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Developments of Sukuk (Islamic Bond) Market and Challenges of Japanese Market

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1. Basic conceptions of Islamic finance

Islamic finance means "finance made in compliance with the tenets of Islam." The rules and laws under Islam are called "shariah" in Arabic, which is derived from the religious precepts of Islam, particularly from the Quran, the Islamic holy bible and Sunnah, the sayings of Prophet Mohammed (Muhammad) and widely governs from the management of a nation to private behaviors of Muslims. Therefore, the Islamic finance can be rephrased as finance made in accordance with shariah, or shariah-compliant finance.

In Islamic finance, some of the conventional financial transactions are not permitted as they are required to be made in compliance with Shariah. The basic principles of Islamic finance include (1) inhibition of receipt and payment of interest (liver)[1], (2) inhibition of speculative transactions (Maisir), (3) inhibition of uncertain transactions (Gharar), and (4) inhibition of religiously prohibited behaviors (Table 1).

[1] According to shariah, it is regarded that money (currency) is simply a means for storing values and it does not create any value by itself in activities other than commercial or production activities.

(Table 1) Main Principles of Islamic Finance

① Prohibition of receipt/payment of interest (liver)	In Islamic Finance, currency/money is only a means of exchange and the receipt and payment of interest that results from lending or borrowing of money is prohibited as uneaned income.
②Prohibition of speculative transactions (Maisir)	Shariah prohibits the use of speculative or gambling behaiviors as a means to generate returns.
③Prohibition of uncertain transactions(Gharar)	Shariah prohibits transactions with uncertain conditions on prices or quantities because they may generate unfairness between the parties concerned or contain fraudulent factors.
④Prohibition of religiously prohibited behaiviors (Haram)	Shariah prohibits any Muslems to make transaction or use of specified business like pork, alcoal, tobbaco, casino, pornography and so on..

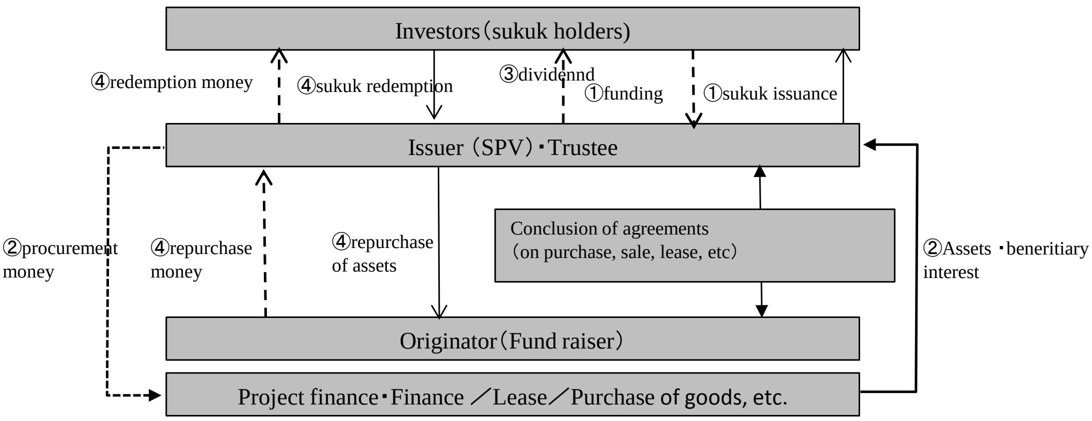
（Source）Wrtitten and editted by the Panel on Islamic Finance; "Islamic Finance--its Structure and Development", etc.

2. Basic schemes of sukuk (Islamic bonds)

Sukuk is an Islamic bond issued in compliance with shariah and used as an important means for raising and managing funds in the Islamic countries. Although the receipt and payment of interest is inhibited by shariah, profits that arise from management of assets and business activities are allowed to distribute.

The basic structure of a sukuk goes as follows. First, an originator (fund raising person or company) establishes a Special Purpose Vehicle (SPV) through which they issue sukuk and raise money from investors. The SPV as a trustee of the fund invests the money in projects and distribute the income/profits that arise from the investment (Chart 1). As described above, the Islamic finance prohibits the receipt and payment of interest, therefore the profits and fees that accrue from the transactions and original assets are instead distributed to the investors.

