

Translating Islamic Finance into Japanese Legal Concepts

By Takashi Tsukioka

Recently, in Japan, Islamic finance has been attracting the attention of many potential market players. In December 2010, the Financial Services Agency of Japan officially announced its aim to “promote the development of an environment for the issuance of Islamic bonds in Japan” in its action plan for a new growth strategy.

In line with this initiative, legal reform to facilitate the issuance of Sukuk through the utilization of a certain type of trust is anticipated, and potential issuers, arrangers and other market players have commenced their study with respect to the possibility of Japanese Sukuk transactions.

Upon completion of such legal reform, actual Sukuk issuance is expected to follow thereafter.

Islamic finance transactions, including Sukuk, will however be novel to Japan and therefore numerous legal issues will need to be addressed. This article briefly outlines some typical Islamic finance transactions within the context of Japanese law to illustrate how these transactions might be structured in Japan.

Mudarabah

To implement a Mudarabah transaction, one possible structure under Japanese law would involve the utilization of a trust arrangement. Trusts are used as the vehicle for Sukuk transactions around the world, and as mentioned above, are anticipated to be used in Japan as the legal vehicle for the Japanese Sukuk. Under the Trust Act of Japan, a settlor entrusts property to a trustee, who then manages the property in accordance with their trust agreement.

The beneficiary of the trust (who may or may not be the settlor) will receive profits generated from such entrusted property, while losses will be reflected in a diminution in the value of the entrusted property, absent trustee misconduct. So long as the entrusted property is properly segregated from the trustee’s own assets, the foregoing trust arrangement will be remote from the trustee’s bankruptcy.

There are certain other matters to bear in mind. For one, under Japanese law, the trust beneficial interest may constitute a “security,” thereby mandating compliance with Japanese securities regulations. In addition, only licensed qualified trust companies and trust banks will be able to serve as a trustee on a commercial basis.

Another possible vehicle would be an anonymous partnership (TK) under the Commercial Code of Japan, pursuant to which an investor contributes an asset to an entrepreneur for the entrepreneur’s business, in consideration for which the entrepreneur agrees to distribute a portion of any profits generated from the business to the investor.

Business losses, on the other hand, will generally be borne by the investor only to the extent of its contributed asset. Unlike with the trust arrangement situation, the investor’s contributed asset will be subject to the TK entrepreneur’s insolvency proceedings.

The TK entrepreneur will not, however, need to have a trust license, as is the case for trustees, but it might be subject to Japan’s Financial

Instruments and Exchange Act, depending on the activities that it engages in. In addition, a TK interest may constitute a “security” for Japanese securities regulations purposes.

Musharakah

Under Japanese law, it might be possible to organize a Japan Civil Code partnership as a Musharakah. In such a case, each partner will make contributions to the business jointly, and each partner will be able to participate in the partnership’s business activities (unlike in the case of a TK, where the TK entrepreneur has sole control of the business).

Importantly, however, the creditors of the partnership will have recourse beyond each partner’s contribution and will be able to reach each partner’s individual assets. For investors who would like to avoid such potential unlimited liability, an investment limited partnership (LPS) under Japan’s Investment Limited Partnership Act would be an option.

The LPS is a partnership comprised of both general partner(s) and limited partner(s) for the purpose of jointly making investments. In the case of a LPS, limited partners will have the benefit of limited liability, but may not actively participate in the LPS’s business activities – only the LPS’s general partners, who have unlimited liability to the LPS’s creditors, may do so.

In addition, it should be noted that LPSs are not versatile vehicles because the business activities they may engage in are quite limited. Potential activities include the acquisition of shares and certain other types of investments.

Both partnership and LPS interests may be subject to securities regulations. In addition, the scope of permissible businesses will be restricted in the event that an investor is subject to Japanese banking law, which strictly limits the types of businesses that may be engaged in by a bank in Japan as well as the percentage of voting shares that such a bank may hold in another company (the current maximum is 5%). With certain exceptions, such prohibitions will also extend to shares held by banks through partnerships.

Murabahah

If the Murabahah business involves retail consumers, it may be subject to Japan’s consumer protective Installment Sales Act, depending on the goods and services in question as well as the method of payment.

Should this be the case, the financial institution will have to comply with the various requirements of that Act, including the duty to provide its clients with a written and detailed explanation of various aspects of the transaction.

In addition, care should be taken in inviting Japanese banks as co-financiers because, as mentioned above, Japanese banking regulations limit the scope of businesses that banks and their group companies can engage in, and thus, it would be difficult for banks themselves to carry out Murabahah transactions in Japan.

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On the other hand, due to the relaxation of Japan's banking regulations in 2008 enabling bank subsidiaries to conduct certain types of Islamic finance transactions, it is now possible for subsidiaries of banks to conduct Murabahah transactions under certain circumstances.

In addition, generally, only certain entities, such as banks (including licensed branches of foreign banks) and registered lenders under Japan's Money Lending Business Act can engage in the money lending business in Japan. Thus, if the Islamic financial institution in question is not any of them, care must be taken to avoid categorization as a lending transaction in structuring a Murabahah transaction in Japan.

Although not "lending" transactions from a Shariah perspective, it is not clear whether Murabahah and Ijarah (discussed below) maybe subject to money lending regulations in Japan.

Ijarah

Ijarah is a transaction involving the acquisition of goods by an Islamic financial institution, which in turn leases the same to its client in exchange for "rental" payments. Typically, title to the goods remains with the financial institution.

However, in the case of one type of Ijarah transaction (Ijarah wa Iqtina), title transfers to the client at the termination of Ijarah period.

In Japan, while similar lease transactions exist, there currently exists no legislation regulating the leasing business specifically.

It is anticipated that after effectuation of the anticipated legal reform discussed above, the typical Sukuk under Japanese law will be the Sukuk Ijarah, which involves Islamic bonds issued in connection with a sale and leaseback transaction.

Therefore, it is anticipated that the Ijarah will be heavily used in the Japanese market in the near future.

The same degree of care will be required in structuring Ijarah transactions as in the case of the Murabahah transactions in light of Japan's banking and lending regulations, as explained above.

Under current Japanese banking regulations, banks themselves are not permitted to engage in the leasing business, while their subsidiaries are permitted to do so.

However, the anticipated legal reform will relax banking regulations so that banks themselves will also be able to engage in certain finance lease transactions (although not likely, Ijarah wa Iqtina transactions).

The relaxation of the banking regulations with respect to bank subsidiaries in 2008 is applicable not only to Murabahah but to Ijarah transactions as well. Therefore, it should be possible for bank subsidiaries to engage in Ijarah transactions under certain circumstances, in addition to other leasing transactions that are already permissible.

Once the anticipated legal reform has been implemented, Japanese entities will be positioned to issue Sukuk. However, in order to materialize the first generation of transactions, many potential issues will have to be addressed. ⁽³⁾

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