# Islamic Finance in Luxembourg: where do we stand?


**A look at the Luxembourg achievements in this domain: new challenges on the way!**

Over the years Luxembourg has managed to become one of the leading Islamic finance centres in Europe. Such achievement is due to a sound effort in the fine-tuning of the reputed financing structures already in place as well as the development of innovative ones towards the sophisticated Sharia compliance area.

In this framework, it is worth reminding the Luxembourg Stock Exchange was the first EU stock exchange to list a sukuk, back in 2002. This opened the way to issuers from Malaysia, Pakistan, Saudi Arabia, the UAE and even Europe listing sukuk in Luxembourg. At the same time, by benefiting from its significant experience as a prime location for investment funds' domicile, the Grand Duchy placed itself as a real hub for Islamic investment funds.

On this purpose, the Luxembourg Authorities demonstrated a strong and coordinated commitment. The financial sector supervisory authority CSSF (*Commission de Surveillance du Secteur Financier*) the central bank and the government itself have worked together to create a business environment in line with the needs of Islamic finance practitioners. Professional training institutions and the private sector did the rest.

The role of the CSSF was and is indeed very significant in the qualification of Luxembourg as a hub for Islamic finance. It signed co-operation agreements, the so-called Memoranda of Understanding (MoUs) with several financial supervisory bodies strongly focussed on Islamic Finance implementation worldwide (e.g. the Dubai Financial Services Authority, the Central Bank of Bahrain, the Emirates Securities and Commodities Authority, the Qatar Financial Centre Regulation Authority and the Egyptian Financial Supervisory Authority).

In 2014 the first Islamic Bank in the Eurozone shall be established in Luxembourg and involve the UAE royal family.

On top of the above, there is no doubt the Luxembourg legal and regulatory context is sufficiently flexible to be adapted to Islamic finance practices with ease. Furthermore the monitoring from the CSSF provides an additional layer of reliability to the Islamic finance structures "made in Luxembourg".

**A few Islamic principles functional to the Islamic Finance**

It is forbidden

- <u>to pay and/or ask for interest (*riba*)</u>: this is the main concept of the Sharia compliance. The risk-free rate which is payable in the conventional economy for a debt financing is considered as usury. Therefore any transaction needs to be connected with the direct acquisition of a portion of the underlying asset or a sort of profit and loss sharing;
- <u>to initiate contracts envisaging excessive risk-taking</u> (*gharar*);
- <u>to engage to financial speculation</u> (*maisir*);
- <u>to engage to economic activities prohibited by the Coran</u>: Alchool, tobacco, weapons, pork meat, pornography, gambling (*haram*).

**Why investing in Islamic Finance?**

Because notwithstanding the global financial crisis the Islamic Finance has demonstrated an average global growth equal to 10-15% in the last ten years; approximately the double than the conventional financial activities. Moreover, though Islamic Finance represents circa 1% of the total world financial assets, revenues collected by Islamic banks over the last 5 years recorded an increase of 44% on a yearly basis.

An outstanding result which is explained by the strong connection of the Islamic finance practices to the real economy. Indeed, in order to be Sharia-compliant, any Islamic finance transaction needs to be related to an underlying "tangible" asset which represents per se an investment alternative more reliable than the purely financial ones, deriving from sophisticated financial engineering.

**Classic Islamic Finance mechanisms**

***Murabaha***

The concept of *Murabaha* relates to a sale operation mediated by an Intermediary and characterized by a payment deferred in time. The acquisition price (including the mark-up for the Intermediary) must be known to both the Seller and the Buyer; and the role of mediation of the Intermediary must be clearly stated (e.g. via an agreement stating his only aim is the reselling of the asset to the Buyer).

<u>*Example*</u>

The Seller aims at alienating an asset for EUR 100K. The Buyer is indeed interested and contacts the Intermediary (an Islamic Finance service provider). The Intermediary offers the service of acquiring the asset from the Seller for EUR 100K with the only purpose of reselling it to the Buyer, for a mark-up of EUR 15K. An agreement shall be established with all the parties so that the ownership of the asset shall be transferred to the Buyer against deferred payments totalling the acquisition cost plus the mark-up (e.g. EUR 23K over 5 years).

***Sukuk***

Sukuk is an instrument similar to a conventional bond in the western economies. However, the substantial difference is that the western bonds are established under the promise to repay the underlying loan, whereas the Sukuk consists in the partial ownership in a debt, an asset, a business, or an investment.

Sukuks are characterized by cashflows distributed to the Sukuks' holders, but instead of being deemed as interest, they are strictly connected with the profits (or losses) generated by the underlying asset and thus representing the partial ownership of the underlying.

Factually, the Sukuks' holders bear a credit risk.

**How can Luxembourg planning ideas practically contribute to Islamic finance?**

Thanks to the circular letter released by the CSSF on January 12 2010 ("the Circular"), Luxembourg offers the right instruments to implement the *Murabaha* and *Sukuk* transactions, with full compliance to Sharia rules.

***Luxembourg approach on Murabaha***

Under the conventional approach of western economy, though there is a deferred payment, the gain derived from an asset's alienation by the seller would become taxable at the level of the seller at the moment of the asset's disposal.

However, by allowing a "substance over form" approach under certain conditions, the Circular provides for a deferred taxation of said gain at term of the deferred payment.

The conditions are the following:

- The Intermediary and the Buyer must enter into an agreement whereby is clearly stated the acquisition by the Intermediary is performed with the only purpose of reselling the asset (immediately or in six month-time maximum);
- This agreement clearly includes the pre-determined mark-up, specifying that is the remuneration for the rendered intermediation services and that its amount is accepted by the parties (i.e. the Seller and the Buyer);
- Accounting and tax wise, such remuneration must be deferred in the Intermediary's books.

***Luxembourg approach on Sukuk***

Although the Sukuk holders have a pro-rata ownership of the underlying assets and the cashflow they obtain is strictly related to the underlying asset's income, the Circular clarifies Sukuks shall be considered as conventional bonds as from Luxembourg tax perspective.

This means that yield served under the Sukuks shall be treated as conventional interest payments and thus **fully tax deductible at the level of the Sukuks' issuer**.

**Conclusions**

The abovementioned Luxembourg institutional commitment to the Islamic Finance development over Europe has as a definite output the qualification of the Grand Duchy as European hub for this business domain.

Moreover, if we add Luxembourg Stock Exchange is the only European stock exchange together with the London Stock Exchange to list Sukuks, Luxembourg represents the only "one-stop shop" solution provider for Islamic Finance business.

Solid financial and corporate experience mixed up with an extremely reactive and business-friendly tax and regulatory environments are directly related to the success already achieved and yet achievable over the years to come.

*Innovative Solutions*

*Reliability*

*Expertise*

*Comply*

*Ethics*

*Responsive*

*Flexibility*

Archon is a tax analyst specialized in integrated solutions and shall be at your disposal to evaluate the benefits you might obtain through the new developments of the limited partnerships.

***To have more insight and advice, contact us:***

***info@archon.lu***