Chart 1 :Basic Scheme of sukuk



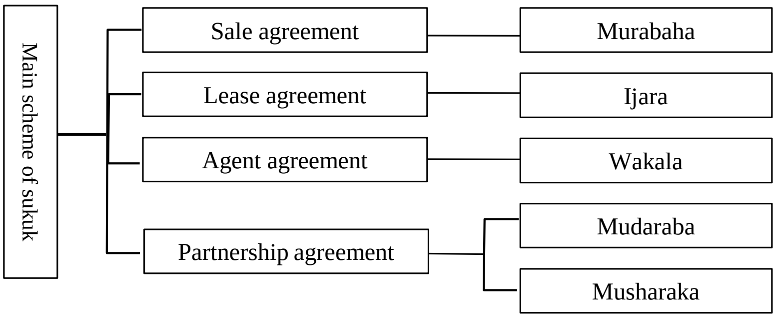
※Dot lines show flow of funds.

（Source）the Panel on Islamic Finance; "Islamic Finance--Its Structure and Development", Shinsuke NAGAOKA "Modern Islamic Finance", etc.

Sukuk are backed by specified assets (tangible assets, securities, loan assets, etc) or equity in a project, and income from these assets and projects is paid as dividend to holders of the sukuk (investors) in a certain period. Later, on a predetermined maturity day, the original principal is reimbursed to the holders of the sukuk by selling the assets concerned to the originator or to a third party. In this way, sukuk avoid the receipt/payment of interest or uncertain transactions prohibited by shariah by making it a transaction intermediated by actual assets or using a scheme to distribute income and fees as dividend instead of interest. Accordingly, sukuk function formally like a financial product similar to an asset-backed security and practically it has an economic function equivalent to a conventional[2] security.

Major types of sukuk are classified into 4 groups including (1) Murabaha (based on sales agreement) (2) Ijara (based on lease agreement), (3) Wakala (based on agent agreement), (4)Mudaraba/Musharaka (based on partnership agreement). (Chart 2)

Chart 2：Major Type of Sukuk



（Source）Panel on Islamic Finance "Islamic Finance ---Its Structure and Development", etc.

3. Development of Sukuk market

3－1 Markets for Issuing sukuk in the world

The population of Moslems in the world amounts to 1.6 billion, accounting for about 23% of the world population (as of 2010). Its share is projected to grow to about 30% by 2050[3]. With the increase of Moslems population, assets in Islamic finance have been on a rising trend centering on the non-interest bearing deposits in Islamic banks, and reached US$2 trillion in 2015. More recently although the growth rate has slowed down due to the low oil price and worsening fiscal conditions in the oil producing countries in the Middle East, the growing trend itself is expected to be sustained in the future. The sukuk market will also continue to expand as one of the investment destinations of such assets.

Chart 3 shows the development of issuing amounts of sukuk since 2005. Influenced by the

2 “Conventional” is used here to mean a traditional (ordinary) financial transaction that is globally conducted, other than a Shariah-compliant financial transaction.

3 “The Future of the World Religions: Population Growth Projections, 2010-2015”, Pew Research Institute, 2 April 2015

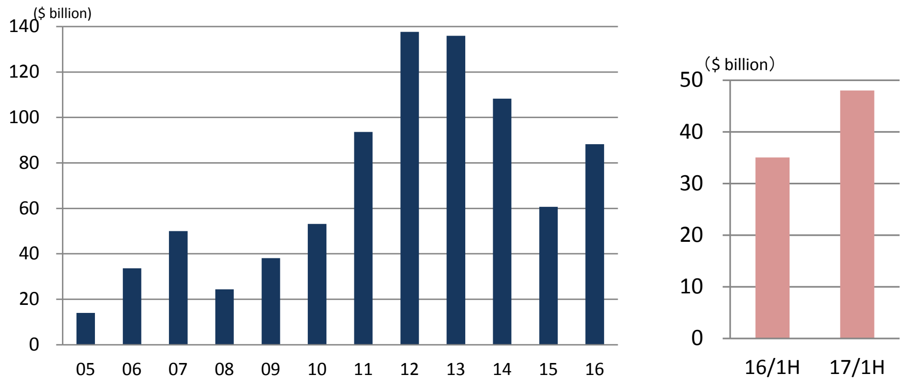
global financial crisis in 2008, the amount of issuance once decreased but it increased largely until around 2014. The growth reflected an increase of countries issuing sukuk as well as an increase of issuance of short-term dollar-denominated sukuk issued by the IILM[4].

