

Islamic Finance in Japan

A. Background on Introducing Islamic Finance in Japan

Japan has strong economic ties with Islamic countries, particularly Middle Eastern oil-producing countries, as evidenced by huge cash outflows from Japan to those countries every year. Facilitating the reverse flow of investment from Islamic countries into Japan and other Asian economies is important for the balanced growth of the global economy.

In 2007, a number of Japanese public and private institutions started to explore Islamic finance as one of the means to attract Islamic investors (particularly those with petrodollars) to invest in Japan by participating as an observer in the Islamic Financial Services Board, an international standard-setting organization for the Islamic finance services industry headquartered in Kuala Lumpur, Malaysia (Table 45).

Table 45: Japanese Organizations in the Islamic Financial Services Board

Name	Country or Origin	Member Status
Bank of Japan	Japan	Observer Member
Bank of Tokyo-Mitsubishi (Malaysia)	Malaysia	Observer Member
Japan Bank for International Cooperation	Japan	Observer Member
Japan Securities Dealers Association	Japan	Observer Member
Mizuho Corporate Bank	Japan	Observer Member
Nomura Asset Management Malaysia	Malaysia	Observer Member
Sumitomo Mitsui Banking Corporation	Japan	Observer Member

Source: Japan Securities Dealers Association.

In terms of private transactions, in addition to the early commitment of Tokio Marine Group to *Takaful* operations since the beginning of the 21st century, several companies and their overseas subsidiaries have carried out Islamic capital market transactions overseas as follows:

- (i) The Malaysian subsidiaries of AEON Credit Service and Toyota Financial Service issued MYR-denominated *sukuk musharakah* in 2007 and 2008, respectively.
- (ii) Daiwa Asset Management arranged the listing of the first Shariah-compliant exchange-traded fund for Japanese stocks in Singapore in 2008.
- (iii) Nomura Holdings issued the first USD-denominated *sukuk Ijarah* (USD100 million) in July 2010 in Malaysia based on aircraft leasing.
- (iv) Daiwa Securities Capital Markets acted as co-lead arranger for Islamic real estate investment trusts listed on the Singapore Exchange in November 2010.

- (v) The Bank of Tokyo-Mitsubishi UFJ launched a USD500 million multicurrency *sukuk* issuance program using *wakala al isthismar* for 1 year in 2014, and has already issued the first JPY-denominated *sukuk* under this program.

B. Regulatory Framework for Islamic Finance in General

For the time being, Japan is not equipped with a full-ranged regulatory framework for operating Islamic finance. However, in December 2008, Japanese banking and insurance business regulations were relaxed to allow subsidiaries of Japanese banks and insurance companies to provide certain Islamic finance services in such forms as *murabahah* (cost-plus sale) or *Ijarah* (leasing) by amending the Ordinance for Enforcement of the Banking Law and the Insurance Business Law.

At present, there is not an explicit movement for Japanese banks to set up such subsidiaries in Japan, except for a few cases where subsidiaries of Japanese banks are applying for the regulatory authorization required for conducting Islamic financial operations in overseas. Consequently, issues of Shariah compliance, or that of supervision of the market, have not yet been taken up for discussion in Japan.

C. Regulatory and Legal Framework for Islamic Bonds (J-Sukuk)

1. Background on the Amendment of Legislation for Fostering J-Sukuk Market

In 2010, further steps were contemplated to facilitate *sukuk* issuance by Japanese domestic corporations (or other public or quasi-public entities) under the Japanese legal system. Since the latter half of 2010, the momentum within the governmental agency, the FSA became explicit:

- (i) Recommendation by expert advisory group within the FSA (July 2010) that “it would be necessary to improve the tax treatment of Islamic finance by taking certain measures such as treating the dividends on *sukuk* in the same manner as interests on bonds.” Interests on book-entry bonds paid to nonresidents and foreign entities are excluded from taxation following the tax reform in 2010.
- (ii) Policy assessment by the FSA (August 2010);
- (iii) Submission of the tax reform request by the FSA (August 2010) (Tax Reform Request);
- (iv) Assessment and acceptance of the Tax Reform Request by Tax Commission (December 2010);
- (v) Outline of the tax reform 2011 announced by the government (December 2010) (Tax Reform Outline 2011); and
- (vi) Action Plan for Japan’s New Growth Strategy, announced by the FSA on 24 December 2010: the FSA will promote the development of the environment for Islamic bond issuance in Japan.

