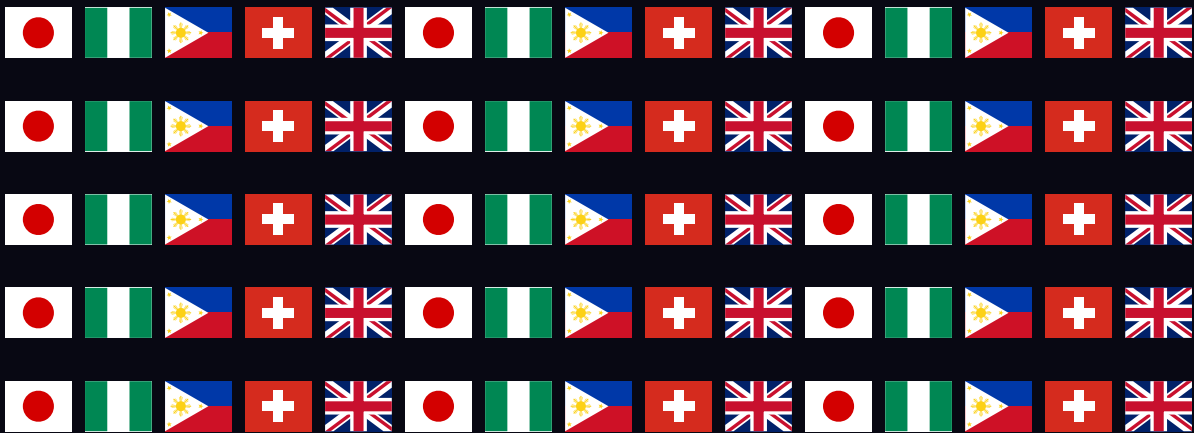


ISLAMIC FINANCE & MARKETS

Japan



Islamic Finance & Markets

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Quick reference guide enabling side-by-side comparison of local insights, including into national policies, market development and legislation; supervision; sanctions, remedies and dispute resolution; contractual concepts (such as mudarabah, murabahah, musharakah, ijarah and wadiah); products and product considerations (such as Islamic securities, legal position of sukuk holders, and takaful – Islamic insurance); regulatory obstacles; Shariah law; takeovers of Islamic financial institutions; and recent trends.

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OVERVIEW

Policies

In general terms, what policy has your jurisdiction adopted towards Islamic finance? Are Islamic finance products regulated differently from conventional instruments? What has been the legislative approach?

Japan's attitude towards Islamic finance is to encourage its establishment in Japan through adjustments of existing laws and regulations that are compatible with the existing fundamental regulatory framework to provide Islamic finance with a level playing field with its conventional equivalents. Islamic finance products are regulated under the same framework that applies to conventional instruments in Japan. Therefore, Islamic finance products are governed by existing legislation applicable to conventional finance products in Japan, while some amendments thereon have been made to accommodate the unique qualities and characteristics of Islamic finance.

Law stated - 01 August 2022

Market development

How well established is Islamic finance in your jurisdiction? Are Islamic windows permitted in your jurisdiction?

Because of the small Muslim population in Japan and the lack of a sufficient customer base for shariah -compliant products in the domestic market, there are currently no Islamic financial institutions (IFI) operating in Japan. Conventional financial institutions and products remain dominant in the Japanese market. However, the establishment of IFIs is not prohibited in Japan. As for Islamic windows, the scope of business that regulated financial institutions (eg, banks and insurance companies) can conduct, and thus the types of Islamic finance transactions they can carry out, is limited to the extent explicitly permitted under the laws and regulations of Japan; yet it is permissible for those institutions to carry out Islamic finance transactions to that extent. A banking regulation guideline makes it clear that Japanese banks themselves (not just through their subsidiaries and affiliates) can offer certain types of shariah -compliant banking products, including lending and deposit-taking equivalents offered in compliance with applicable regulations. Also, certain types of Islamic financial business can be conducted through their subsidiaries (including sister companies). For example, under Japanese banking regulations, conventional banks can own subsidiaries offering certain Islamic finance products that are similar to lending (eg, murabahah and ijarah) based on fatwa rendered by shariah supervisory boards. Conventional insurance companies can also take advantage of this framework under Japanese law. It is understood that several Japanese bank subsidiaries conduct shariah -compliant businesses outside Japan based on this rule. Japanese bank subsidiaries are also active in conducting cross-border Islamic finance transactions and making investments in Islamic finance products that are available in foreign markets.