In 2015, the amount of issue decreased substantially. It was mainly because the Bank Negara Malaysia (the central bank) suspended[5] issuing short-term sukuk aimed at domestic banks to observe the regulation on liquidity coverage ratio[6].

In 2016, it amounted to $88 billion, increasing by 44% year over year. The increase reflected the increase of sovereign sukuk that the oil producing countries largely depended on income from oil export had issued, together with conventional bonds, for Islamic investors (Islamic banks, Islamic investment funds, etc.) to finance the fiscal deficit caused by the lower oil prices.

The issuance amounted to $48 billion in the first half of 2017, increasing 38% over the corresponding period of the previous year, carrying on last year's strong momentum. It was driven by large amount of issuances of sovereign sukuk by the GCC[7] countries including $9 billion by Saudi Arabia. It is expected that the issuance of sovereign sukuk by oil producing countries will push the total amount of issuance also in the second half.

Chart 3：Issuance of Sukuk



（Source）International Islamic Financial Market（IIFM）, S&P global ratings

The share (cumulative of 2001-2016) of currency denomination is as shown in Chart 4. The sukuk denominated in Malaysian ringgit accounts for 61%, reflecting Malaysia's leading role in

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4 It stands for "The International Islamic Liquidity Management Corporation", which is contributed by nine central banks of Indonesia, Kuwait, Luxemburg, Malaysia, Mauritius, Nigeria, Qatar, Turkey, and UAE and the Islamic Development Bank. It was established in 2010 to administer the liquidity of Islamic financial institutions in the countries concerned.

5 As it had secured a sufficient amount of circulation of short-term sukuk, the Bank Negara Malaysia issued instead Malaysia Islamic Treasury Bill (MITB) that is not classified as sukuk to the financial institutions which need to manage their funds in shariah compliant assets.

6 This is part of the Basle III for bank's prudential regulations which require banks to maintain a certain level of qualified liquid assets. The short-term sukuk issued by the central bank corresponds to the asset.

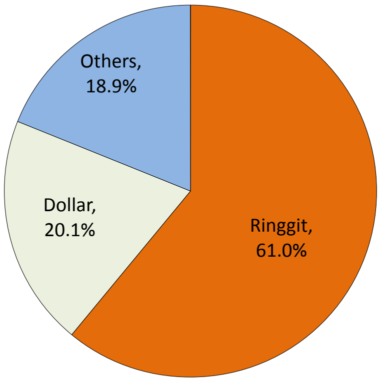
7 Abbribiation of Gulf Cooperation Council which consists of Saudi Arabia, UAE, Bahrain, Qatar, Kuait, and Oman.

the world Islamic financial markets.

In recent years, issuance of international/global sukuk (sukuk directed for foreign investors) has been increasing, especially the one denominated in dollars, reflecting strong demand for higher yields in the backdrop of global low interest rates. Foreign investors tend to prefer dollar-denominated sukuk to the one denominated in local currencies with the intention to reduce foreign exchange risks.

