



# Islamic Microfinance in Luxembourg

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## Objectives and summary:

The following article was co-written by a partner of a well established law firm in Luxembourg and an expert in Islamic Finance with the objective to demonstrate the extent to which the Luxembourg microfinance vehicles can be used to foster the development of Islamic microfinance schemes. The argumentation is centered on the unique combination of the robust Western governance framework and structuring vehicles together with Oriental philanthropic and religious principles; this association is likely to meet the financing needs of the neediest who, so far, were kept aside of conventional interest-based microfinance solutions.

## Introduction:

Grand-Duchy of Luxembourg's position as a financial centre has strengthened in the past years, as growing number of international investors are making investments in Grand-Duchy of Luxembourg ("**Luxembourg**") to benefit from its various advantages.

Indeed, the Luxembourg Government has implemented major legal and tax reforms with the aim of permitting greater flexibility and to meet the needs of international investors. Luxembourg has become today Europe's number one investment fund centre and the world's leading hub for global fund distribution.

Luxembourg has been also involved in the field of Islamic finance for many years, indeed in 1983, Luxembourg was the chosen domicile of the first shari'ah compliant insurance company in Europe and the Luxembourg Stock Exchange was the first European stock exchange to enter the Sukuk market, having listed Sukuks since 2002.

On September 2008, Luxembourg was gathering a value of Sukuk issued on the Luxembourg stock exchange of an amount of USD 5.5 billions (source: LuxembourgforFinance), which makes Luxembourg's financial place a leader of the implemented Islamic finance in Europe.

Moreover the experience matured in the areas of fund administration, management and distribution enables Luxembourg to offer a valuable expertise and an extraordinarily wide range of investment products to the promoters. Among them Microfinance institutions have experienced a high development during the last years.

Obviously such results are the consequence of a know how developed and improved all over the past years throughout the combination of various high level services providers and of a flexible legal framework which meets international requirements and is easily adapted to other national legislations.

The purpose of this paper is to briefly present the principles of microfinance, the Shari'ah requirements and as a result, the tenets of the Islamic microfinance. Once introduced, we will identify the challenges faced by the Islamic microfinance and demonstrate to what extend Luxembourg constitutes a place of choice for Islamic

microfinance schemes. The Luxembourg investment law and vehicles associated with the regulatory oversight and with the organisations specifically dedicated to microfinance constitute key differentiators which may facilitate the emergence of the Islamic microfinance.

### Concept of Microfinance:

Microfinance may be defined as “*the supply of loans, savings, insurance, transfer services and other financial products to people who are traditionally excluded from the traditional banking system, mainly because they lack the guarantees that can protect a financial institution against a loss risk*”.

Microfinance is considered as an effective and flexible tool based on the local needs and economic and financial situation. For this reason, the 2005 year has been declared by the General Secretary of the United Nations “*International Year of Microcredit*”.

### Shari’ah compliance:

While in conventional microfinance, the financing granting strategy focuses mainly on generating risk adjusted optimal returns, in Islamic microfinance however, the objective shall only be to finance authorized transactions in tangible assets (this excludes activities harmful for the society such as alcohol, pork, weapons, drugs or the pornography business). Additionally, the Islamic microfinance scheme should not involve any interest (not even refer to an interest) or element of uncertainty, speculation or gamble between parties.

### Islamic Microfinance:

Most of the underpinning elements of the conventional microfinance are embedded in the Muslim religion. Therefore, Islamic finance integrates a great amount of ethical values encouraging supportive alternative programmes to promote economic activity helping the community.

There is therefore no surprise why the microfinance scheme first appeared in areas influenced by Islam (e.g. Bangladesh): precisely the religion has instilled principles and institutions to strengthen the Islam social order by redistributing income and wealth of the believers in their communities.