Law stated - 01 August 2022

Legislation

What is the main legislation relevant to Islamic banking, capital markets and insurance?

Japan has no legislation specifically addressing Islamic finance. Islamic banking, capital markets and insurance are subject to general finance laws and regulations in Japan, as well as the tax treatment that applies to their conventional equivalents. However, several amendments have been made to existing laws and regulations to specifically facilitate Islamic finance transactions in Japan. One example is the regulation and guidelines allowing conventional banks and

insurance companies to conduct Islamic finance businesses on their own and through their subsidiaries. Also, as a consequence of an amendment to the Act on the Securitization of Assets, which is a Japanese securitisation law, the trust framework under such Act can be used for the issuance of sukuk utilising a lease and sale-back scheme (sukuk al-ijarah). At the same time, tax reform was enacted to achieve tax neutrality between Japanese sukuk issued under the revised Act on the Securitization of Assets and conventional bonds. As a consequence of such tax reform, a tax exemption applies to coupon payments to foreign investors and repurchases of real estate as a sukuk asset from the trustee if the relevant sukuk meet certain requirements.

Law stated - 01 August 2022

SUPERVISION

Principal authorities

Which are the principal authorities charged with the oversight of banking, capital markets and insurance products?

The Financial Services Agency of Japan (FSA), led by the Minister for Financial Services, is the principal authority charged with the oversight of banking, capital markets and insurance products in Japan. Also, depending on the regulations and relevant products, other organisations like the Securities and Exchange Surveillance Commission of Japan and stock exchanges in Japan may have certain oversight responsibilities. Concerning the tax system applicable to those financial products, Japan's Ministry of Finance is the responsible authority. As the policymaking perspective of the Ministry of Finance is not always in line with that of the FSA, the relaxing of certain regulatory requirements concerning Islamic finance has not been followed by tax reforms corresponding to such changes.

Law stated - 01 August 2022

Guidance

Identify any notable guidance, policy statements or regulations issued by the regulators or other authorities specifically relevant to Islamic finance.

A banking regulation guideline makes it clear that Japanese banks themselves (not just through their subsidiaries and affiliates) can offer certain types of shariah -compliant banking products including shariah -compliant lending and deposit-taking equivalents offered in compliance with applicable regulations. Apart from this guideline, there is no guidance, policy statement or regulation issued by Japanese regulators or other authorities specifically relevant to Islamic finance. However, before adopting amendments to laws and regulations to accommodate Islamic finance, the Japanese government solicits comments from the public on the bills proposing amendments and makes public its views on those comments. These comments and the views of the Japanese government give some guidance on the laws and regulations addressing Islamic finance.

Law stated - 01 August 2022

Central authority

Is there a central authority responsible for ensuring that transactions or products are shariah-compliant? Are IFIs required to set up shariah supervisory boards? May third parties, related parties or fund sponsors provide supervisory board services or must the board be internal?

There is no central authority responsible for ensuring that transactions or products are shariah -compliant. Islamic

financial institutions (IFIs) are not required to set up shariah supervisory boards internally or externally as a matter of Japanese law in general. However, IFIs established as subsidiaries of banks or insurance companies must have shariah supervisory boards to offer certain Islamic finance products that are similar to lending (among others, murabahah and ijarah). The functions of shariah supervisory boards can be outsourced to third parties, but additional supporting material might be required to rely on the relevant fatwah in certain cases, such as where an IFI relies on a fatwah rendered by a shariah supervisory board set up by other IFIs or borrowers.

Law stated - 01 August 2022

Board approval

Do members of an institution's shariah supervisory board require regulatory approval? Are there any other requirements for supervisory board members?

In general, there is no requirement for regulatory approval or any other requirements for shariah supervisory board members under Japanese law. The only requirements applicable to members of shariah supervisory boards set up by IFIs established as banking or insurance company subsidiaries under Japanese regulations are that they must be knowledgeable about shariah and a board must consist of at least two members.

Law stated - 01 August 2022

Authorisation

What are the requirements for Islamic banks to be authorised to carry out business in your jurisdiction?