Chart 4: Share of sukuk by Currency Denomination

（Cumulative of 2001-2016）

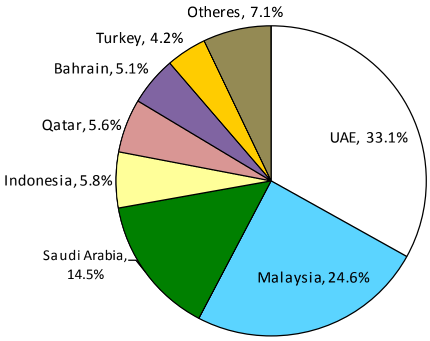


（Source） IIFM

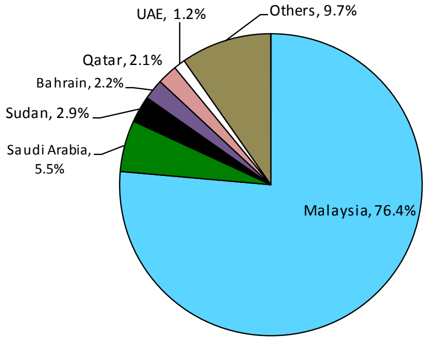
Chart 5 shows the issuance of sukuk by country for the cumulative of 2001-2016. In the global sukuk market, UAE and Malaysia account for a combined share of slightly less than 60%. In UAE, government affiliated enterprises and Islamic financial institutions and private companies have actively raised funds by issuing global sukuk. On the other hand, in Malaysia, the government and the central bank made efforts to improve the system and regulations to foster sukuk market, and as a result not only in the international sukuk markets but also in the domestic sukuk market (aimed at domestic investors), its share of issuance reached 76.4%, overwhelming the other markets.

Chart 5：Issuance of sukuk by country（for cumulative of 2001-2016）

Global Sukuk



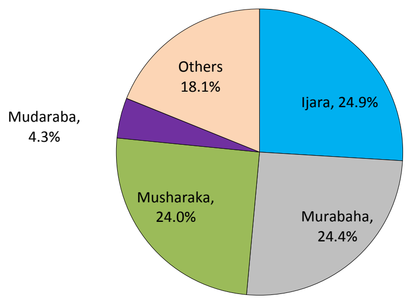
Domestic Sukuk

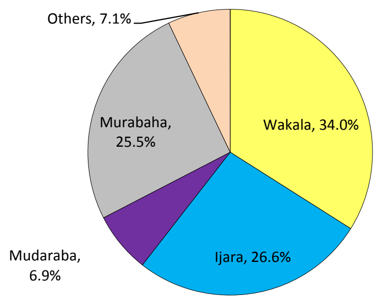


(Source) IIFM

Issuance of sukuk by structure/scheme is shown in Chart 6. Until 2009 when they suffered from a Dubai shock[8], Ijara and murabaha were the main structures of sukuk, but more recently the share of wakala has increased. In the GCC countries ijala was mainly used from the past, but since wakala, unlike ijara that requires tangible assets to lease, can be backed by shariah compliant investment assets other than the tangible assets, more issuers with no tangible assets seem to be making active use of wakala.

Chart 6: Sukuk Issuance by Scheme





(Source) IIFM

3－2　Market Performance by region　(Excluding Japan)

(1) Southeast Asia

(i) Malaysia

Malaysia has a long history in Islamic finance since about 60% of its population are Muslims and it has had a domestic demand for the finance like an establishment of Mecca Pilgrimage fund (1963) to accumulate the travel money needed to make a pilgrimage to Mecca. In 1983 the Malaysian government issued its first shariah compliant Government Investment Issue. This issue was regarded as the same as the government bonds and became a tool for the Islamic banks to manage their domestic liquidity. The first private sukuk denominated in ringgit was issued in 1990[9].

In Malaysia, efforts have been made since the 1990s under the leadership of the government to foster Islamic financial market. In the area of securities market, the Security Commission that oversees the securities business established in 1997 a Shariah Advisory Council to manage in a

[8] In the backdrop of global credit crunch triggered by the collapse of Lehman Brothers in September 2008 and worsening cash management due to sluggish sales of properties to invest in, Dubai World, an investment company affiliated with the government, unexpectedly declared in November 2009 to delay repayment of its debts.

[9] Shell MDS (Malaysia) Bhd (A joint company of Petronas, a national oil company of Malaysia, Shell Oil Company, one of the international major oil companies, Mitsubishi Corporation and Sarawak Government) was the issuer.

unified fashion the interpretation of the shariah by domestic Islamic financial institutions.

