CHAPTER 8

Legal Structures of Islamic Funds in Luxembourg

8.1. Introduction

Luxembourg is one of the world's leading international financial hubs and also the leader (in a non-Islamic jurisdiction) in setting up Islamic funds. According to the Islamic Funds Report, the main difference between Islamic fund domiciles such as Saudi Arabia and Malaysia and Luxembourg is that the first domicile group intends to initially offer access to local investors and local assets, while the second domicile category provides access to an international investor base to utilize favourable tax structures and a reliable and globally recognized fund regime. Given that Luxembourg is amongst the four leading jurisdictions for setting up Islamic Funds and has a special role as a hub domicile serving international markets, we pay close attention to the development of Islamic finance in Luxembourg and the different products available to investors.

8.2. Islamic finance in Luxembourg

Luxembourg has been recognized as an important hub for Islamic finance. It has been part of the growth in Islamic finance recently, and continues to be a very active international financial hub for global investors.

In 1978, the Islamic Banking System[27] was incorporated in Luxembourg as the first Islamic financial institution in the western part of the global hemisphere. The Islamic Banking System institution was established with the purpose of serving the needs of High Net Worth (HNW) individuals in a Shari'a-compliant manner. In 1983, the Bahraini Solidarity Group domiciled in Luxembourg became the first Shari'a-compliant insurance company in Europe, and is still in existence today. Following Solidarity's footpath in Luxembourg, the FWU Group, which has become a recognized provider of takaful products in the Middle East, has engineered many of its Islamic finance products through its subsidiaries, including: a life insurance company, an asset management company and a mutual fund company - all based and regulated in Luxembourg. Other renowned Islamic finance institutions have followed, with the incorporation of Faisal Finance (Luxembourg) S.A. and Faisal Holdings (Luxembourg) S.A. in 1990.

The Luxembourg stock exchange also became the first European stock exchange to enter the sukuk market, and in 2005, the Central Bank of Luxembourg hosted the first Islamic Financial Services Forum with the Islamic Financial Services Board in Luxembourg.

8.3. Luxembourg funds

The authority that oversees the investment funds in Luxembourg is the Financial Services Authority (Commission de Surveillance du Secteur Financier, CSSF). It was established in 1999 after having taken over the responsibilities of the Exchange Supervisory Commission (Commissariat aux Bourses) that has been in existence since 1990. Luxembourg is the world centre for the cross border distribution of retail funds, taking 75.2% of market share.[28] Many financial institutions have therefore been using Luxembourg investment funds to structure their investment portfolio in a Shari'a-compliant way. This can be explained by its undisputed leadership in cross-border sales of investment funds, its reliable and flexible regulatory framework, the innovation shown by its investment management industry and its broad range of tax-efficient opportunities for investment structuring. As of July 2009, 3,438 investment funds are registered in Luxembourg, with an AUM of EUR 1,706 trillion or US$ 2,035 trillion.

[27] It was later renamed Islamic Finance House Universal Holdings S.A.

[28] PricewaterhouseCoopers, Global Fund Distribution – June 2009, available on: www.pwc.com/lu.

8.4. The UCITS framework

Almost two-thirds of the Islamic funds in Luxembourg have been set up as an undertaking for collective investment in transferable securities (UCITS).[29] UCITS is a sub-category of funds that fulfil the relevant EU regulations and can be offered to investors throughout the EU on the basis of a single authorization from one member state. With Luxembourg leading the way, there has been a significant growth in Shari'a-compliant UCITS funds in recent years and it is expected that the number of Islamic UCITS will increase in the near future.[30]

UCITS offer a unique regime in terms of structuring and delegation of functions and supervision with the purpose of ensuring high level protection for investors. A UCITS may be created either as a common fund, i.e., a contractual vehicle, or as an investment company with either a variable capital, which is always equal to the net assets of the investment company, or with a fixed capital. A UCITS created as a common fund must appoint a management company, whereas a UCITS created as an investment company may be self-managed or it may decide to appoint a management company. UCITS and their management companies must also comply with minimum capital requirements (EUR 1.25 million or US$ 1.7 million to be reached within six months by the UCITS).

A UCITS must comply with stringent transparency requirements and issue a prospectus, a simplified prospectus, yearly and half-yearly annual reports all in compliance with the UCITS Directive. It should also be noted that a UCITS may be created as an umbrella fund with a variety of different compartments. In such a structure, each compartment has its own assets and liabilities, investment policy and fee structure, and may have a different investment manager or advisor to other compartments. As the assets and liabilities of one compartment are segregated from the assets of other compartments, creditors of one compartment may, in principle, not have recourse to the assets of another compartment, and the profits made by one compartment can only benefit its own shareholders. The creation of compartments allows for segregation of Shari'a-compliant activity within an umbrella structure in order to serve the interest of different investors. This method is cost-effective and has been approved in many cases by recognized Shari'a scholars.