2. Amendment of Legislation for Issuing *Sukuk* under Japanese Law

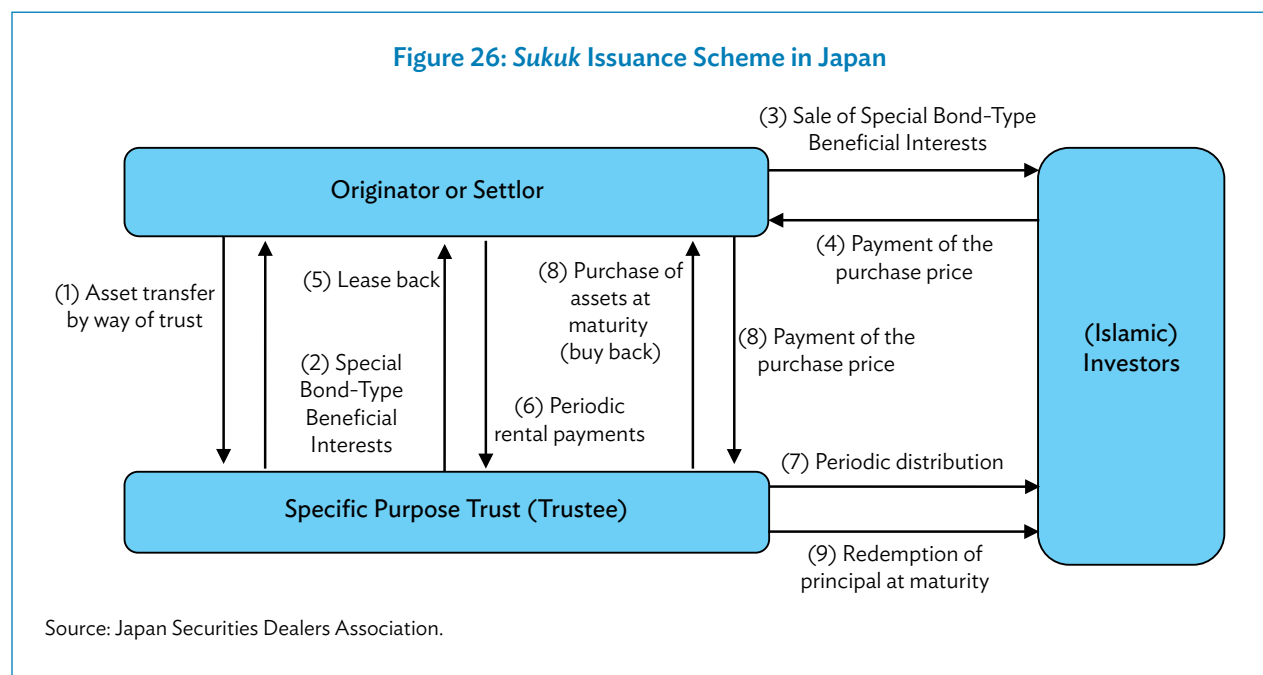
Following the momentum described above, the National Diet passed a bill on 17 May 2011 to facilitate *sukuk* issuance in Japan by way of amendment of the Asset Securitization Act (*shisan ryudoka ho* 「資産流動化法」). The bill is accompanied by amendments on relevant

tax legislation with a view to creating a level tax playing field compared to conventional bonds.