There is no regulatory framework specifically applicable to Islamic banks in Japan. However, for an Islamic bank to carry out its business as a bank in Japan, it must be licensed as a qualified bank (or a branch office of a foreign bank) under Japanese banking regulations and, similar to conventional Japanese banks, it will be subject to strict supervision.

Entities not subject to banking or insurance regulations would also be able to offer credit facilities utilising murabahah and ijarah concepts in Japan. They might still be required to register as money lending companies with the authorities under the Money Lending Business Act . They would be prohibited from taking deposits.

Law stated - 01 August 2022

Foreign involvement

May foreign institutions offer Islamic banking and capital markets services in your jurisdiction? Under what conditions?

In many cases, foreign institutions offering Islamic banking and capital markets services in Japan are subject to substantially the same regulatory framework applicable to Japanese domestic institutions. Foreign institutions can conduct banking, money lending or securities brokerage businesses in Japan through their Japanese subsidiaries or branch offices. To conduct each of those businesses, certain requirements must be met for licensing or registration, as applicable. For example, registration of a money lending business requires, among other things, the establishment of a certain internal control system to properly conduct the money lending business and assets whose net value is at least ¥50 million. In the case of a banking licence and a securities brokerage business registration, the applicable requirements are much stricter than those for a money lending business. However, foreign securities brokers conducting business outside Japan under foreign regulations would be exempt from such registration requirements if

the scope of their business in Japan is limited to certain types of business, as specified in the relevant regulations, such as transactions with financial institutions and certain transactions for which a broker does not solicit customers.

Law stated - 01 August 2022

Takaful and retakaful operators

What are the requirements for takaful and retakaful operators to gain admission to do business in your jurisdiction?

Takaful and retakaful operations would fall within the definition of insurance business under Japanese financial regulations and would be subject to licensing requirements under Japanese law. Under the present framework, however, Japanese insurance laws and regulations only contemplate conventional insurance businesses and takaful or retakaful business may not fully fit into this legal framework. Therefore, it would be difficult to conduct such operations in Japan under the present regime.

Law stated - 01 August 2022

Foreign operators

How can foreign takaful operators become admitted? Can foreign takaful or retakaful operators carry out business in your jurisdiction as non-admitted insurers? Is fronting a possibility?

Generally, a foreign insurance company is required to open a branch office in Japan and be licensed by the appropriate Japanese authority to operate an insurance business in Japan. This requirement applies to foreign takaful operators too. However, Japanese insurance laws and regulations only contemplate conventional insurance businesses and a takaful business may not fall under this legal framework. Therefore, it would be difficult for a foreign takaful operator to conduct those operations in Japan under the present regulatory regime. Additionally, there is a possibility that a foreign takaful operator would need to be licensed in Japan even if it only underwrites risks in Japan through fronting insurance companies licensed in Japan. Foreign insurance companies are allowed, by an exemption under the Insurance Business Act of Japan, to provide reinsurance to Japanese insurance companies without obtaining a licence in Japan, but it is uncertain whether a foreign takaful operator's underwriting of risks in Japan through fronting companies licensed in Japan would be deemed to be providing reinsurance to Japanese insurance companies, for the application of this exemption.

Law stated - 01 August 2022

Disclosure and reporting

Are there any specific disclosure or reporting requirements for takaful, sukuk and Islamic funds?

There is no disclosure or reporting requirement specifically applicable to takaful, sukuk or Islamic funds. For each of these products, disclosure requirements applicable to conventional equivalents would apply to them as well.

Law stated - 01 August 2022

Sanctions and remedies

What are the sanctions and remedies available when products have been falsely marketed as shariah-compliant?

If financial products have been falsely marketed as shariah -compliant, investors might be able to seek damages arising from those misstatements, although there is no court precedent confirming the legality of that action. The amount of damages would be calculated based on the economic loss incurred by the investor. Generally, an investor as a plaintiff has the burden of proving his or her right to the damages sought in court proceedings.

If a securities offering is made through a public offering involving statutory disclosure documents, like securities registration statements or registered prospectuses, and those disclosure documents inappropriately describe the products in question as shariah -compliant, and they constitute a material misstatement or omission for Japanese securities regulations, special liabilities would arise under the Financial Instruments and Exchange Act . In those situations, the issuer, its directors, underwriters and certain other parties might be liable to investors who acquired the products at the offering. The issuer would be held strictly liable for the misstatement or omission and the other parties would need to prove that they did not know of the misstatement or omission after exercising due care to avoid this liability. Also, the investor would benefit from a statutory presumption regarding the amount of damages the issuer would be required to pay. The issuer might be subject to criminal proceedings as well as an administrative surcharge.