A UCITS must appoint a custodian bank that is entrusted with the custody of the UCITS assets and which must have knowledge at all times of where the assets are invested. The custodian bank of a Shari'a-compliant UCITS does not need to be operated in a Shari'a-compliant manner, but only needs to be in a position to service the fund in a way which is not violating any Shari'a principles. This has been generally accepted and practised with the existing Shari'a-compliant UCITS. A UCITS is further required to have its books audited once a year by an authorised independent auditor. Additionally, a UCITS also usually delegates, either directly or through its management company, tasks that require high specialisation or specific know-how. For instance, this is usually the case in all corporate, domiciliary, registrar and transfer agency functions, but also distribution and investment management or advisory services.

A UCITS, its management company, its custodian and auditors must be approved by the CSSF. Furthermore, the constitutional documents, prospectus, simplified prospectus, risk management process and agreements with the main service providers of the UCITS must also be approved by the CSSF, which further supervises the UCITS on an ongoing basis. Once a UCITS is approved and launched, it may market its shares in its home Member State, and must comply with some formal notification requirements in the relevant host Member States. This notification procedure is applicable in all member states. The recently adopted revision of the UCITS Directive intends to render it more efficient.

The success of the UCITS brand is apparent when one looks at the total AUM by UCITS. According to statistics reported by the European Fund and Asset Management Association (EFAMA) as of the last quarter of 2008, EUR 4.593 billion or US$ 6.206 billion were managed by UCITS reduced from an all-time high of EUR 6.160 billion or US$ 8.324 billion a year earlier. This amount represents approximately 75% of all net assets managed by European investment funds. More importantly, UCITS managed assets represented 32.3% of worldwide investment fund assets, the second-largest market share after US managed assets (which accounted for 49.2% of the worldwide total).

The specificity and strength of UCITS is that it can be marketed throughout more than 50 countries. The most commonly chosen route for the distribution of UCITS in the GCC is via commercial distributors licensed in their local markets. In Bahrain, 95% of the registered funds are foreign, and 77% of the foreign funds in Bahrain are funds domiciled in Luxembourg.[31] Under the rules of the DIFC, for example, Luxembourg is a recognized jurisdiction and UCITS are considered to be recognized funds. UCITS can therefore be marketed in and from the DIFC to qualified investors, provided that the relevant disclosure rules are respected. The possibility to market a UCITS on a cross-border basis, combined with the high level of investor protection provided by the detailed supervision and applicable regulations, explain the success of the UCITS brand.

8.4.1. Compatibility of UCITS with Shari'a rules

The Islamic fund industry does not have any central regulatory body and therefore disclosure of information on fund size, types of asset held, management objectives and other matters remains voluntary. While some funds provide detailed information others provide little more than their contact details and the types of financial products offered. Investor protection remains a national matter of the fund domicile. In order to ensure high investor protection, it is crucial to choose a reliable framework. As mentioned, one of the main features of the UCITS regime is the high level of investor protection. Such protection is ensured by the level of supervision over UCITS and the transparency of the structure through the information provided to investors (prospectus, simplified prospectus, annual and semi-annual reports), but also because UCITS must ensure a certain level of diversification of their assets, maintain an appropriate risk management process and only invest in certain types of assets. The rules that ensure that UCITS provide reliable products make them well-suited for Shari'a compliance. UCITS may only invest in transferable securities (such as company shares and bonds), money market instruments, and shares of UCITS or Undertaking for Collective Investment (UCIs) and derivatives instruments. Such investments must meet quality standards and comply with requirements in terms of liquidity, valuation and pricing principles as implemented in the European Directive on eligible assets. UCITS may not enter into short sales, acquire precious metals or certificates representing them, or borrow for more than 10% of their assets except under specific conditions. Furthermore, a UCITS may only acquire movable and immovable property, which is essential for the direct pursuit of its business.

The main diversification rules applicable to UCITS are the following:

• A UCITS may invest no more than 10% of its assets in transferable securities or money market instruments issued by the same body (the limit may be a maximum of 25% or 35% depending on the quality of the issuer of such securities).

• A UCITS may acquire the units of another UCITS and/or UCI, provided that not more than 20% of its assets are invested in the units of a single UCITS or UCI and with a maximum exposure of 30% for non-UCITS (but which are equivalent to UCITS);

• A UCITS may not invest more than 20% of its assets in deposits made with the same body; and

• The risk exposure to a counterparty of the UCITS in an over-the-counter derivative transaction may not exceed 5%, or 10% of its assets (depending on the quality of such counterparty).

