Developing an Islamic Finance Hub in Europe: Luxembourg

By Bishr Shiblaq

Luxembourg is a small Central European country which has been recognized as one of the leading financial centers, with a leading position in investment management, wealth management, insurance and reinsurance, as well as capital markets and structured finance. It has in fact become the second-largest investment fund center in the world after the US, the premier captive reinsurance market in the European Union (EU) and the premier private banking center in the Euro zone.

This strong position is based on a stable regulatory environment, flexible and innovative legal frameworks and a favorable tax treatment for cross-border transactions. Although Luxembourg is not located in the Middle East or Asia, Islamic finance in Luxembourg has seen remarkable growth in the key strengths of the Luxembourg financial market. A growing market

Luxembourg was in fact witness to the first steps of Islamic finance. The Islamic Banking System (which later changed its name to Islamic Finance House Universal Holdings) was established in 1978 in Luxembourg, the first Islamic financial institution in a non-Muslim country. Building on the strengths of Luxembourg in private wealth management, the Islamic banking system was established with the purpose of serving high net worth individuals in a Shariah compliant way.

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In 1983, Luxembourg was also chosen for the first Sharia compliant insurance company in Europe. Other innovators in Islamic finance followed, with the incorporation of Faisal Finance (Luxembourg) and Faisal Holdings (Luxembourg) in 1990.

Over time, an increasing number of the companies that are registered in Luxembourg, currently more than 125,000, became involved in Shariah compliant transactions around the world.

In 2005, the Central Bank of Luxembourg recognized the growing importance of Islamic finance and hosted the first Islamic Financial Services Forum with the Islamic Financial Services Board. In April 2008, the Luxembourg government set up a working group, bringing together interested parties in Islamic finance, in order to identify potential obstacles hindering the development of Islamic finance and to propose improvements to further develop Islamic finance in Luxembourg.

More recently the government expressed support for the application by the Luxembourg Central Bank to become the first “non regional” associate member of the Islamic Financial Services Board.

The Luxembourg authorities are showing a proactive approach to accommodate the interests of the Islamic finance industry. The growing awareness has also led to the establishment of specialized teams in many financial institutions, law firms and audit companies.

In addition Alfi, the representative body for the Luxembourg investment fund industry, has set up a working group with the task of analyzing the regulatory framework and proposing improvements to facilitate the setting up of Shariah compliant funds.

Sukuk

To many Islamic finance professionals Luxembourg is already known as a listing location for Sukuk, as it is one of the preferred jurisdictions for the listing of international bonds. The Luxembourg Stock Exchange has indeed played a leading role as the first European stock exchange to enter the Sukuk market.

Many sovereign Sukuk are listed in Luxembourg. Based on unofficial numbers, Sukuk with a combined value of US$8.8 billion are currently listed and traded on the Luxembourg Stock Exchange. The inaugural US$1.5 billion Sukuk of Malaysian oil firm Petronas, issued in August this year, was triple-listed on the Euro MTF market of the Luxembourg Stock Exchange, Labuan International Financial Exchange and Bursa Malaysia.

One of the legal frameworks in Luxembourg allows for innovative Sukuk structures. The Luxembourg securitization law of 2004 creates a legal framework for securitization transactions and is said to be the most complete, comprehensive and advantageous legal framework in Europe today. It is also the first securitization law in Europe which was specifically designed for cross-border transactions. The main goals were to:

- Allow for a high degree of flexibility when structuring a securitization transaction through Luxembourg.
- Ensure a high level of investor protection and legal certainty.
- Ensure a tax-neutral treatment of securitizations in Luxembourg.

The securitization law covers basically all types of securitization transactions in the broadest meaning of the term, ranging from term transactions and commercial paper conduits to simple repackaging, regardless of the type of asset classes. This gives the concept of securitization a very flexible scope so as to cover both traditional securitization structures as well as the most innovative ones.

The practical applicability of the securitization law in a Sukuk issuance can be demonstrated by a recent example. In early 2009, Deutsche Bank established the Al Mi’yar issuance platform, taking advantage of the various benefits offered by the Luxembourg legal framework.

It is considered to be a Shariah compliant multi-party Medium Term Notes (MTN) program, allowing for multiple market participants to be originators.  

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The Al Mi’yar transaction illustrates how the features of the Luxembourg securitization law can be used for an innovative Shariah compliant transaction. The issuance of Sukuk has been embedded into a fiduciary framework in order to maximize investor protection. This transaction is considered to be a new standard in Sukuk issuance, as issuance platforms are usually closely controlled by the deal-originating banks.

The popularity of Sukuk also brought about the establishment of a local Sukuk broker-dealer. One of the advantages for the listing of Sukuk in Luxembourg is that it is the domicile of the leading international clearing and settlement house Clearstream, which has accepted international Sukuk issues.

Holding companies and venture capital vehicles
Due to their high flexibility and the ability to structure global investments in a highly tax-efficient manner using Shariah compliant financing instruments, participation companies (société de participations financières, Soparfi) have been used for a long time in many Shariah compliant transactions. A Soparfi is an unregulated vehicle that may adopt any company form available under the Luxembourg law on commercial companies.

