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The Introduction of Islamic Finance in Japan: Possibilities and Issues

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Islamic finance, which has had high annual growth rates in the 15–20% range for the past few years, is now being used in an extended area of the world that includes not only Islamic countries but also non-Islamic countries, and involves both Muslims (followers of Islam) and non-Muslims. The major regions involved are the Middle Eastern countries and few other Asian countries such as Malaysia, Indonesia and Singapore. Recently, however, Middle Eastern investors have started looking toward China, and Hong Kong has announced plans to introduce Islamic finance to its market. Given these circumstances, how should Japan respond, as home to Asia's largest financial market? This article examines the possibilities and issues in Japan regarding the introduction of Islamic finance.

1. Cases of Japanese Enterprises Using Islamic Finance

Before examining the introduction of Islamic finance to Japan, it would be well to examine cases of the use of Islamic finance by Japanese enterprises.

Some Japanese enterprises have used Islamic finance in other countries. Aeon Credit Service (M), which is the Malaysian affiliate of Aeon Credit, this year, became the first Japanese or Japanese-affiliated enterprise in Malaysia to issue a Sukuk (an Islamic bond). Aeon Credit in Malaysia carries consumer loans, and the use of its funds is Shariah compliant. The Japan Bank for International Cooperation has also been planning since last year to issue Sukuk.

Also in Malaysia, some Japanese manufacturers and their affiliates located there have used Islamic finance to borrow operating funds or other working capital. Local banks in

Malaysia have been actively developing ways to provide Islamic finance, and because of the competitive conditions, they have been making relatively inexpensive funds available for this. Thus cost advantages, if any, in Islamic finance over regular finance would definitely lower the hurdle that Japanese enterprises face.

Also, there are a growing number of projects in Middle Eastern countries in which Japanese enterprises are involved. When Japanese manufacturers or trading houses win the contracts for such projects, there is conspicuous participation by Japanese banks in financing them. According to figures compiled by Project Finance International, an English-language financial journal, the project finance market in 2006 had grown 27% year on year to reach $209.3 billion, its highest level ever. By region, the largest shares were in Europe, the Middle East, and Africa, regions where project finance has shown particularly rapid growth since 2005. Mizuho Financial Group was ranked third in the volume of project finance deals that originated in 2006, Mitsubishi UFJ Financial Group was tenth, and Sumitomo Mitsui Financial Group was fifteenth.

For project finance in the Middle Eastern countries, the use of Islamic finance is increasing, in response to their requests. Under the current circumstances, the lead bank usually offers both regular and Islamic financing alternatives under the same conditions so that the lending side can simply choose one or the other, and recently the demand for Japanese banks to choose the Islamic finance alternative has been growing. For the Rabigh Petrochemical Project deal, organized by the Sumitomo Mitsui Banking Corporation in Saudi Arabia in March 2007, $600 million of the $5.8 billion raised was procured from Islamic financial institutions.

Syndicated loans, which are showing the same rapid expansion as project finance, are also open to participation by all financial institutions. In Islamic syndicated loans (such as loans based on a Mudarabah pattern), major advantages for the participants are that they do not need to negotiate directly with the borrower, and that no management work or costs are generated even during the period of the contract.

In those projects funded in Middle Eastern countries, more use of Islamic finance is expected, and Japanese banks will be requested to provide more funds using Islamic financing forms.

In the Islamic insurance (Takaful) market, The Millea Group, of which Tokio Marine & Nichido Fire Insurance is a subsidiary, has been doing outstanding business. They originally initiated a Takaful business in Saudi Arabia in 2001, providing fire and casualty insurance mainly for petrochemical plants, power stations, and other such major projects by Japanese enterprises. This was followed by the establishment of a Takaful operation joint venture with a local bank in April 2005. Before that, in 2004, The Millea Group had launched a re-Takaful company in Singapore. In Asia they actively developed Takaful operation network, including one in Indonesia in 2006, and another in Malaysia in the form of a joint venture with Hong Leong Bank, a medium-sized Malaysian bank, after the Malaysian government approved the participation of foreign capital in Takaful operations. Currently they are planning to establish a presence in the Uighur districts of China, where many Muslims reside.

Investment by Islamic funds in Japan has already begun, as well. The Arcapita Bank, an Islamic investment bank in Bahrain, joined with CapitaLand, a developer in Singapore, to set up a real estate fund ($300 million) for investment in rental apartments in Japan in May 2005. This fund has acquired properties in Tokyo, Osaka, and Fukuoka. Nomura Asset Management and DLIBJ Asset Management Co., Ltd., are operating Japanese equity funds that are Shariah compliant.