It should be noted that these rules are only the most important diversification principles applicable to UCITS, and there are a number of other diversification rules and exceptions allowing greater flexibility. Some of these requirements and restrictions are not only compatible with Shari'a principles, but are fully in line with recent standards issued by AAOIFI.

8.4.2. UCITS adaptability

UCITS may easily adapt to include the following Shari'a features in terms of structure and documentation:

• A ban on investment in any interest-bearing asset/debt instruments and cleansing of cash and dividend receipts.

• A ban on entering into futures or forward contracts.

• The prohibition of investment related to haram activities, such as gambling, production or sale of pork products, etc.

• The creation of a Shari'a advisory board and appointment of stock screening providers.

The UCITS framework is therefore perfectly adaptable to the needs of promoters of Shari'a-compliant investment funds. Recent developments suggest that the growth of Shari'a-compliant UCITS will continue and most likely accelerate once the crisis is over. Some of the highest-performing Shari'a-compliant investment funds with a global mandate are domiciled as UCITS funds in Luxembourg, such as the BNP Paribas Islamic Fund and the HSBC Amanah Global Equity Index Funds or the UBS (Lux) Islamic Fund. Most funds that have been approved so far by the CSSF under UCITS regulations have been mainly Shari'a-compliant equity funds. This follows the global trend according to which 278 out of the 504 Islamic funds were equity funds as of 2008.[32]

8.5. Specialized investment funds

Following demands from the finance industry, Luxembourg introduced in 2007 a new type of fund, the specialized investment fund (SIF) which benefits from great flexibility in terms of organization, eligible assets and investments and 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 fulfilling certain criteria.[33]

SIFs are collective investment vehicles subject to the principle of risk-spreading. The SIF qualifies as a UCI, although the functioning rules are more flexible and the prudential regime lighter. The flexible rules allow the SIF to invest in any type of assets, including inter alia, hedge funds, real estate funds, funds of funds, PE funds, funds investing in money market instruments, transferable securities, financial derivative instruments, micro finance, debts, and so on.[34]

The overall popularity of the SIF in the investment management industry has also been true for the Islamic finance industry. Approximately 15% of all Luxembourg Islamic funds have been set up as SIFs, and the Islamic Investment Funds Committee of the Association of the Luxembourg Fund Industry (ALFI) has therefore considered the SIF to be suitable for a variety of asset classes, including PE, property or alternative investment schemes mainly aimed at institutional or HNW investors.[35] Examples of Islamic SIFs are the Shari'a-compliant umbrella fund set up by the Bank of London and the Middle East (BLME Umbrella Fund SICAV-SIF) or 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. Along with other financial institutions, EFH has stated its interest in the establishment of a number of new funds in Luxembourg, including the recently announced Global sukuk fund. The possibilities offered by the SIF regime and the flexibility of its legal framework make this vehicle an ideal instrument for the structuring of Shari'a-compliant investments in a tax-efficient manner.

8.6. SICAR

Luxembourg also offers other investment vehicles, which are being increasingly utilised by the Islamic finance industry. One vehicle of interest is the SICAR (Société d'investissement en capital à risqué), which is a risk capital investment vehicle with the principal purpose of investing in risk-bearing assets issued by domestic and foreign enterprises. A SICAR can be included in the corporate or partnership form, and can also be set up with

[29] According to statistics of the CSSF, www.cssf.lu.

[30] PricewaterhouseCoopers: Investment Management and Real Estate News, March 2009, 24

[31] Central Bank of Bahrain, Capital Markets Review – September 2008, 3.

[32] Funds Management Division, AmBank Group, Developments in the Global Islamic Funds Industry, in: Asset & Wealth Management Guide 2008 (Islamic Finance News), 9-11

[33] C. Kremer and I. Lebbe, Collective Investment Schemes in Luxembourg, (Oxford University Press), 38.

[34] M. Moulla and M. Chanthalangsy, "Presentation of the Law of 2007 compared to other existing legislations governing collective investments structures – The historical overview of the Law of 2007" in Specialized Investment Funds (Arendt & Medemach), 16-17.

[35] ALFI Islamic Investments Funds Committee Report 2009

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 have been officially declared Shari'a-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 Shari'a principles, encouraging risk sharing and prohibiting the taking of interest.

8.7. Looking ahead

The Islamic fund industry has not been immune from the effects of the global financial crisis; however, its outlook remains promising. Recent reports by rating agencies estimate that Islamic banking assets and AUM have reached US$ 1 trillion in 2010.[36] Fund domiciles serving the international appetite for new Shari'a-compliant products have only appeared recently on the playing field, and are becoming increasingly attractive to the Islamic funds industry as they offer sophisticated products that can be used for international investment structures. The current economic situation is also showing the deficiencies of many Islamic funds making a shakeout of the fragmented landscape more likely.