As the vulnerability of the Malaysian financial market that was heavily dependent on indirect finance got revealed by the Asian currency crisis of 1997, the Security Commission of Malaysia pushed through reforms of taxes on sukuk and other regulations in the 2000s by announcing "Capital Market Master Plan" bearing in mind to develop its market into a world top Islamic financial market. Specifically, it formulated in 2004 a guideline for issuing sukuk and clearly stated the scheme/structure of sukuk and procedures for issuing it while simplifying the procedures. On taxation, the Commission removed such problems as double taxation by exempting profits on ringgit-denominated sukuk issued domestically by nonresidents from withholding tax.

In addition, the Bank Negara Malaysia formulated "Financial Sector Master Plan" in which the Bank assured the shariah compliance and safety of sukuk market to investors in and out of the nation by mandating the central bank and commercial banks that underwrite sukuk to establish Shariah Advisory Council which evaluates their compliance with shariah. As a result, the Malaysian sukuk market has grown into the largest market in the world with issuance of sukuk increasing by 20.1% on an annual average during 2000-2015, and its outstanding amount accounting for 54% of the global total as of the end 2015[10].

In the current Malaysian securities market, the demand is strong on both sides of issuers and investors for the sukuk that can be traded equally with conventional bonds. On the issuer side, when a listed domestic company raises funds by issuing sukuk, its stock is certified as shariah-compliant stock defined by the Security Commission of Malaysia[11]. The certification has a merit to stabilize the price of the stock as it is regarded as a shariah compliant investment destination by Sovereign Wealth Fund (SWF)[12] and Employees Provident Fund (EPF)[13]. Also some of the companies (especially foreign affiliates) which develop B to C business such as shariah compliant consumer finance, food manufacturing and retail sales have issued sukuk with an aim to make an appeal to Muslim consumers.

On the investor side, it has drawn attention that the EPF established in January 2017 an Islamic fund (Simpanan Shariah) geared to Muslim employees. As this fund is required to be totally invested in shariah compliant assets, it will further increase the demand for sukuk.

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10 Malaysia Security Commission, "Islamic Fund and Wealth Management BLUEPRINT" Page 7, January 2017

11 There are requirements such as to limit the share of conventional debts (borrowings and corporate bonds that accrue interest) below 33% of total assets and to limit in the complex industries sales from haram business below a certain percentage (5~20%).

12 Refers to investment funds operated directly or indirectly by the governments. The funding is mainly from retained earnings of income on resources such as oil and foreign exchange reserves.

13 Malaysian pension fund that corresponds to the Employees' pension fund in Japan. It is the biggest institutional investor in Malaysia with total asset of about ¥19 trillion. It is also the second largest institutional investor after GIC in Singapore among the ASEAN countries.

Furthermore, in Malaysia the newest types of sukuk tailored to the needs of investors have been along in development, resulting in the appearance of the world-first Sustainable and Responsibility Investment (SRI) sukuk issued by the government agency Gazana National (2015), a project sukuk to finance the expansion work of Kuala Lumpur International Airport (2013), and a green sukuk to finance environmentally friendly projects (2017). As the Malaysian government has been implementing preferential treatments on taxation and issuing fees for sukuk related to SRI investment and infrastructure projects for the period of 2016~2020, issuance of sukuk in these areas is expected to further increase, at least for the time being.

(ii) Indonesia

Indonesia is the biggest Islamic country in the world with a population of 260 million of which about 87% are Muslims. The government bond act was enacted in 2002 enabling the government to issue government bonds to finance a fiscal deficit. The Indonesian securities markets used to be dominated by the government bonds, but in 2008 the State Shariah Securities Law was enacted which permitted the issuance of sukuk bonds. In that year, the government issued its first sovereign sukuk of 7 year and 10 year maturity for institutional investors. Starting 2009, the government regularly issues retail sovereign sukuk for domestic individual investors to promote a participation of Islamic investors in the sukuk market. The government also issues global sovereign sukuk directed to foreign investors. At the end of June 2017, sukuk accounted for about 13% of total outstanding of bond issuance in Indonesia[14], playing a part in developing the Indonesian securities market.