In these ways, connections between Islamic finance and Japanese enterprises, as well as investment in Japan by Islamic funds, are gradually emerging.

2. An Overall Perspective on Islamic Finance in Japan

I would like to introduce the main perspective of how to establish ties with Islamic finance in Japan and in Japanese enterprises, as well as what preparations will be needed for this.

The Muslim population in Japan is so small that it is unlikely that Islamic finance will be very common within Japan. Consequently, Japanese banks will hesitate to offer any Islamic financial services in Japan.

As seen, however, there have been some cases, such as Japanese enterprises outside Japan using Islamic finance, Japanese banks choosing Islamic financing method as a lending side in project finance in the Middle East, investment in Japan by Islamic funds, and investment in Islamic finance by Japanese investors. All these activities will increase, together with the expansion globally of Islamic finance. In order to achieve this, an institutional policy framework must be prepared. The most important perspective for that is Japan's position in Asia and Japan as a link between Asia and the Middle East. The Tokyo market is the largest financial market in Asia. The economies of Japan and the Middle Eastern countries are closely tied together, as we are dependent on the Middle Eastern countries for our energy supply, while at the same time, Japanese enterprises accept large numbers of orders and contracts for projects in those countries. Given this, Japan is expected to expand Islamic financial operations in the same way with Singapore, which has been a leader in this regard. The Middle Eastern countries themselves have great expectations for Japan, more specifically, for its investment and nurturing of a Sukuk market.

Although it is difficult to predict to what extent the Islamic finance market will grow, there are signs that Islamic finance is spreading beyond Malaysia and the Gulf Cooperation Council states, which are presently the centers of Islamic finance, to Indonesia, Pakistan, India, and Turkey. The expansion of cross-border operations by Islamic banks will no doubt provide a boost to the regional expansion of Islamic finance. The regional expansion of Islamic finance suggests that we need to expand our perspectives from the Islamic finance in Japan to Islamic finance in Asia.

3. Conceivable Scenarios for the Expansion of Islamic Finance

What scenarios are conceivable for the expansion of Islamic finance in Japan? I would like to further examine the feasibility of the four cases mentioned in the previous chapter.

First, in utilization of Islamic finance by Japanese enterprises overseas, the Islamic funding method will most likely be used more often if Japanese enterprises find it advantageous in terms of cost. As to the issuance of Sukuk, we have looked at the case involving Aeon Credit in Malaysia. But Japanese companies, including finance companies operated by Japanese trading firms, are expanding their consumer loan operations in Indonesia and Singapore, and they are showing more interest in Islamic finance, such as the issuance of Sukuk, as one means of finance for those loans. In Singapore, where an Islamic financial system has been set up, many financial holding companies for Japanese enterprises have been established and they will show more interest in Islamic finance as one means of raising funds.

Second are the cases of Japanese banks that are participating in project finance in the Middle Eastern countries, and funding by Middle Eastern countries using an Islamic finance alternative is on an increasing trend. As there are many cases of Japanese enterprises accepting orders for such projects, Japanese banks, either as the lead bank or a participant, will be required to invest more using Islamic finance. There is no immediate problem for these banks vis-a-vis engaging in Islamic finance, since the original capital does not have to be Islamic fund. However, note that Japanese banks will be required to provide separate risk management and operation management from regular financing.

Third is Islamic fund investment in Japan. Fund investment, such as real estate investment funds or Shariah-compliant equity funds, which were previously mentioned, will be the most probable form of investment. This can be possible only through an active inflow of Islamic capital, provided by fund formation. Currently, however, we are relying on financial institutions overseas, such as in Singapore, for fund formation, and the capital increase in Japan will be very limited under these circumstances. If Japanese financial institutions are to set up funds to bring in Islamic capital, whether they have Muslim investors in their customer base or not will be the key. This is going to be an upcoming issue for Japanese financial institutions and I assume it will take some time to build up confidence among Muslim investors and to expand their customer bases.

More rapid growth will be seen in Islamic finance investment by Japanese investors, and that will be the fourth case. Al Rayan Investment, which was the first Islamic bank to have its establishment approved by the Qatar Financial Center, included Japanese investors in its primary client base at the time of its founding. Activities targeting Japanese investors to acquire capital for Islamic financial investment are expected to increase rapidly.

