. Thus issuing corporate sukuk in Japan remains difficult for several reasons.

In contrast, outside of Japan there have been a number of sukuk issues from Japanese companies in recent years (see above). Following Aeon, UMWTC, and Nomura Holdings, in September 2014 The Bank of Tokyo-Mitsubishi UFJ issued sukuk in Malaysia. It has also been reported that Aeon now is considering issuing a perpetual sukuk in Malaysia[20]. A common trait of the Japanese companies that have used sukuk to raise funds so far is that they are all operating Islamic financial businesses overseas.

A critical issue for Japanese companies issuing sukuk is sharia compliance. As already noted, differences of opinion among Islamic scholars on whether a sukuk is sharia compliant are a potential source of problems, particularly in the case of cross-border issuance. It is fairly easy to raise funds by issuing sukuk in Malaysia, for example, because the country has enacted comprehensive relevant legislation. For domestic issuance, however, fund raising is primarily done in ringgit, and that is not necessarily a currency that is in great demand among Japanese issuers. If raising funds to finance a local business, the locally-denominated funds can be used as is, but if not, the funds must be swapped for the needed currency, and consideration must be given as to whether the sukuk is still a competitive funding method after the swap. On the other hand, when issuing sukuk internationally and with the approval of Islamic scholars and Islamic investors worldwide, as Nomura Holdings did, there is a risk that the fees paid for sharia advisory services on structuring and accounting/legal advice regarding type of issuance will be higher than they would be for a domestic issue. Thus sukuk come with constraints from both currency and cost.

Despite this, sukuk could become an important method for funding the expansion of business in the Islamic world for Japanese companies. Nearly half of the population of ASEAN, and a quarter of the world's population is Muslim. The Muslim population is growing fast, and expected to reach 2.2 billion in 15 years[21]. Furthermore, the global weighting of Islamic markets will increase in step with income growth in Islamic countries, because most Muslims consider it preferable to use sharia-compliant capital to fund halal businesses.

Aeon, Toyota Motor, Nomura Holdings, and The Bank of Tokyo-Mitsubishi UFJ have been pioneers in the international sukuk market, and they are likely to be followed by other Japanese companies working to increase their presence in Islamic markets in Southeast Asia and elsewhere.

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[19] Financial Services Agency, "Q&A on taxation of Japanese sukuk (Islamic bonds)," p. 19 (in Japanese).

[20] "Aeon Credit said opting for perpetual notes or sukuk issue," The SunDaily, 22 October 2013.

[21] PEW Research Center "The Future of the Global Muslim Population," January 2001.