According to the Indonesian Financial Services Agency (OJK), the share of the assets of Islamic banks in the total assets of banks including conventional banks currently accounts for only about 5%. The OJK announced in June 2017 a roadmap to foster the Islamic financial market in Indonesia which will be favorably comparable to conventional banks in the three year period of 2017-2019, especially keeping in mind the underdeveloped Islamic finance among the SMEs and individuals[15]. The Ministry of National Development Planning (BAPPENAS) also revealed its intention to utilize the Islamic financial assets to promote the development of growth industries[16].

Furthermore, the Joko Widodo administration is discussing to utilize project sukuk in the infrastructure development initiatives it has actively been promoting since 2015 and the administration is expected to participate in the establishment of an Indonesian Islamic

14 Asian Development Bank (ADB), "Asia Bond Monitor", June 2017.

15 "Finance authority launches Islamic finance road map", The Jakarta Post, 14 June 201 (http://www.thejakartapost.com/news/2017/06/14/finance-authority-launches-islamic-finance-road-map.html)

16 " Indonesia takes big step towards boosting Islamic finance industry", Gulf Times, 1 August 2017 (http://www.gulf-times.com/story/558660/Indonesia-takes-big-step-towards-boosting-Islamic-)

Investment Bank (IIIB) which aims to invest in infrastructures not only in Indonesia but also in other Islamic countries. These factors will help increase the importance of sukuk in the infrastructure investment in Indonesia in the coming years.

(2) GCC countries (Bahrain, Saudi Arabia, UAE, Qatar, etc.)

The 6 GCC members largely depend on exports of natural resources of oil and gas which account for more or less 80% of total exports and have a fiscal structure easily affected by the development of oil prices. For this reason, their oil money income had been invested mainly in the highly liquid and high rating foreign bonds, especially in the U.S. government bonds and government agency securities like those issued by Fanny May and Freddy Mac. However, since the synchronized terrorist attacks of 2001, the GCC countries reviewed, under the strengthened financial regulations including money laundering, their vestment stance that had heavily focused on the U.S. securities, causing them to divert some of the money to the Islamic financial assets. Also the rise of oil prices in the middle 2000s increased the scale of SWFs of the GCC countries, which prompted them to increase investment in stocks and real estates in advanced economies, while Islamic financial assets were also incorporated in their portfolios as a part of investment diversification.

It was Bahrain that had made the most advanced efforts in Islamic finance among the GCC countries. Since it has had less oil production than other GCC countries, Bahrain has for long promoted liberalization of the economy and diversification of the industries aiming at achieving economic management without dependance on crude oil. Specifically it focused on the development of financial business, and strengthened its infrastructure, commencing with the establishment in 1975 of the first offshore financial market in Middle East, aiming to become an international financial center. On the Islamic finance area, Bahrain established in 1991 the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and has made efforts to formulate the standards on interpretation of the shariah relating to financial transaction business including accounting and auditing methods and schemes of financial products. These standards defined by the AAOIFI are currently referred to by many Islamic financial institutions.

(3) Leading countries in Financial Business

Apart from the Islamic countries in Southeast Asia and GCC countries noted above, such leading countries in financial business as the UK, Hong Kong and Singapore withe international financial centers have also issued sukuk despite smaller Muslim population in the country. But their background in the development of sukuk market differs from those in the Islamic countries.

In these leading countries in financial business, since they have smaller share of Muslims, it is the wholesale business like issuance of sukuk and cross-border transactions, rather than the retail business, that dominates the market. There are few banks specialized in Islamic finance except for the UK[17] where the Muslims account for about 5% of population reflecting the inflow of immigrants from the former colonial countries. But the hurdles to an introduction of the Islamic finance seem to have been low in these countries since the subsidiaries of major banking group like the HSBC and Standard Chartered Bank have established banks specialized in Islamic finance and accumulated knowhow on practical operations.

On the regulatory side, there were some cases in the Islamic countries where, like Indonesia, it took more than a year to introduce legislation needed for issuance of sukuk, but in the financially advanced countries such as the UK, institutions needed for issuance of sukuk were introduced by only utilizing the existing laws and regulations without legislation of new laws.