The Financial Instruments and Exchange Act (Amendment) for Reinforcement of Infrastructure of the Capital Market and Financial Business was presented before the National Diet on 1 April 2011 by the Government of Japan. The bill involves an amendment of the Asset Securitization Act that anticipates accommodating a legal framework for the issuance of *sukuk*, particularly *sukuk Ijarah*, in Japan. *J-Sukuk*, under the new legal framework, will be established typically by taking the form of Bond-Type Beneficial Interests (*Shasai-teki jueki-ken* 「社債的受益権」) to be issued under the architecture of a specific purpose trust (SPT) (*tokutei mokuteki shintaku* 「特定目的信託」), pursuant to the amended Asset Securitization Act. And, more specifically, if *J-Sukuk* takes a form of *sukuk Ijarah*, with the buyback commitment of underlying assets at its maturity by the originator, it will be legally constructed under the scheme titled Special Bond-Type Beneficial Interests (*Tokubetu shasai-teki jueki-ken* 「特別社債的受益権」).

The Special Bond-Type Beneficial Interest is a certain type of beneficial interest under an SPT, for which a predetermined amount of money is distributed and a condition is attached to the effect that the originator shall purchase (buy back) the underlying assets or such other terms to be prescribed in the Cabinet Order. The following is the outline of the structure, whereby steps are taken in the manner illustrated in Figure 26:

- (1) A Japanese institution acting as the originator (or settlor in the context of the SPT Agreement) and a trustee, which would typically be a trust bank, enters into a specific purpose trust agreement (SPT Agreement) whereby the originator transfers the ownership of an asset (such as real estate, Underlying Asset) to the trustee who holds the same on trust.



- (2) The originator acquires Special Bond-Type Beneficial Interests in exchange for the transfer of the Underlying Asset to the trustee pursuant to the SPT Agreement.
- (3) The originator sells the Special Bond-Type Beneficial Interests to investors that include Islamic investors.
- (4) Investors pay the amount equivalent to the purchase price for the Special Bond-Type Beneficial Interests to the originator.
- (5) The originator enters into an *Ijarah* lease agreement with the trustee in respect of the Underlying Asset.
- (6) The originator makes periodic rental payments to the trustee under the *Ijarah* lease agreement.
- (7) The trustee makes periodic distribution of the profit to the investors by way of dividends on the Special Bond-Type Beneficial Interests, which are funded by the rental payments under the *Ijarah* lease agreement.
- (8) At maturity, the originator purchases (buys back) the Underlying Asset at a predetermined price equivalent to the Special Bond-Type Beneficial Interests amount then outstanding.
- (9) The trustee redeems the Special Bond-Type Beneficial Interests by utilizing the purchase price received from the originator.

In order for an instrument to fall within the definition of the (Special) Bond-Type Beneficial Interests under the new Article 230 of the Asset Securitization Act, it needs to have all the following key characteristics:

- (i) **Amount of distribution.** The amount of distribution must be set out in the SPT Agreement in the form of a predetermined amount or such other calculation whose method is to be prescribed in the Cabinet Order, which deems to result a predetermined amount.⁵⁵
- (ii) **Structure of payments.** The principal must be redeemed at a predetermined point in time. The payment structure must allow not only payment at the end of the *sukuk* term but also in installments.
- (iii) **Voting rights.** The holders of the (Special) Bond-Type Beneficial Interests are not granted voting rights save for prescribed resolutions such as amendment and termination of the SPT Agreement.
- (iv) **Asset-based nature (rather than asset backed).** The credit standing of the originator (settlor of the SPT) should have a material effect on the investment decision of the investors. On the face of the provision of the Asset Securitization Act, the asset-based nature of the (Special) Bond-Type Beneficial Interests is recognized by a purchase undertaking of the Underlying Asset by the originator under the SPT Agreement or other alternative arrangements to be prescribed in the Cabinet Order, which would likely be an arrangement where the Underlying Assets are recognized in the balance sheet of the originator, regardless of the transfer of its ownership to the trustee pursuant to the SPT Agreement.