The Islamic microfinance schemes are organized around two principles:

- (i) On one hand the sourcing based on the Muslim philanthropy, be it compulsory through the charity tax (*Zakat* one of the pillar of Islam), or a voluntary almsgiving through *Sadaqah*;

- (ii) On the other hand two redistributions vehicles channelled through either voluntary loans (*Qard Hasan* loan granted as if it was in favour of God without any expectations) imposing neither profit nor deadline for the repayment or the foundations (*Waqf*) entailing no reimbursement at all, consisting in pure charity.

The efficient association of *Qard Hasan* and *Waqf* are the main differentiators of the Islamic microfinance scheme compared with the conventional counterparts in so far as *Qard Hasan* and *Waqf* really address the financing need of the poorest of the poor, category usually excessively penalized (either through the usurious interest rate or the collective pledge) in the conventional microfinance solutions.

### Challenges faced by Islamic microfinance:

Appeared recently in the industry, the Islamic microfinance still faces a number of challenges, limiting its credibility and hence its expansion in the financial word besides the current turmoil.

Islamic finance has gone through various standardisation and consolidation phases in order to emerge as a resilient industry. However, focusing on the core financial and banking business and client segments, has led to two negative results: the marginalisation of the poorest members of the society who were already kept aside of the banking and financial system and meanwhile the neglecting of microfinance.

Local examples of Islamic microfinance exist in few countries (Bangladesh) but these are not yet efficiently organised and funded; consequently, they often appear less favourable for the needy than conventional financing and hence miss their objectives.

We may hope that Islamic microfinance will be further developed in the nearest future considering the importance and potential of the sector whose relevance become more and more of interest with the storm in the conventional, interest based finance. Besides, important promotion work has been achieved by the Islamic International Ratings Agency (IIRA) and the increasing involvement of global financial institutions (e.g. Deutsche Bank venturing with the Islamic Bank of Thailand into Shari'ah-compliant microfinance).

Microfinance institutions (the “**MFIs**”) initially intended for local markets are now expanding into larger markets and offering a broader range of services.

### Incorporation of a Microfinance investment vehicle:

The legal framework in connection with the incorporation of a Microfinance investment vehicle (the “**MIV**”) in Luxembourg is very pragmatic as such MIV can take various forms of vehicles regulated under Luxembourg law (e.g. SICAR, SICAV, SIF).

Various laws applicable to Luxembourg investment funds have been set out and cater for the case of MIV:

- (i) The Undertakings for Collective Investment Law dated December 20, 2002, as amended from time to time, which may be divided in two parts: the first part is related to Luxembourg investment funds which are freely marketable throughout the European Union countries with a minimum of formalities, whereas the second part is related to Luxembourg investment funds which may only be marketed in other European Union countries after complying with some investment restrictions and with each country's local distribution rules;
- (ii) The Specialised Investment Fund Law of February 13, 2007, as amended from time to time (the "**SIF Law**") which significantly simplifies the rules for setting up fund structures such as hedge funds. Funds under the SIF Law may only be distributed to "informed investors" and High Net Worth Individuals and are subject to each country's local distribution rules.
- (iii) The law on Investment Company in Risk Capital of June 15, 2004, as amended from time to time, which allows investments in "risk capital" within a highly flexible framework in terms of risk spreading. Such vehicle may appear particularly convenient in connection with MIVs.

In addition, local regulatory authorities are constantly innovating in implementing new regulations in order to maintain and increase the attractiveness of the Luxembourg financial place, notably in the matter of investment funds.

It is relevant to note that the law on securitisation of March 22, 2004, as amended from time to time, enables investors to securitise all kinds of assets notably in innovative fields like MIVs.

As well as of the large range and flexible investment vehicles, Luxembourg also offers a very attractive tax system which enables investors to optimize their tax duties and repatriate in Luxembourg income generated abroad with high flexibility.

### [Luxembourg financial place as a guaranty of stability, efficiency and safety](#)

Luxembourg offers investors a high level of security through its supervisory authority in the financial sector, namely the *commission de surveillance du secteur financier* ("**CSSF**"), which carries out a permanent supervision over the MIV notably with respect of their compliance with the applicable laws and regulations. The CSSF is thus in charge of the granting of an authorisation for the setting up of a MIV and is empowered to withdraw such authorisation in case of non compliance with the applicable laws and regulations. Such supervision performed by the CSSF ensures (i) the protection of the financial stability of the supervised companies and of the financial sector as a whole and (ii) the quality of the organisation of internal control and of the systems used for that purpose.

