

ISLAMIC FINANCE: A SECTOR WITH A PROMISING FUTURE

Islamic finance takes an ethical approach to the delivery of financial services: is this a sector whose time has come?

A packed two day conference on Islamic finance held recently in Luxembourg illustrates the imminent arrival of Islamic finance as a mainstream sector in the investment fund industry. Islamic scholars and experts in Islamic finance from Europe, the Middle East and Asia shared their experience in front of an audience invited by the Luxembourg Institute for Training in Banking (IFBL), the Association of the Luxembourg Fund Industry (ALFI) and the agency for the development of the financial centre, Luxembourg for Finance. A number of clear messages emerged.

Islamic finance is recognised by both Muslims and non Muslims as an ethical alternative, protecting against the worst excesses of leverage whilst reinstating values, such as trust, which have been lost in conventional finance. Figures cited show that Islamic finance is growing in popularity as a result of the current crisis and there is scope for it to move into the financial mainstream with the sector estimated to reach \$4,000 billion in the next five years.

Nevertheless the audience noted that Islamic finance was not immune to the crisis even if it has been somewhat protected by its nature: equity-based products with a profit/loss structure backed by real assets and a high level of transparency, alongside the ban



on speculation and interest. Global equity prices have fallen, though shariah indices have fallen less steeply than conventional indices due to lack of exposure to the credit crunch. Sukuk have been severely impacted by the liquidity squeeze and the first defaults in sukuk issues have emerged.

Sukuk have to date been the most successful Islamic instrument outside the Muslim community: already 60% of sukuk investment comes from non-Muslims. Both France and the UK, amongst others, are considering a sovereign debt issue.

Requirements for growth of the sector

Relatively speaking, Islamic finance is still in its infancy: the lack of historic data, critical mass, standardisation and experience are key concerns. Practitioners recognise a need to develop specifically Islamic risk management principles, in addition to conventional risk management practices.

Other requirements for continued growth include increased harmonisation between different cultures,

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The ALFI Committee on Islamic Investment Funds will set and maintain best practice standards for the Luxembourg market place.

Germain Birgen, Chairman of the Committee and Managing Director, HSBC Securities Services (Luxembourg) SA

standards, practices, shariah interpretation and regulatory oversight. Islamic finance practitioners must understand the culture of their regulators, whilst service providers and jurisdictions need to comprehend and respect the principles on which Islamic Finance is built and acknowledge that there will always be differences between Muslim schools of thought.

There is a need to build up a secondary market for sukuk or fixed income equivalent instruments. However, the paradox arises that whilst a secondary market is an absolute requirement for growth, the “buy and hold” principle is true to shariah whereas active trading (speculation) on a secondary market is not. Nevertheless, the sukuk market needs to develop a yield curve and there is a distinct lack of sukuk from AAA issuers.

Cash management is an issue for fund managers, since interest (riba) is forbidden, along with conventional borrowing. Solutions include operating a conventional account with zero interest, or making arrangements for fully shariah compliant accounts. Short term liquidity facilities are permissible for Islamic investment funds in order to cover any mismatches: a point particularly relevant for UCITS⁽¹⁾ and even more so for UCITS investing in sukuk given the current lack of a secondary market.

Advice from the financial supervisory authority

The Luxembourg supervisor, CSSF, and other speakers familiar with the authorisation process had the following advice for potential fund promoters:

- understand your material;
- choose the jurisdiction as you would for a conventional fund;
- the application and regulatory process will be the same, with additional questions asked on individual target investments, such as sukuk;
- recognise that the fund must be subject first to the law of the land and then also to Islamic principles;
- provide full disclosure in the prospectus of all shariah related processes and potential outcomes (e.g. purification);
- manage risk as for a normal fund, but be aware of additional shariah compliance risks, increased liquidity risk (borrowing restrictions, illiquid investments) and potential FX risk (no hedging).

Regarding the shariah board and shariah compliance, both are the responsibility of the board of directors and not subject to control by the CSSF (except where a shariah board member is also a regular board member, or where shariah rules touch UCITS regulations). The board of directors is responsible for all investment decisions. The CSSF does not intend to issue specific rules or definitions for shariah compliant funds – these should be defined in individual fund documentation – but it does not rule out the possibility of issuing guidelines in the future.

The Luxembourg regulator is familiar with the main shariah compliant asset types, including various kinds of sukuk, and is able to provide feedback on what is or is not acceptable, depending on the structure described in the documentation.

Cross border experience attracts fund promoters

Speaking at the conference, companies such as HSBC, the Bank of London and the Middle East, BMB Islamic, Blackrock, NCB Capital and Nomura Asset Management were all confident that UCITS can provide Islamic

The Luxembourg Government supports the development of Islamic finance

- In April 2008, Minister Frieden set up a working group to identify potential obstacles to the development of Islamic finance in Luxembourg and ways that it can be further developed.
- The Government has asked the tax authorities to look into the characteristics of Islamic finance deals and come up with proposals to ensure that these transactions are applied equivalent tax treatment as traditional banking and financial transactions.
- The Government is examining to what extent Islamic financial products, such as sukuk, could be used for funding purposes of the Government or entities belonging to the Government.
- The Government supports the application by the Luxembourg Central Bank to become the first “non regional” associate member of the Islamic Financial Services Board, the international regulator of Islamic financial markets.

funds with international recognition and distribution. These companies praised the ease with which an Islamic fund can be set-up and distributed internationally from Luxembourg. Advantages cited include the flexible legal and regulatory framework, export-oriented workforce and the network of tax treaties – factors that have earned Luxembourg a 75% market share in the cross-border distribution of traditional funds.

