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Islamic bonds unbound: Japan's samurai sukūk

Japan is an evolving case showing how a form of financial praxis originally based in the identity and ethical concerns of Islam has acquired new appeal and is thereby expanding into regions of the global economy that is lacking large Muslim populations. This article surveys the initiation and the proffered justifications of Japan's issue of Islamic bonds (sukūk). It examines Japanese or J-sukūk, and the tax and legal regulatory reforms underlying their issuance, to explore the significance of the current state and future trajectory of Islamic finance in Asia.

Scott Morrison

A turn at the turn of the century

When tracing the evolution of the ideology and institutional expansion of Islamic banking in the twentieth century and its emergence in key countries across South Asia (Pakistan), Southeast Asia (Malaysia) and the Middle East (Egypt, Iran, and the wealthiest of the Gulf Cooperation Council states), religious identity and faith commitments appear as primary motivations for what has become known as 'shariah-compliant' banking and finance.

Without diminishing the religious and principled attraction of Islamic banking and finance to Muslims (and those of other or no faith tradition who are concerned with the moral implications of their financial and investment activities), in the current century the global spread of the industry reveals how it has become decoupled from considerations of identity and faith – as countries with little or no Muslim population seek to promote and encourage the growth of this financial sector.

Instances of economic motives – either alongside, or in the absence of traditionally religious motivations – include actions and policies undertaken by agents in both the public and private sectors in those countries featuring the largest economies of North America, Europe, and Asia. In the U.S., Islamic finance has been driven by private banks, with some measure of tax and policy reform permitting them to do business in relative parity with their conventional counterparts. In Britain, a greater degree of governmental promotion (of London in particular) hosting shariah-compliant finance is evident. Similarly, Islamic banks and banks with Islamic windows have been encouraged by state bodies in both Singapore and Hong Kong with a view to fostering regional capitals of Islamic finance.

Margins and centers in Asia

The country with the largest Muslim population in the world is Indonesia. However, banking catering to Muslims is of greatest scale in Malaysia, with its 40% non-Muslim minority. Within Southeast Asia, Malaysia has been an historic leader in both the size of deposits and investments, as well as the regulation of its own range of Islamic financial products, regulations, and norms of corporate governance. Within South Asia, Pakistan has been the historical leader.

Entering the competition for international investment, and in particular for investors from the oil-rich states of the Arabian Gulf (in an era of consistently high oil prices), the recent and increasing interest of countries with very small minorities of Muslims in East Asia most dramatically illustrates the effect of motivations that are of a more purely economic –rather than a religious –valence. Two relative latecomers in this Asian sub-region are South Korea and Japan. In keeping with the religious demographics of these two countries, the appearance of shariah-compliant finance in these jurisdictions does not include retail banking; it emphasizes cross-border investments and capital flows, and organized (to varying degrees) efforts to capture these by means of regulatory accommodations and reformed tax treatment.

Contemporary Islamic bonds (sukūk) – entering a novel jurisdiction

The Arabic term usually translated as 'Islamic bonds' is the plural (sukūk) of the word *sak,* which means check, legal instrument or deed. Just like bonds that do not adhere to shariah principles ('conventional bonds' for the purpose of this article), sukūk are securities. They represent shares "in the ownership of tangible assets, usufruct and services or...assets of particular projects or special investment activity."[1] Unlike conventional bonds, sukūk do not guarantee a fixed return; in observance of the prohibition of interest and speculation in Islamic law, sukūk operate on a profit and loss basis, and are asset-backed. Proponents maintain that sukūk and Islamic finance are less prone to volatility and market failure, and that the industry better weathered the latest global economic crisis.

The fact that the terminology and, until recent years, the reality of sukūk reflected an Arabo-Islamic origin does not diminish the local or national flavor of contemporary instances and issues of Islamic bonds occurring outside of this religious-cultural milieu. In Japan, sukūk have been effectively rendered a national project with a distinctively Japanese tincture. The effort to couple sukūk with Japanese culture and history is most apparent in the samurai sukūk; an appellation that excavates and reconstitutes the feudal Japanese warrior. Samurai sukūk speak to a national interest in prosperity and bringing investment and capital from abroad into Japan, in a metaphorical battle for prosperity and economic competitiveness .

The legal and regulatory treatment of J-sukūk

Examining governmental publications, policies and legislation concerning J-sukūk, permits an investigation of the packaging or branding of J-sukūk, and the substantive governmental position concerning shariah-compliant instruments, contracts, and transactions. The picture that emerges of Islamic finance in Japan is that of a preliminary and experimental national project. Sunset provisions in relevant tax legislation reflect the tentative and staged nature of the Japanese regulatory authorities' novel venture into Islamic finance. At the same time authorities hold out the possibility of renewing legislation upon its expiry; the scope of legislative amendment bespeak the intensity and seriousness of purpose in exploring Islamic finance as a source of transnational capital and investment. Rhetoric about the religious origins or background, or any other such concerns that might be found in some western jurisdictions, are decidedly absent.