3. Recognition of *Sukuk* Issued under Foreign Law

It has not been explicitly reported that the *sukuk* issued under overseas jurisdiction have been offered in Japan. Some factors that are attributable to the above include uncertainty of

⁵⁵ The draft Cabinet Order has not yet been disclosed to the public as of 11 July 2011 but is expected to allow periodic distribution determined by reference to market rate of interest such as LIBOR.

tax treatment, a lack of market demand within Japan which has a small Muslim population, and challenges over regulatory definitions of overseas Islamic products.

D. Type of Instruments Available, Segments, and Tenure

The (Special) Bond-Type Beneficial Interests (which is anticipated to be recognized as *sukuk* by Islamic investors) introduced in the amended Asset Securitization Act aim typically at the issuance of the *sukuk Ijarah* within the context of Japanese legislation. However, by amendment of the Implementation Rule on Asset Securitization Act in November 2011, participating interests in the silent partnership or partnership based on the Civil Code, which are equivalent to the interests in *mudarabah* and *musharakah*, respectively, became also allowable as underlying assets of SPT.

E. Tax-Related Issues

There are four key measures in the amendment of the relevant tax legislation to address taxation issues that would otherwise put the (Special) Bond-Type Beneficial Interests at a disadvantage in view of conventional bond issues:

1. Exclusion from Taxation on the Distribution of Profits

The distributions of profit on the book-entry Special Bond-Type Beneficial Interests payable to

- (i) foreign corporations and nonresidents (who do not have permanent establishment in Japan) shall be excluded from taxation, and
- (ii) domestic banks and other Japanese financial institutions shall be exempted from withholding tax.

This measure was initially enacted as a temporary measure effective until March 2013. However, in line with the perpetuation of other preferential tax treatment regarding bond investment by nonresidents, etc. (e.g., Japanese Bond Income Tax Exemption Scheme), it was extended for 3 years until March 2016.

2. Tax Transparency of the Special Purpose Trust

The conditions for deductibility of dividends paid by the SPT have been amended to the effect that the Special Bond-Type Beneficial Interests have been exempted from the requirement that more than 50% of the issue amount must be offered domestically.

3. Exclusion of Asset Transfer-Related Tax

The purchase (buyback) transaction of the underlying asset from SPT to the originator (or the settlor of the SPT) shall be excluded from