In this respect, Luxembourg centralises numerous qualified service providers in connection with the setting up and the management of MIVs.

Furthermore Luxembourg's regulatory authorities managed to establish an efficient and pragmatic anti money laundering regulation. The legal framework for preventive anti money laundering obligations is set out by the law of 12 November 2004, as amended from time to time, implementing the second money laundering directive 2001/97/EC dated December 4, 2001, which provides to investors which have entered into Luxembourg's financial place a high secured framework for their investments and their business.

### Luxembourg's institutions dedicated to the purpose of the Microfinance

Two main institutions were created in Luxembourg, which may be considered as a precursor in the matter, in order to improve performance and transparency enough to attract professional lenders, to securitize the Microfinance market and to provide confidence and security to Microfinance investors:

- (i) LUXMINT (*Luxembourg Microbanking Intermediary Scheme*), a non-profit fund established in 1999 by A.D.A. (*Appui au Développement Autonome*), an independent non-governmental organization based in Luxembourg, and by the government of Luxembourg which aims at granting loans and bank guarantees to certain MFIs. On June 2007, LUXMINT supported 19 MFIs in 10 countries and provided services to over 700,000 clients for a total amount of EUR 307,000,000 (source: A.D.A. report dated June 2007); and
- (ii) LUXFLAG (*Luxembourg Fund Labeling Agency*) which was created on July 2006 by founders representing the private sector, the non-governmental organizations' sector and the State of Luxembourg. The aim of this organization is to grant a Microfinance fund label to specific investment undertakings on the basis of agreed and published criteria. National and international investment funds or similar vehicles which fulfil the criteria to qualify them as eligible MIVs will be awarded with a label. This label facilitates fund distribution and contributes positively to the image of the fund and more generally provides confidence to Microfinance investors.

Indeed, in order to obtain a LUXFLAG Microfinance label, a fund shall comply with a certain number of criteria laid down by LUXFLAG among which the MIV shall (a) be subject to a national supervision authority, (b) have a Microfinance portfolio corresponding to at least 50% of the MIV's total assets, (c) have at least 25% of its Microfinance portfolio invested in MFIs rated by a Microfinance rating agency recognised by LUXFLAG and (d) have a commercial purpose which shall not include charity and donation institutions (i.e. the label will not be granted to donor organizations).

In this respect, Mr. Thomas Seale, former chairman of the A.L.F.I. (*Association of the Luxembourg Funds Industry*), declared: *“This agency forms another step in helping make Luxembourg attractive as an innovative fund centre and at the same time gives strong support to Microfinance, which is a proven development tool.”*

Luxembourg government has been actively involved since the beginning of Microfinance through the development of assistance with a view to encourage its financial institutions to embrace Microfinance and to become a worldwide Microfinance centre of excellence.

Luxembourg also regularly organizes the hosting, in cooperation notably with A.D.A., of various international conferences in connection with the Microfinance such as the “Luxembourg Round Table on Microfinance”, “Luxembourg Week of Microfinance” and the “Midi of Microfinance”.

Flexible and welcoming authorities added to the professionalism and the independence of its specialized innovative Microfinance institutions should allow Luxembourg to continue strengthening its position as one of the world’s most attractive investment fund centre in the sector of Islamic Microfinance.

Owing to its reactivity, high skills and strong reputation Luxembourg financial place appears to be a great opportunity for foreign investors to develop their activity worldwide.

### Concluding remarks

The modern conventional financial system has demonstrated its shortcomings and failed to alleviate the poverty in the world increasing on the contrary the gap between the wealthiest and the poorest. Luxembourg made the first step for the emergence of microfinance tactically embarking into this market development. Let us hope the European financial industry will seize the market opportunity of Islamic microfinance to improve its contribution to society and the community.

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