Law stated - 01 August 2022

Jurisdiction in disputes

Which courts, tribunals or other bodies have jurisdiction to hear Islamic finance disputes?

In Japan, there is only one court system consisting of, among others, the Supreme Court of Japan, high courts and district courts. These courts have jurisdiction to hear Islamic finance disputes as well as conventional finance disputes.

Law stated - 01 August 2022

CONTRACTING CONCEPTS

Accommodation of concepts

Mudarabah – profit sharing partnership separating responsibility for capital investment and management.

A possible structure to implement a mudarabah transaction is a Japanese trust arrangement. In this framework, a settlor entrusts its asset to a trustee who manages it under the trust agreement. The beneficiary of the trust (who may or may not be the settlor) will receive profits generated from the trust asset, while losses will also be borne by the beneficiary (unless there is any mismanagement by the trustee) as the value of the trust asset decreases. As long as the trust asset is properly segregated from the trustee's assets, the trust asset will not be included into the trustee's bankruptcy estate in the case of the trustee's bankruptcy (bankruptcy remoteness). The beneficial interest of a trust may constitute a 'security', which is subject to Japanese securities regulations. Only licensed trust companies and trust banks are qualified to conduct a trust business in Japan.

An anonymous partnership (TK) would be an alternative vehicle to implement a mudarabah transaction. In this arrangement, an investor contributes its asset to an entrepreneur for the entrepreneur's business, and the entrepreneur agrees to distribute a portion of the profits generated from the business to the investor under the TK agreement between them. However, losses will generally be borne by the investor only to the extent of its contributed asset. In a

TK, only the entrepreneur will carry out the business while the investor has only limited control concerning it. Unlike the trust arrangement as stated above, the investor's interest in the assets contributed for a TK arrangement will not be protected in the event of the bankruptcy of the entrepreneur and those assets will constitute part of the entrepreneur's bankruptcy estate. TK entrepreneurs do not require trust licences. However, they might be subject to securities regulations depending on the activities they conduct. Also, a TK interest is deemed to be a security subject to securities regulations.

Law stated - 01 August 2022

Murabahah – cost plus profit agreement.

Murabahah transactions can be generally implemented under Japanese law. However, there is no special tax exemption applicable to murabahah transactions and thus taxes (eg, consumption tax, registration tax and real estate acquisition tax, where applicable) may be charged for each transfer of the relevant assets.

Regarding financial regulations in Japan, those who implement murabahah transactions may need to be registered under the Money Lending Business Act depending on the structure of the relevant transactions. Banks can conduct lending and deposit-taking businesses involving commodity murabahah to the extent the relevant transactions meet certain requirements under the applicable banking regulation guideline. Banks can also carry out lending equivalent activities utilising murabahah through their subsidiaries as a matter of Japanese banking regulations.

Creditors under murabahah transactions may take collateral to secure indebtedness arising therefrom.

Murabahah transactions with retail consumers may be subject to consumer protection regulations under the Instalment Sales Act if they involve certain goods and services as well as a certain method of payment. In that case, an IFI conducting a murabahah transaction must comply with the various requirements of that act, including the duty to provide its customers with a written and detailed explanation of the various aspects of the transaction.

Law stated - 01 August 2022

Musharakah – profit sharing joint venture partnership agreement.

Musharakah can be created through a partnership under the Civil Code . A partnership agreement is entered into among partners, and each will jointly make contributions to the business under the agreement. As opposed to a TK, each of the partners will be able to participate in the partnership's business activities, even though that power might be delegated to one or more managing partners with no specific formality requirement. Profits and losses would be shared among the partners under the provisions of the partnership agreement, which may or may not be proportionate to their contributions. Care should be taken in setting up a Civil Code partnership because each partner's liability to creditors of the partnership will be unlimited, which means that the creditors will have rights of recourse that extend beyond each partner's contribution and to the partner's assets if necessary.