“A Sicar can be incorporated in the corporate or partnership form and can also be set up with different compartments, allowing for an umbrella structure of the vehicle. It also benefits from a very attractive tax regime, depending on the legal form under which the Sicar has been created.

Although none of the 221 Sicars has been officially declared Shariah compliant, in practice this vehicle has been very much of interest to the financial industry and is well-suited for unleveraged investments in risk-bearing assets, in accordance with Shariah principles encouraging risk sharing and prohibiting the taking of interest.

Investment funds
The Luxembourg investment fund industry in general has grown rapidly over the years and despite the financial crisis, the number of investment funds has been constantly increasing from 3,284 funds in August 2008 to 3,435 funds, as of the 30th June 2009. Luxembourg investment funds currently have €1.631 trillion (US$2,335.69 trillion) of assets under management. This is also applicable to the growth of Islamic funds in Luxembourg.

Luxembourg has established itself as an international hub for Islamic funds and is, according to the recently published Islamic Funds Report by Ernst & Young, among the four leading jurisdictions, and the leading non-Islamic jurisdiction, for the setting up of Islamic funds. About 72% of the Islamic funds in Luxembourg have been set up as an undertaking for collective investment in transferable securities (UCITS). This is a subcategory of funds that fulfill the relevant EU regulations and may be offered to investors throughout the EU on the basis of a single authorization from one member state.

The use of Soparfs (as well as other investment vehicles) in Shariah compliant transactions has been limited to assets located in pan-European countries, but has also included real estate acquisitions in North America, the UK, Russia, Central Asia, Turkey and the MENA region.

Another holding regime is the family estate planning company (société de gestion de patrimoine familial, SPF). The SPF is a recently introduced instrument which replaced the 1929 holding company. It is not limited to family wealth and has as a tax-efficient vehicle designed for wealth management — ideal attributes for the Shariah compliant wealth management of European-based investments.

Other Luxembourg investment vehicles are also being discovered by the Islamic finance industry. One interesting vehicle is the investment company in risk capital (société d’investissement en capital à risque, Sicar), which is an investment vehicle with the principal purpose of investing in risk-bearing assets issued by domestic and foreign enterprises.

Some of the highest-performing Shariah compliant investment funds with a global mandate are domiciled as UCITS funds in Luxembourg, such as the BNP Paribas Islamic Fund, the HSBC Amanah Global Equity Index Funds and the UBS (Lux) Islamic Fund.

Most funds that have been approved so far by the Luxembourg Financial Services Authority (Commission de Surveillance du Secteur Financier, CSSF) under UCITS regulations have been mainly Shariah compliant equity funds. Luxembourg introduced the specialized investment fund (SIF) in 2007, creating a new type of investment vehicle which benefits from great flexibility in terms of organization and eligible assets and investments, and which may be offered to a wider range of eligible investors.

In addition to the “traditional” institutional investor, SIFs can be offered to “professional” investors within the meaning of Directive 2004/39/EC, as well as other well-informed investors. A SIF may also start its activities even before it is approved by the CSSF, provided that within a month of its launch, an application for approval is filed.

Examples of Islamic SIFs are the Shariah compliant umbrella fund set up by the Bank of London and the Middle East (BLME Umbrella Fund SICAV-SIF) and the Credit Suisse Virtuoso SICAV-SIF Prime Islamic Fund I, managed by European Finance House (EFH), a subsidiary of Qatar Islamic Bank, for Credit Suisse.

The possibilities offered by the SIF regime and the flexibility of its legal framework make this vehicle an ideal instrument for the structuring of

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Shariah compliant investments in a tax-efficient manner. So far, 15% of all Luxembourg Islamic funds have been set up as SIFs.

The advantages for Islamic funds set up in Luxembourg are not only the reliable legal and regulatory framework or the tax-efficient structures. Luxembourg certainly also has the advantage that it is in the heart of Europe and within the Euro zone, giving immediate access to Muslims in countries such as France, Germany, Italy, Spain and the UK.

UCITS, for example, may not only be marketed to both retail and institutional investors throughout Europe but also around the world, with a dominant position in Asia and South America. The potential for the growth of UCITS in the Muslim world, and the Gulf region in particular, is promising, as UCITS are perfectly fit for Shariah compliant investment structures.

Legal certainty is an important factor in the structuring of Islamic finance products. Luxembourg has chosen to offer innovative legal frameworks to meet the needs of investors. It offers a wide choice of different investment vehicles for the different Shariah compliant products. It has also decided to offer a wide network of double taxation treaties which it is constantly seeking to increase.

Luxembourg has also concluded investment protection treaties with more than 79 countries (including Saudi Arabia, Kuwait, the UAE, Kazakhstan, Uzbekistan, Malaysia, Turkey and India), while new treaties with Azerbaijan, Sudan, Pakistan and Bahrain are in the process of being ratified or negotiated.

The global financial crisis has shown that Luxembourg is a reliable jurisdiction for international investment structures. Despite the economic slowdown, the number of conventional and Shariah compliant investment funds has increased. Additionally Sukuk structures were set up and Soparfinis were involved in Islamic cross-border transactions.

A proactive financial community, government support and a stable regulatory framework which is flexible enough to allow for innovative Shariah compliant structures, combined with a favorable tax environment for international investment, are a good basis for the structuring of Islamic finance products.

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