It is also conceivable that Middle Eastern financial institutions might tie up with Japanese financial institutions (such as investment trust companies) in order to acquire a client base of Japanese investors. The greatest bottleneck for Japanese financial institutions in dealings with Islamic finance is the judgment of Shariah compliance. But I believe that they will overcome this obstacle through schemes whereby Japanese financial institutions earn fees by introducing customers and leave compliance to the Middle Eastern financial institutions, It is possible, too, that they may establish new firms geared toward that scheme in countries with tax advantages, such as Malaysia.

To carry the conjecture still further, Middle Eastern investors and Japanese financial institutions will possibly establish new financial institutions that specialize in the Islamic finance business in Japan in the form of the joint ventures. If that happens, it would be similar to the case of the Islamic Bank of Asia, which as the first Islamic bank in Singapore, was established in May 2007 by the Development Bank of Singapore in a joint venture with investors from the Gulf Cooperation Council states. To bring this about in Japan, however, institutional frameworks for legal and taxation systems regarding Islamic finance transaction will have to be established, as was the case in Singapore.

4. The Necessity for Institutional Development Related to Islamic Finance in Japan

The first Islamic finance seminar was held in Tokyo in January 2007. It was sponsored by the Islamic Financial Services Board (IFSB), the Japan Bank for International Cooperation, and the Japan Institute for Overseas Investment, with support from the Ministry of Finance, the Financial Services Agency, and the Bank of Japan.

The topic of Islamic finance was taken up in reports by the Council for the Asian Gateway Initiative and by the Working Group on Financial and Capital Markets. Those are working councils in the Expert Committee on Reforms Addressing Globalization, a committee instituted under the Council on Economic and Fiscal Policy of the Japanese Cabinet Office.

Thus, Islamic finance is gradually being featured in Japan, but the movement is still at the study stage, and no specific steps toward institutional development have yet been taken. Research of Islamic finance by the authorities is being handled by sections concerned with Asian affairs, and one could say that Islamic finance is still being treated in the context of ties with Asia.

Even though the expansion of Islamic finance in the Japanese domestic market seemingly has low potential, demand for institutional development related to Islamic finance will grow in the context of international activities by Japanese enterprises, as well as movements of investment capital. In the legal and tax systems, similar reforms to those that were adopted in Singapore and the United Kingdom will probably be necessary. For instance, Japan's banking laws, like those in Singapore, do not allow banks to engage in the sale of goods, and legal reform would be necessary to make allowances in the case of Islamic finance. Measures for a fair tax system, to equalize the handling of ordinary finance and Islamic finance, will also be required, such as the elimination of double taxation in the form of consumption and stamp taxes and tax system reform regarding the treatment of distributed returns as interest income where that is the case. Just as with the difficulties experienced in the case of commitment fees, adjustment and consideration of how to interpret properly situate profits made under Islamic finance with respect to Interest Limitation Law and the Investment Law will be necessary.

The question also arises of how to implement financial supervision when the overseas branches of Japanese financial institutions engage in Islamic financial transactions in Middle Eastern countries. Since Islamic finance can incur risks that are different from those in ordinary finance, the question of the types of examination that should be carried out as part of financial supervision will also be open to debate. In Japan, installment sales in the Murabahah format and leases in the Ijarah format come under the jurisdiction not of the Financial Services Agency, but of the Ministry of Economy, Trade and Industry. This means that supervision of Islamic finance is split up among multiple supervisory agencies, and unifying measures that cut across those government offices will likely be necessary.

As Islamic finance appears unlikely to expand within Japan, common steps toward the institutional development --- that is, steps taken by the authorities in response to unified requests from financial institutions and other private-sector organizations ---- would not happen. Instead, it is probable that individual cases will arise first, and the authorities will be required to deal with them on the fly.

If Japanese investors were to buy a Sukuk, for instance, the applicable tax rate would differ depending on how their profits are defined. Early definition by the authorities in such a case would be necessary. If that is not done, taxation will not be transparent, and this would result in an obstruction to investment using Islamic finance.

I think Japan needs to hasten institutional development by the government regarding Islamic finance in order to elevate the status of the Tokyo market as an international financial market. For non-Muslims, it is very hard to predict future development of Islamic finance. But the fact is that Islamic finance is expanding very rapidly. System preparation, as a caliber for further expansion, is necessary even apart from the question of whether such systems will ultimately be required.

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