Among the financially advanced countries, global sovereign sukuk have been issued in Singapore (2009), the UK (2014), Hong Kong (2014, 2015, 2017) and Luxemburg (2014). It is pointed out, however, that the purpose of these issuance was not to meet the religious requirements or needs from Islamic investors as were in the Islamic countries but it was rather intended to externally show off the options of various financial schemes available in their international financial centers[18]. So the possibility of further expansion of sukuk in these countries is considered to be limited.

4. The Sukuk market in Japan and its challenges ahead

In Japan, among the schemes of Islamic finance, dealing of its main schemes such as murabaha had been prohibited by the Japanese Banking Act as they were deemed formally as cash transactions. However, as the institutional environment to issue sukuk had been enhanced in non-Islamic countries like the UK and Singapore, the Banking Act was revised in December 2008 with an aim to attract Islamic money. The "cash transaction based on the religious doctrine" came to be deemed as comparable to an ordinary lending, enabling the banks' subsidiaries and fellow subsidiaries to deal in the Islamic finance. Further, with the amendment of the Asset Securitization Act of 2011, sukuk was defined as "special bond-type beneficial interests" issued under the architecture of a specific purpose trust (SPT) and was positioned as practically comparable to corporate bonds. This enabled the issuance of sukuk in Japan. In turn, sukuk issued by foreign issuers became eligible in the same year to be listed on the Tokyo Pro-bond Market.

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[17] In the UK, they improved the status of Islamic Finance by revising tax on housing loans with Islamic finance scheme (2003), allowing inclusion of commission fees on Murabaha transactions and lease fees on Ijara (2005), to make the Islamic finance well comparable to the conventional finance.

[18] Yoshiaki YOSHIDA: "Global Islamic Finance", P64, Nakanishiya Shuppan, 2017.

Tax treatment was also amended in 2011 and it was decided registration license tax and real estate acquisition tax shall be excluded from taxation when a transaction of real estate trust is conducted in relation to special bond-type beneficial interests (Japanese-version sukuk). Also the tax exemption measures on dividends paid to foreign investors were extended until March 2019, as in the case of investment in ordinary corporate bonds.

In spite of this improved institutional environment for issuance of sukuk within Japan, however, there is no record of issuance of sukuk in Japan so far. Several reasons were pointed out, say, the preferential tax treatment on issuance of sukuk is not a permanent measure, the underlying real estate asset for the Japanese version sukuk should be located within Japan and its ownership should belong to the issuer of the sukuk, the issuance of sukuk by foreign corporations is not easy because of non-existence of competent shariah advisor in Japan. There is also an external factor that the funding costs are overwhelmingly cheaper for bank borrowing and corporate bond issuance in the prolonged environment of low interest rates.

Although Japanese companies have records of issuance of sukuk, most of them have been issued in the Malaysian market. (Table 2) In order to revitalize the Japanese sukuk market, it will be needed for Japan to take significant measures not only from the institutional aspect but also from the aspects of human resources and issuance costs.

(Table 2) Major issuance of Sukuk in Malaysian Market by Japanese Companies

Issuers	Year	Type	Amount	Maturity
Aeon Credit Service (Malaysian subsidiary)	2007	Musharaka	400 million ringgit	7 years
UMW Toyota Capital (Malaysian subsidiary)	2007	Musharaka	1 billion ringgit	7 years
Nomura Holdings	2010	Ijara	100 million dollar	2 years
Bank of Tokyo Mitsubishi UFJ (Malaysian subsidiary)	2014	Wakala	①2.5 billion yen ②25 million dollar	10 years

(Source) Websites of each company

5. Conclusion～Prospect for the use of sukuk by the Japanese companies

In the previous chapter, the author noted that the Japanese sukuk market is not so active as compared to other financially advanced countries. There will be two cases where a more active utilization of sukuk can be expected in the future among the Japanese companies. They are: (1) asset management by institutional investors and (2) diversification of funding tools by financial institutions and business companies.

(1)Asset management by institutional investors

As a possible idea on asset management by institutional investors, the author would like to suggest an investment in global sukuk, mainly denominated in the U.S. dollar. As most sukuk are issued in emerging countries, their yields tend to be higher than for the conventional bonds issued in advanced economies.

