Islamic Finance in Japan

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Introduction
Despite the continuing global financial meltdown and its intrinsic nature as a non-Muslim country, Japan has recently witnessed two positive developments in regulatory reforms, which has led to the promotion of Islamic finance. This report reviews the events of 2009, and surveys possible directions for Islamic finance involving Japanese entities in 2010. Islamic finance in Japan has actually shown steady growth, thus facilitating petrodollar investments and boosting the competitiveness of Japan's financial and capital markets.

Looking back at 2009
The most significant regulatory reforms influencing Islamic finance in 2009 were amendments to the Ordinance for Enforcement of the Banking Act/Insurance Business Act, under which certain types of Islamic finance transactions were for the first time added to the scope of business that the subsidiaries of banks/insurance companies may conduct. Second, tax reforms have reduced Japanese taxation risks for foreign fund managers of certain investment funds on their income and capital gains from the disposition of funds.

These reforms stemmed from the Japan Financial Services Agency's (JFSA) 2007 "Plan for Strengthening the Competitiveness of Japan's Financial and Capital Markets".

(i) Regulatory reforms I
Broadening the Scope of Business for Banking Subsidiaries / Insurance Companies

In contrast to the universal banking system of the UK, Japanese banks, insurance firms and securities companies have long been separated in principle in terms of restrictions on the scope of their business. Banks, insurance firms and their respective subsidiaries may conduct certain types of business that are listed under the laws and business ancillary to such listed types of business. Recent amendments enacted in December 2008, however, relaxed the restriction and allowed the subsidiaries of banks or insurance companies to conduct Islamic finance transactions subject to the following conditions:

- The transaction is "deemed equivalent to money lending," although it takes a different form therefrom;
- Receipt of interest is prohibited due to restrictions imposed by religious discipline; and
- A board, consisting of experts with professional knowledge of the religious discipline, approves the transaction.

Two points should be noted regarding the scope of the amendments: First, the amended ordinances apply to "subsidiaries, etc" of banks or insurance companies (i.e. the scope of business that banks or insurance companies themselves may conduct did not change). Second, such subsidiaries may conduct Islamic finance transactions only when the transactions are "deemed equivalent to money lending" (i.e. transactions that are deemed deposits or fund-raising are still prohibited).

The JFSA explained, responding to publicly invited comments regarding the draft amendments, that any transaction may be "deemed equivalent to money lending" if it generates an identifiable effect as money lending. The JFSA added that the amendments were generally considered to apply to Murabahah (cost-plus-sale) and Ijarah (lease), although they were not limited to these two types, but that they would not apply to transactions taking the form of capital subscription or securities underwriting.

The scope of the amendments is thus limited; however, this change marked a notable initial step in the deregulation of the long-lasting unique separation of banks and securities companies.

(ii) Regulatory Reforms II
Tax reform to promote foreign direct investment

(i) Before the reforms, investment in a Japanese investment limited partnership, formed from general partners and limited partners, (Toshi Jigyo Yugen Sekinin Kumiai; "Investment LPS" as defined in the Limited Partnership Act for Investment) created a Japanese permanent establishment (PE) risk for foreign investors. After the reforms, a foreign partner may invest in an Investment LPS without being regarded as owning a Japanese PE, subject to certain conditions including that the foreign partner owes limited liability and is not involved in the management of the Investment LPS, and that the foreign partner's investment ratio in the Investment LPS is less than 25%.

(ii) Before the reforms, a foreign partner without a PE in Japan was taxable on a gain from the sale of shares in a Japanese corporation if the foreign partner sold 5% or more of the shares of such a corporation and such a foreign fund, combining all foreign partners, owned 25% or more of the shares of such a corporation for a certain period (the "25/5% rule"). After the reforms, application of the 25/5% rule has been relaxed, and the 25% threshold may be applied at the individual foreign partner's level, instead of the whole foreign fund level, subject to certain conditions.

(iii) Movements in the private sector
Wary of the impact of the credit crunch and the Dubai crisis, there were few announcements in 2009 regarding Islamic finance transactions involving Japanese entities. However, there existed growing interest in launching Islamic finance units among Japan's financial institutions and other businesses.

Following movements in 2008 (i.e. Bank of Tokyo-Mitsubishi UFJ (Malaysia) set up its international currency business unit with approval from the Central Bank of Malaysia. Sumitomo Mitsui Banking Corporation launched its Doha office, and Daiwa FTSE's Shariah Exchange Traded Fund was listed as the first Shariah compliant ETF on the Singapore Exchange). Nomura Islamic Asset Management was licensed in January 2009 in Malaysia to create an Islamic fund management and branding footprint. In December 2009, Mizuho Securities and Maybank Investment Bank announced that they had signed a MoU to form a strategic alliance in primary and secondary markets along with Islamic markets.

(iv) Movements towards International Tax Treaties
Along with the above domestic tax reforms, Japan has reached basic agreements on new tax treaties, mainly to avoid double taxation, with Kuwait in January 2009 and Saudi Arabia in June 2009.

Looking Ahead at 2010
Importantly, even before the amendments, some considered that banks and their subsidiaries were allowed to conduct certain types of Islamic finance transactions under other statutes. For instance, a bank's subsidiary may conduct Ijarah (lease) as a type of finance leasing, subject to certain conditions. In addition, a bank may be entitled to invest in Mudarabah or Musharakah (profit-loss sharing financial structures) provided its role is that of a pure investor, because Mudarabah and Musharakah may be considered "deemed securities" under the Financial Instruments and Exchange Act (FIEA). Further, regardless of whether Sukuk is categorized as a bond, beneficial interest or a collective investment scheme, Sukuk is after all considered to fall under "securities" as defined in the FIEA. Thus, banks may conduct Sukuk-related transactions, subject to certain conditions under the FIEA.

In contrast, securities companies are under more relaxed regulations in terms of the types of business they may conduct. Securities companies appear to be establishing their foundations for Islamic finance, and are weighing the right timing for launching more Islamic finance transactions in 2010. Symbolically, in January 2010 Nomura Holdings announced that it plans to become the first Japanese company to make a full-scale entry into Islamic financial markets, utilizing its acquisition of Lehman's global units.

Proposed further tax reforms will continue to add momentum to Islamic finance in Japan, as the country is currently negotiating a basic agreement on new tax treaties with the UAE. One of the long-awaited reforms in tax and accounting is the clarification of the nature of Sukuk, because tax authorities thus far have had no other choice but to apply existing tax rules in accordance with the presumed nature of Sukuk, either bond or trust beneficiary rights or otherwise.

Conclusion
Although recent turmoil in the financial markets may have an adverse effect on the impetus, Islamic finance is expected to attract a great deal of attention due to its ability to increase options for investors open to recycling petrodollars into Japanese financial markets. With the backing of regulatory reforms and movements in the private sector, we believe 2010 will witness more active transitions to Islamic finance in Japan. Things will go slowly in the beginning but will gradually gain momentum.

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