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## **The Islamic finance industry in Luxembourg: Advantages, opportunities and challenges**

*By Sufian Bataineh, Managing Director, Dananeer, Luxembourg*

### **Historical background and recent developments**

Luxembourg has a long history in Islamic finance that dates back to 1978 when the Islamic Banking System Holdings Limited Luxembourg was established as the first Islamic financial institution in Europe. This was followed by the establishment of *Takafol S.A.* in 1982, the first Islamic insurance company in Europe. Such history has improved the attractiveness of Luxembourg within Islamic finance industry.

In this context, the main recent developments are the following:

- Since April 2008, the Minister of Finance has set up a task force bringing together key actors of the Islamic finance industry in Luxembourg. Its mission is to look at how Islamic finance can be further developed in Luxembourg.
- In 2008, the Association of the Luxembourg Funds Industry (ALFI) launched a working group focusing on the development of Luxembourg as a centre of excellence for *Shariah* compliant funds.
- In early 2009, the Luxembourg Deutsche Bank launched "*Al Mi'yar*", a Luxembourg domiciled platform which aims at smoothing the issuance of *Shariah* compliant securities.
- In 2009, the Central Bank of Luxembourg became a member of the Islamic Financial Services Board (IFSB) and, as such, is the first Central Bank of the European Union to become a member of that institution.
- In January 2010, the Luxembourg Tax Authority published a circular, the object of which is to clarify the tax treatment of *Murabaha* and *Sukuk* transactions and ensure that they benefit from the same tax treatment as conventional financing products.
- In April 2010, Luxembourg for Finance (LFF) issued a brochure describing in detail the vehicles available in Luxembourg for Islamic finance transactions and structures.
- In May 2010, the Central Bank of Luxembourg managed to get the green light to host the 8<sup>th</sup> IFSB annual summit in 2011 in Luxembourg and thus to be the first EU member state to host such a meeting.

This article illustrates the main reasons why Luxembourg is one of the leading jurisdiction for Islamic finance transactions in Europe. It will also identify business opportunities in Luxembourg for Islamic finance, mainly for the *sukuk* and investment fund markets and then examine the challenges that will have to be faced to ensure the development of this sector.

## **Advantages**

The main advantage that Luxembourg has over other jurisdictions is that the government has made continuous efforts to promote the country as a robust Islamic financial centre. This governmental support is encouraging the different institutions in the private sector to explore this emergent market, and thus to adopt new business strategies to improve *Shariah* compliant business. Ministerial missions, headed by the Crown Prince Guillaume and members of the Government, are regularly organised in the Gulf countries. More generally, Luxembourg has very good political relationships with the Gulf countries and Malaysia, which shall ensure the attractiveness of the country for these two centres of Islamic finance.

Luxembourg also has a modern legal and regulatory framework that is continually updated through regular consultation between the government, the legislator and the private sector. Thus, over the years, specific regulatory frameworks have been created for a wide range of innovative products and services. Islamic finance products and services enjoy the same level of care and treatment.

Luxembourg is a member of the European Union and major economic organizations such as the OECD. As such, it is characterised by a strong culture of investor protection and rigorous financial business policies.

Although a small country, Luxembourg is a leading world business centre which enjoys political stability. In addition, Luxembourg is a private banking centre with almost 148 banks, it is the second largest investment fund centre in the world after the United States, it is the world leader in the cross-border distribution of retail investment funds, the largest wealth management centre in the Eurozone and the leader captive reinsurance market in the European Union.

## **Opportunities**

### ***Islamic investment funds***

To date, 45 Islamic investment funds are already established in Luxembourg and the constitution of various other new funds is already planned. This figure places Luxembourg alongside Kuwait and behind only Malaysia and Saudi Arabia<sup>1</sup> as the most popular domicile for *Shariah* compliant investment funds.

It is not surprising to know that Luxembourg is the leading non-Muslim country for the domiciliation of Islamic investment funds with its long and well known history in the investment funds industry and a well established legal framework that allows it to launch a wide range of products. The LFF brochure issued in April 2010 explains the variety of choices for investors who are interested in setting up a *Shariah* compliant investment fund in Luxembourg, the brochure provides information on the tax treatment applicable.

## ***Sukuk***

Luxembourg was the first European exchange to list a *sukuk* in Europe in 2002. Today, 16 *sukuk* worth US\$7.3bn are listed on the Luxembourg stock exchange while 20, worth US\$11bn, are listed on the London stock exchange.

*Sukuk* issues and issuers are subject to the same rules as those applicable to non Islamic debt securities. They are admitted to trading on the Euro MTF market and could possibly be admitted to trading on the regulated market if the issuer wishes so.

It is interesting to note that the governor of the Central Bank of Luxembourg, Mr. Mersch, recently said: “*In order to facilitate the emergence of a resilient Islamic financial market in Europe, we have to adapt and shape the infrastructure and supervisory environment to allow efficient and cost effective trading and clearing for a significant number of investment-grade Islamic financial papers across the whole maturity spectrum. In this perspective, it is worth noting that in the current turbulent period, raising finance through Sukuk issuance appears to be cheaper than recurring to conventional bonds due to the burgeoning demand for Islamic instruments.*”<sup>ii</sup>.

Moreover, it seems that the Luxembourg government, like other EU and non-EU non-Islamic countries<sup>iii</sup>, is studying the possibility of issuing sovereign *sukuk* in order to raise its profile for Islamic funds. Likewise, leading global organizations endorse *sukuk* as a viable and effective method of raising funds for their business, such as General Electric which already has a second *sukuk* issuance in the pipeline<sup>iv</sup>.

## **Challenges**

***Marketing:*** Luxembourg, with all its continuous marketing efforts, is still not known to a lot of investors and businessmen in Muslim countries, who usually go for structures in offshore jurisdictions such as the Cayman Islands, the British Virgin Islands or Bermuda.

***Culture differences:*** It seems that Luxembourg actors still lack sufficient knowledge of the political, economic and social features of Muslim countries. This lack of cultural awareness could result in a lot of missed opportunities and decrease economic cooperation between Luxembourg and the Muslim world.

***Expensive costs for the service providers:*** Luxembourg service providers’ fees are higher than in other financial centres, which leads some investors to investigate offshore jurisdictions in order to save money (without even considering the high quality of the services that can be rendered by Luxembourg service providers).

The ***very small Muslim community in Luxembourg*** compared with its neighbouring countries, makes it difficult to foresee the establishment of a retail Islamic bank on Luxembourg soil, at least in the near future. However, it is worth noting that the recent circular of the Luxembourg Tax Authority, which deals with *murabaha* transactions, appears

to be paving the way for the marketing of Islamic finance products to the large surrounding Muslim communities via a Luxembourg Islamic retail bank.

*This article was originally published by IFC Review in November 2010 ([www.ifcreview.com](http://www.ifcreview.com)).*

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<sup>i</sup> Ernst & Young's 2009 Islamic Funds & Investments Report.

<sup>ii</sup> Mr. Mersch, the Governor of the Central Bank of Luxembourg, in his speech at the 5<sup>th</sup> Economic Forum Belgium-Luxembourg Arab Countries, Brussels, 17 November 2009.

<sup>iii</sup> Such as, in particular, Sweden, France, UK, Belgium, Italy.

<sup>iv</sup> In 2009, GE raised additional funds by issuing *sukuk*. The instrument turned out to be one of the best options for the company, that is why they are now looking at a second issuance, planned for the end of the year 2010.