There are three merits other than the interest rate level. The first is that the sukuk leads to a diversification of investment destination as there are variety of issuers including governments, government agencies (SWF and government operated corporations), international institutions (World Bank Group and other regional development banks) and private companies. In addition to ordinary sukuk, sukuk with different purposes such as sukuk and green sukuk available in Malaysia can be further developed in the future, which will contribute to the diversification of asset management. Actually, in FY2016 Malaysian sovereign sukuk was added to the portfolio of Government Pension Investment Fund (GPIF) of Japan, separately from the Malaysian conventional bonds.

The second merit relates to the affinity of investment in sukuk to ESG investment[19] which institutional investors have more and more emphasized recently. Since sukuk is a scheme based on the compliance with shariah, there may be cases where that investment in sukuk excludes the investment activities by conventional financial business that accrues interest (consumer finance, credit companies) or investment in industries related to pork meat, but it is in a very close position to ESG investment. As the momentum is mounting for issuing sukuk that are compatible to SRI, they will support a part of ESG investment strategy of institutional investors[20].

The third is a relatively low exchange volatility risk of global sukuk because most of them are denominated in the US dollar, although they represent investment in emerging economies. The dollar-denominated sukuk will have an advantage in cross-border transactions. Although the main investment strategy in the 2000s was to buy and hold newly issued sukuk as the supply of sukuk was smaller than demand for them, improved secondary market has enabled more timely transactions of ijara and wakala type of sukuk through securities companies.

On the other hand, (i) shariah risk and (ii) ambiguity in tax treatment will be the points to remember. Shariah risk means the risk that the profits and principals could not be received when the originally shariah compliant sukuk becomes disqualified in a continuous monitoring on the use of the fund or appropriateness of underlying assets.

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19 Investment that places emphasis on Environment, Social, and Governance.

20 At the Kuala Lumpur Islamic Finance Forum（KLIFF2017） the author attended on October 3-4, it was known from the keynote speech (Managing Director of Development and Islamic Markets of Securities Commission Malaysia) that in the conventional financial market SRI and ESG have been developing rapidly in recent years, having a lead over the Islamic financial market which has a close affinity to the former, and that they have a sense of crisis on this situation.

The ambiguity in tax treatment refers to the unclear judgement on whether the earnings from sukuk are regarded as earnings from beneficiary certificates or yields on conventional bonds when Japanese institutional investors invest in them. It seems this ambiguity has somewhat alienated the Japanese investors from investment in sukuk.

(2)Diversification of funding of financial institutions and business companies

As described above, there are records of issuance of sukuk by Japanese companies in the foreign markets and other entities than financial institutions can issue sukuk if the underlying assets and purpose of the fund comply with shariah. It should be noted the sukuk become incompliant with shariah if the underlying assets are related to the equipment used for haram industries (those dealing in alcohol or pork, etc.) and real estate. Sukuk can be issued when shariah-compliant real estate assets held by financial institutions or general business companies for investment or equipment used for shariah compliant business are used as underlying asset. For instance, companies operating in Islamic countries can achieve diversification of fund suppliers when they use sukuk, rather than borrowing from conventional financial institutions or issuance of bonds, by using as underlying asset the equipment (buildings and machines) they are investing in or real estate for investment[21] they are planning to develop.

In recent years, more Japanese companies, especially financial institutions, have been increasing their equity capital through issuance of subordinated bonds denominated in yen or dollar in the environment of low interest rates. In the future, utilization of subordinated sukuk will become one of the options for it. The merits of fund raising through sukuk include (i) there is a significant demand for high rating sukuk from Islamic investors, (ii) it can achieve diversification of fund suppliers by attracting Islamic money which has a potential to grow.

The Japanese financial institutions and business companies find it difficult to grow in domestic market only due to negative interest rate, decreasing population, and progress of aging. Some Islamic countries have relatively higher geopolitical risks than advanced economies, but they have a big room for economic growth. Improved sukuk dealing in the Japanese market will make a good appeal to the Islamic countries, and can and should be discussed as an option for a new growth to support further global development of the Japanese companies.

[21] There are such requirements as that the rental income from haram industry (alcohol and pork, etc.) should not exceed 20% of total income).

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