An investment limited partnership (LPS) is an alternative structure that can be used to secure limited liability concerning a transaction. An LPS is a partnership among one or more general partners and limited partners, the purpose of which is to jointly make investments. Certain matters concerning an LPS, like the scope of its business and the names and addresses of its general partners, must be registered with a legal affairs bureau. The scope of business that an LPS can conduct is limited to certain investment activities such as the acquisition of shares and monetary claims and thus this vehicle can be utilised for limited activities. As in the case of a Civil Code partnership, profits and losses would be shared among the partners under the provisions of the partnership agreement, which may or may not be proportionate to their contributions. However, limited partners of an LPS will enjoy limited liability and thus they will not incur losses beyond their contributions. Limited partners may not actively participate in the LPS' business

activities. However, general partners of an LPS, who have unlimited liability concerning the claims of the LPS' creditors, will have full control over the LPS' business.

Both Civil Code partnership interests and LPS interests will be deemed to be securities subject to Japanese securities regulations. Also, financial institutions whose scope of permissible businesses is restricted might be prohibited from joining partnerships conducting businesses that are not permitted under applicable regulations. In addition, ownership of voting shares in companies above a certain threshold by financial institutions (the current threshold is generally 5 per cent for banks) is restricted unless that ownership is permitted under a statutory exemption. Share ownership through partnerships or LPSs could be covered under an exemption if it meets certain requirements.

Law stated - 01 August 2022

Ijarah – lease to own agreement.

Ijarah would constitute leasing transactions in Japan, and, in general, would be valid. At present, no law specifically regulates the leasing industry. However, if, at the end of a leasing period, ownership of the leased asset is transferred to the lessee (ijarah wa iqtina), such a transaction may be subject to the Instalment Sales Act (one of Japan's consumer protection laws), as in the case of murabahah .

Banks may conduct certain types of leasing businesses under Japanese banking regulations, but the terms of those leases are strictly limited. Lease agreements entered into by banks should not contemplate a transfer of the leased assets to the lessee at the end of the lease term, which would prohibit banks from carrying out ijarah wa iqtina transactions. Therefore, ijarah transactions conducted by banks using a lease framework may not be flexible enough to accommodate the various needs of customers. However, bank subsidiaries can carry out ijarah transactions subject to compliance with banking regulations, as in the case of murabahah .

Law stated - 01 August 2022

Wadiah – safekeeping agreement.

Wadiah , if appropriately drafted, might be treated like bank deposits for the Japanese deposit insurance regime, although no such agreements currently exist. However, Japanese banking regulations allow only licensed banks and similar organisations to conduct a deposit-taking business. Therefore, wadiah transactions should generally only be carried out by licensed banks in Japan. Concerning deposited cash, it is generally understood that banks do not owe a fiduciary duty to depositors under Japanese law. Additionally, the possibility of making gifts (hibah) to depositors instead of interest has yet to be tested in Japan. Although it may not be impossible, those gifts may be limited in value to the maximum amount set by Japanese consumer protection law. As long as the gift's payment is at the bank's discretion, it would not be protected by Japanese deposit insurance.

Financial products designed under the concept of sharing risk and profit (ie, products whose principal amount cannot be guaranteed) are not contemplated to be covered by Japanese deposit insurance.

Law stated - 01 August 2022

PRODUCTS

Securities structuring

Sukuk – Islamic securities. Have sukuk or other Islamic securities been structured and issued in your jurisdiction to comply with Islamic principles, such as the prohibition of interest?

We are not aware of any sukuk issuance publicly announced in Japan to date. However, amendments to the Act on the Securitization of Assets and certain tax laws have accommodated the issuance of sukuk al-ijarah (sukuk utilising a lease and sale-back structure) through the Japanese trust structure, which allows for profit distributions rather than interest payments. Japanese issuers and foreign issuers issuing sukuk in the Japanese market are expected to use this framework.

Law stated - 01 August 2022

Legal position

What is the legal position of sukuk holders in an insolvency or a restructuring? Are sukuk instruments viewed as equity or debt instruments? Have there been any court decisions or legislation declaring whether sukuk holders are deemed to own the underlying assets?

There is no court decision, legislation or official Japanese securitisation law guideline in Japan concerning or clarifying the legal position of holders of sukuk issued under the Act on the Securitization of Assets (J- sukuk) in the event of the insolvency or restructuring of the issuer. It is anticipated that many J- sukuk issuance schemes will be structured with the expectation that J- sukuk will be treated in the same manner as conventional bonds in the case of the issuer's insolvency.