As for any fund structure, the choice of jurisdiction, the legal structure and the tax implications of a Shari'a-compliant fund that is investing internationally or has international investors is crucial. Given that taxation is a key consideration for fund managers, it must be the centre of focus when comparing the different Islamic fund domiciles. In many transactions, in particular many originating from the countries of the GCC, the reflex of considering the tax implications of investment structures seems to be often neglected or underestimated. A further consideration for the domiciles of an investment structure is the strength of its regulatory framework.

Thought should also be given to the possibilities of marketing specific funds to a wider investor basis. It is thus of major importance to consider cross-jurisdictional issues between the investor, the investment fund and the jurisdiction where the asset is located. The current situation of international financial markets has created an opportunity for the Islamic fund industry to review the existing products, and to select distribution platforms that are reliable and meet the demands of the investors.

[36] McKinsey & Company, Annual Intelligence Report 2009.

CHAPTER 9
Sukuk Products

9.1. Introduction – Islamic debt capital instruments (sukuk)

Sukuk[37], or Islamic debt security, is generally thought of as the Shari'a-compliant alternative to bonds. Indeed, it was originally created for that purpose: to offer an Islamic alternative to mobilising medium to long-term debt capital. Over a period of time, however, efforts to standardize the industry have also sought to give sukuk a more distinctive Islamic identity, in part by basing them on the principle of risk-sharing, something that has led some observers to compare certain proposed structures to preference shares. Sukuk are different from conventional bonds in the sense that they provide ownership in an underlying asset or project to the investors, unlike conventional bonds, which merely represent a promise by the issuer to repay the loan amount to investors. The issuer of a sukuk provides a financial certificate to investors who are given proportionate ownership of the underlying asset for a pre-defined period. In fact, recent efforts to standardise the market sought to ensure that sukuks have a concrete underlying asset. Moreover, unlike conventional bonds, which provide a fixed interest to bond holders, the sukuk issuer agrees to provide a return to investors in the form of payments that are linked to cash flows generated from the underlying asset for which capital is mobilised. Sukuk issuances can be broadly categorized into:

• Murahaba sukuk

This type of sukuk is based on the murahaba form of contract for the sale and purchase of an asset using the cost plus (mark-up) method. It is widely used for short-term financing in trade finance. In the murahaba form of contract, an agreement is signed between the special purpose vehicle (SPV) and the customer according to which the SPV undertakes to buy the asset required by the customer. The SPV then issues sukuks to investors and buys commodities on spot basis from the sukuk proceeds. After that, the SPV sells the commodity to the customer at the spot price plus a profit margin on an instalment basis over an agreed period of time. The sukuk certificate represents a monetary-debt payable by the customer to sukuk holders, the amount of which is agreed initially. Consequently, the secondary trading of murahaba sukuk is not permissible as its transfer to a third party will mean transfer of debt which, according to Shari'a law, can only be exchanged at par value.

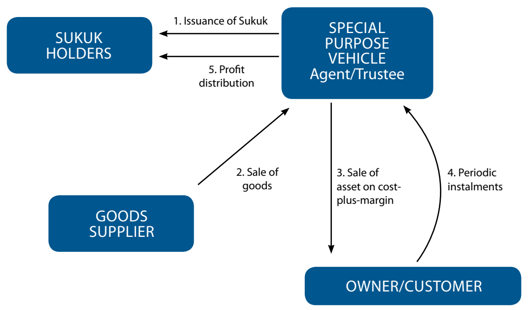

Figure 51: Structure of murahaba sukuk
Source: NCBC Research

• Ijara sukuk

This type of sukuk is based on the ijara form of contract to buy equipment and lease it to a customer. ijara-based sukuks are primarily used in project financing.

[37] Interestingly, sukuk or sakk is not a new invention of the Islamic finance industry. The concept of sukuk has been with the Islamic world since the early days of Islamic civilization. Imam Malik has recorded the first historical account of sukuk in his famous treatise al-Muwatta. It is stated that in the 1st century Hijri (corresponding to the 7th Century AD) the Umayyad Government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of sukuk al-badai, which has been translated as "commodity coupons" or "grain permits". See, HASHIM KAMALI, ISLAMIC COMMERCIAL LAW AN ANALYSIS OF FUTURES AND OPTIONS 3 (Cambridge: Islamic Texts Society 2000); MALIK I BILLION ANAS, AL-MUWATTA 296 (Mohamed Rahimuddin trans., Kitab Bhavan 5th ed. 2000). The holders of the sukuk were entitled to present the sukuk on its maturity date at the treasury and receive a fixed amount of commodity, usually grains. Some of the holders used to sell their sukuk to others for cash before the maturity date. Although the validity of such trade was questioned by scholars of that period, it shows that the concept of sukuk al-badai as a tradable instrument has been known to the Islamic world for a very long time.