In December 2008, the Financial Services Agency of Japan authorized the subsidiaries of Japanese banks to engage in shariah-compliant finance transactions; Japanese banks such as the Bank of Tokyo-Mitsubishi UFJ (Malaysia) transacted shariah-compliant deals, as did Nomura and Sumitomo. In 2011, further measures for the treatment and promotion of Islamic finance were implemented; in April 2012 the Japan Securities Depository Center announced that it could act for the issuance of J-sukūk.

Under the amended Asset Securitization Act (number 105 of 1998), in Japan sukūk are treated as quasi-bonds within the existing beneficial interest and rights structure; they are issued by a special purpose trust. While sukūk are not deemed a bond, they are treated as such for tax purposes by reforms that came into force in 2011.[3] Following enactment of the Act on the Partial Amendment of the Financial Instruments and Exchange Acts to Enhance the Infrastructure of Capital Markets and Financial Sector (2011 Act Number 49), along with a variety of related tax laws, the Japanese legal and regulatory environments were fully readied for the issue of J-sukūk.

The Japan Securities Depository Center (JSDC) states that "Sukūk refers to securities with bond-like characteristics that are issued in a format that complies with 'Sharia' Islamic law. As Islam generally prohibits receiving and paying interests [sic], investments that correspond to investments in corporate bonds in substance adopt such schemes as capital contributions and lease transactions in order to receive and pay proceeds from assets and businesses in the form of dividends, thereby enabling Islamic investors to invest in securities, similar to bonds."[4] The JSDC and the tax regime seeks to treat sukūk as a bond, while recognizing the distinction between sukūk and fixed income bonds. The JSDC defines samurai-bonds as "a yen-denominated debt security issued in Japan by a foreign government or foreign company" for the purpose of allowing those foreign governments and companies "in the Islamic world" to use J-sukūk as financing measures in Japan.[5] The chief benefits that the JSDC highlight are "favorable attention to the issuers in the Islamic world [...] Thus, the issuers are expected to gain favorable positions in marketing in the Islamic world"[6] as well as the diversification of investment portfolios.

The tax regime applicable to the dividends of J-sukūk grants an exemption to foreign parties; it also exempts financial institutions in Japan from tax withholding at source. In order to make J-sukūk competitive, the tax authorities have also granted exemptions for transfer taxes on trust assets, real estate acquisitions, and licensing and registration and property transfer taxes. Notably, individuals as distinct from institutions, resident in Japan, are required to pay tax (20%) on J-sukūk dividends.[7]

Shariah-compliance and Japan

Originally devised as a means for Muslim consumers and investors to conform their financial affairs to their religious beliefs, shariah-compliant banking and finance have in recent years grown to appeal to new populations and world regions. Given the very small numbers of Muslims in East Asia, and the distance from South and Southeast Asian countries possessing larger Muslim minorities (or majorities), the expansion of such investment instruments may be most striking in countries such as Japan and South Korea.

This article has surveyed the process through which a particular shariah-compliant instrument, sukūk, has entered a new jurisdiction: Japan. In the twenty-first century the motivations of attracting capital and investment, particularly but not exclusively from the oil rich states of the Arabian Gulf and Muslim investors, have supplemented the global demand for shariah-compliant finance. It may be queried whether the interest rather than the identity-based motivations powering the expansion of sukūk into Japan and other novel jurisdictions may actually be a more effective force for the expansion not only of shariah-compliant banking and finance, but also for the ethical ideals to which Islamic banking and finance refers and aspires. Whether the adoption of the vocabulary of Islamic law and fiscal morality implies anything more than an instrumental acceptance of the belief system from which that vocabulary emanates, is an open question.

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Notes

1 Accounting and Auditing Organization for Islamic Finance Institutes (AAOIFI), Sukūk standards published January 2005 (section 2), as referenced in Michael JT McMillen (2006) 'Islamic Capital Market: Development and Issues', *Capital Markets Law Journal,* 1(2):136-172 at page 164 (http://tinyurl.com/ml6dqk4)
2 See page 2 of *Financial Services Tax News.* Taxation of J-Sukuk Q&A (May 2012) (http://tinyurl.com/llmf32s)
3 JASDEC Newsletter, Volume 14, Winter 2011 (http://tinyurl.com/my8mtff)
4 ibid
5 ibid
6 Financial Services Agency, The Japanese Government, 'Publication of "Taxation of J-Sukuk Q&A"' (http://tinyurl.com/kerzgju)
7 Financial Services Agency (April 2012) *Taxation of J-Sukuk Q&A* (http://tinyurl.com/m2zbodm)