Generally, trust certificates tend to be seen as equity instruments in Japan. However, for Japanese taxation, J- sukuk (although they are trust certificates) that are designed to meet certain requirements to be economically similar to conventional bonds would be treated as if they were debt instruments. In this way, tax neutrality with conventional bonds would be achieved.

In Japan, it is understood that title to trust assets is held by the trustee as opposed to the beneficiaries (ie, investors), yet beneficiaries can benefit from the trust assets under the trust agreement even in the case of trustee's bankruptcy (in other words, creditors of the trustee will have no recourse to the trust assets). As J- sukuk are based on Japanese trust principles, they should be treated in the same manner as explained above.

Law stated - 01 August 2022

Insurance

Takaful – Islamic insurance. Are there any conventional cooperative or mutual insurance vehicles that are, or could be adapted to be, shariah-compliant?

Under the present legal framework, Japanese insurance laws and regulations only contemplate conventional insurance businesses, and a takaful business may not fall under this legal framework. It would thus be difficult to find an insurance vehicle suitable to undertake a takaful business under Japanese law because of Japanese insurance regulations.

Law stated - 01 August 2022

Which lines of insurance are currently covered in the takaful market? Is takaful typically ceded to conventional reinsurers or is retakaful common in practice?

Currently, there is no takaful market within the Japanese insurance market. Conventional insurance is dominant in Japan.

MISCELLANEOUS**Regulatory obstacles**

What are the principal regulatory obstacles facing the Islamic finance industry in your jurisdiction?

Generally, businesses involving the purchase, sale or lease of certain goods or products (eg, medical equipment and real estate) would be subject to registration and licensing requirements under sector-specific regulations. Those regulations would also apply when an Islamic financial institution (IFI) conducts murabahah or ijarah transactions. To facilitate the entry of Islamic finance into Japan, those financing transactions should be exempted from the registration and licensing requirements.

Also, some people argue that new accounting standards need to be adopted in Japan, as Japan's current accounting standards are not entirely appropriate for shariah-compliant transactions.

Law stated - 01 August 2022

Shariah law

In what circumstances may shariah law become the governing law for a contract or a dispute? Have there been any recent notable cases on jurisdictional issues, the applicability of shariah or the conflict of shariah and local law relevant to the finance sector?

There is currently no judgment by a Japanese court addressing whether shariah law would be the appropriate governing law for a contract made in Japan or a dispute arising in Japan. However, in light of Japanese civil procedure, it is unlikely that general shariah principles (which are not the law of any specific country) would be recognised as the governing law for a contract or a dispute under Japanese conflict-of-laws rules, even if the parties to the relevant contract so designate.

Law stated - 01 August 2022

Institutional takeover

Are there any special considerations for the takeover of an Islamic financial institution, outside the requirements of the general merger control regime?

Although there is no precedent in this regard, there would not be any special considerations for the takeover of an Islamic financial institution outside the requirements of the general merger control regime as a matter of Japanese law.

Law stated - 01 August 2022

Other notable features

Are there any notable features of the Islamic finance regime and markets for Islamic finance products in your jurisdiction not covered above?

Recently, Japanese financial institutions have become increasingly active in the global Islamic finance market. It is reported that several Japanese financial institutions have successfully arranged Islamic credit facilities and other types of shariah-compliant products in the markets, particularly in Asia and the Middle East. It is very much expected that

they will accumulate experience in offering shariah -compliant products and, with such accumulated experience, will be able to better assist foreign and Japanese market players interested in Islamic finance soon.

Law stated - 01 August 2022

UPDATES AND TRENDS

Key developments of the past year

Are there any proposals for new legislation or regulation, or to revise existing legislation or regulation? If so, please give a reference to any written material, whether official or press reports. Are there any other current developments or trends that should be noted?

An amendment to Japan's tax laws which seeks to establish equal tax treatment of sukuk issued under the Act on the Securitization of Assets (J- sukuk) with conventional bonds has been implemented temporarily. Among other things, tax exemption on coupon payments to foreign investors and repurchase of real estate as a sukuk asset from the trustee was established, and that exemption was to expire at the end of March 2022. However, in light of the expectation that J- sukuk would be issued soon, this period was extended to the end of March 2024.

Law stated - 01 August 2022

Jurisdictions

	Japan	Nagashima Ohno & Tsunematsu
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