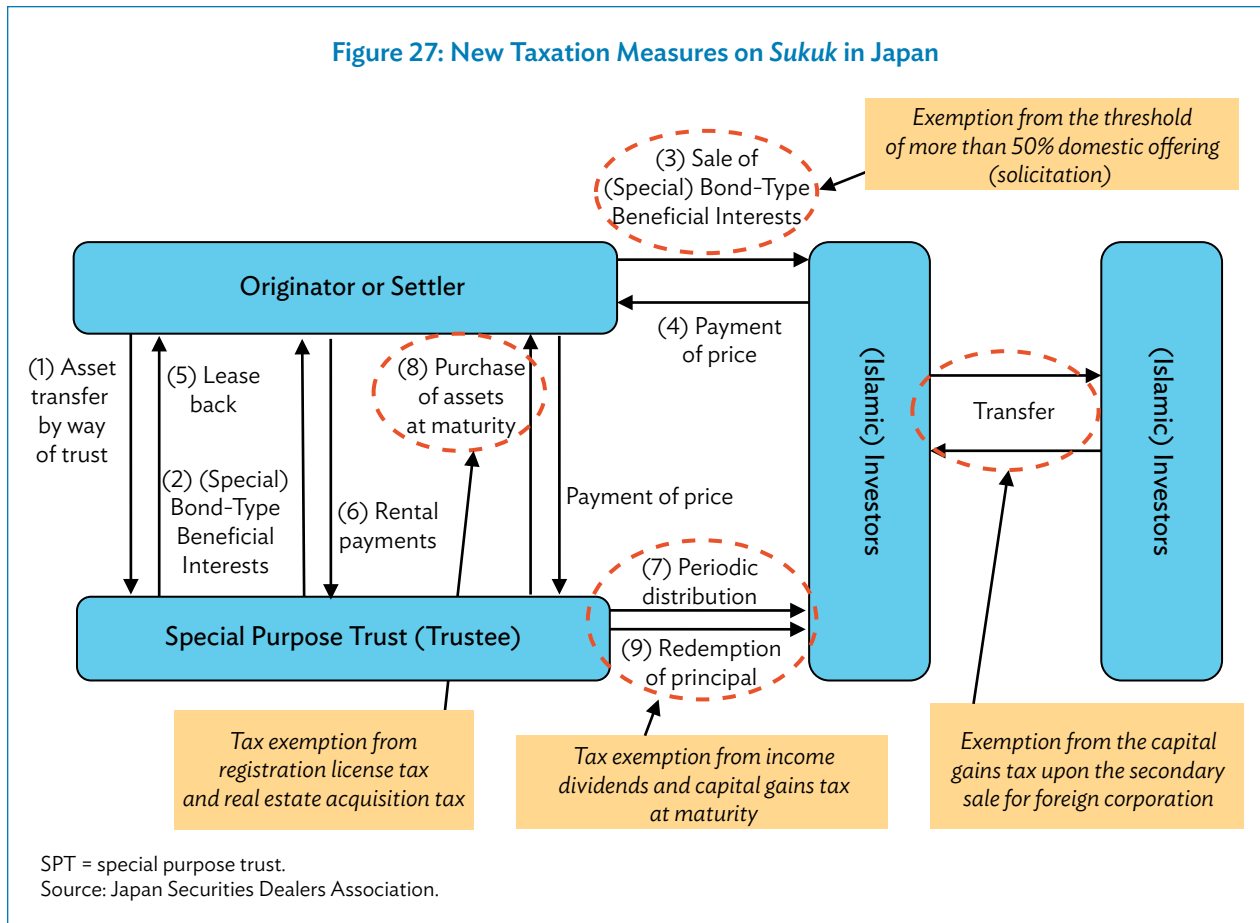
- (i) registration license tax, and
- (ii) real estate acquisition tax (in respect of the SPT involving real estate as an underlying trust asset) in relation to the Special Bond-Type Beneficial Interests under the SPT.

This measure was initially enacted as a temporary measure effective until March 2014. However, it was extended for 2 additional years until March 2016.

4. Exemption from Capital Gains Tax

Foreign corporations shall be exempted from capital gains tax upon the secondary sale of the (Special) Bond-Type Beneficial Interests.

Figure 27: New Taxation Measures on Sukuk in Japan



F. Impediments for Structuring Sukuk

Aside from the tax-related issues above, a number of other impediments continue to affect the issuance of *sukuk* in Japan:

- (i) The *J-sukuk* is a (Special) Bond-Type Beneficial Interests issued by SPT under the amended Asset Securitization Act, which is legally unique compared with the most commonly used type of trust certificates based on the Declaration of Trust. Thus, the usability of such vehicle is not well tested in the international context.
- (ii) As this structure presupposes the underlying assets that actually exist and produce a stream of fixed cash-flows, it would be difficult to be used for the

- development-type real-estate leasing projects where the underlying assets do not physically exist yet.
- (iii) Relevant infrastructure such as a settlement system, listing, implementation rules, accounting treatment, etc. should be developed concomitantly for facilitating the issuance of *J-sukuk*.

G. Significance of the Islamic Finance and Islamic Bonds (*Sukuk*) Market

Only one Shariah-compliant finance deal has been reported in Japan involving *tokumei kumiai*, a statutory category of partnership established by an agreement between a business operator and an investor who invests in a specified business of the operator, in the field of real-estate finance transaction. However, other types of Islamic financial transactions have not yet been achieved within Japan, including Islamic banking and *sukuk* issuance.

In this regard, the TPBM, which was initially established by TOKYO AIM as a joint venture between the TSE and the London Stock Exchange in May 2011, and is now functioning as one segment of the TOKYO PRO-BOND Market under the TSE, has included the (Special) Bond-Type Beneficial Interests among its eligible bonds for listing and trading.

As mentioned above, several Japanese entities have issued *sukuk* in overseas markets.