There are currently 23 Luxembourg domiciled Islamic funds and fund compartments. A further 10 structures have been authorised but are still to be launched. The funds are predominantly UCITS run by European fund managers, although service providers confirm increasing interest from the Middle East and Asia.

⁽¹⁾ Undertakings for Collective Investment in Transferable Securities – UCITS – are funds that qualify for the EU passport for retail distribution throughout the European Union

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OPPORTUNITIES FOR ISLAMIC FINANCE IN LUXEMBOURG

Since 1983, when Luxembourg welcomed Europe's first shariah compliant insurance company (takaful), the Grand Duchy has been an active sponsor of Islamic finance.

The Luxembourg Stock Exchange was the first European exchange to list a shariah compliant bond (sukuk) in 2002 and now lists 15 sukuk with a combined value of \$5.5bn, putting the exchange on a par with London. These have been issued by a geographically diverse range of borrowers from the GCC region and from countries such as Pakistan and Malaysia. The majority are sovereign debt issues, attracted by the political neutrality of Luxembourg.

However it is in the area of shariah compliant investment funds that Luxembourg stakes its claim for the title of European capital. This is a market in which Luxembourg has enjoyed a clear competitive edge for several decades.

Luxembourg domiciled shariah funds are managed by some of the world's leading investment managers, such as the Al Dar Islamic World Equity Fund (managed by Pictet), the BNP Paribas Equity Optimiser, the Citi Islamic Portfolio Global Equity and the HSBC Amanah

Global Equity Index Fund. Other managers include Crédit Agricole Asset Management, Nomura and Bank of London and the Middle East (BLME).

Luxembourg's importance as a centre for Islamic funds is not confined to equity-based products. There is also a growing interest in "fixed interest" equivalent funds, invested in sukuk. For example, KFH Bahrain and Fortis Private Real Estate have recently launched a shariah compliant overnight fund (SCOF), which is an innovative Luxembourg incorporated solution for managing short-term liquidity in accordance with Islamic principles.

Outlook for the sukuk market

According to Standard & Poor's (S&P), global issuance of sukuk fell sharply in 2008, driven by the global credit crisis. The sukuk market was also negatively impacted by the uncertainty that arose when doubts were expressed about the religious compliance of the structure



Sohail Jaffer,
Partner - FWU Group

by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Nevertheless, analysts agree that the longer term case for the sukuk market remains compelling. As S&P commented in its review at the start of 2009, "several factors support sustainable growth of this market, including increasing popularity of shariah compliant products and government openness to Islamic finance, massive investment and financing needs in the Gulf, and issuers' desire to tap investors from the Middle East and Muslim Asia. Issuers from more than 20 countries have expressed interest in issuing, or announced their intention to issue, sukuk, and we anticipate that several new sovereigns will enter the market."

Luxembourg – a pragmatic choice for sukuk issuers

The Luxembourg Stock Exchange is expected to attract a strong share of sukuk listings. As Central Bank Governor Mersch said in February, "when it comes to the listing of sukuk, the Luxembourg Stock Exchange is pragmatic as it requests only documentation concerning the underlying transactions rather than a comprehensive description of the sukuk's structure."

Advice from a shariah scholar

Do

- expect Islamic culture to be different in India, Malaysia, Bahrain, Saudi Arabia or North Africa; local culture will effect what is acceptable;
- apply expected standards (act in good faith);
- offer an appealing profit: your clients expect it.

Don't

- be cynical with regards to differing legal opinions or the search to create shariah products that replace European instruments;
- short-cut on the facts (act in good faith).

The Governor added that Luxembourg's pre-eminence in clearing and settlement also stands the Duchy in good stead to play a leadership role in the sukuk market. "On the operational side, Clearstream Banking, the Luxembourg International Central Securities Depository (ICSD) holds under custody and offers the clearing and settlement of a range of Islamic securities."

Sukuk-based products

Luxembourg is well-positioned to attract managers and distributors of shariah compliant funds based on sukuk, which are a relative newcomer to the universe of Islamic funds, compared with the longer-established equity-based products. One example of a player that is demonstrating its commitment both to the sukuk market and to Luxembourg is European Finance House (EFH), a subsidiary of the Qatar Islamic Bank. EFH has announced the launch of the Luxembourg-based Global Sukuk Plus Fund, which is targeting a size of US\$200m.

Another international player, Deutsche Bank, has recently unveiled the Al Mi'yar open architecture platform domiciled in Luxembourg which "looks to transform Islamic markets by offering truly shariah compliant, liquid investment products which span a wide range of asset classes and pay-offs."

The range and depth of skills concentrated in Luxembourg are such that the financial centre will undoubtedly stake a claim to several niche markets within the European Islamic finance sector in the years ahead.

Principles of Islamic finance

The concept is that a transaction should be fair and just:

- both sides must profit from a deal;
- there must be equal risk on both sides;
- an item and its consideration must be lawful, in existence, deliverable and unmistakable;
- deception, speculation and gambling are prohibited;
- usury is prohibited;
- making a profit from fear or misery is prohibited.

It results from these rules that the charging of a fixed interest, short sales, derivatives trading, dealing in goods and services prohibited by Islam (such as alcohol, pork, casinos and pornography) and traditional insurance products are not permitted.

Dr Aly Khorshid, shariah scholar and consultant