Advantages and Expertise of the Luxembourg Financial Sector in Setting Up Shariah Funds

According to the latest statistics, Luxembourg is the fifth largest domicile for Shariah-compliant investment funds (‘Sharia Funds’) worldwide and the first non-Muslim domicile. Its success is due to its structuring expertise and its track record in cross-border distribution. It is also due, in large part, to the flexibility of its legal and regulatory framework (which is designed to accommodate products from different traditions and thus does not require the implementation of any specific provision to host Shariah Funds). The only Islamic finance specific Luxembourg provisions are two tax guidelines referred to hereinafter and a note issued by the Luxembourg regulator (the ‘Commission de Surveillance du Secteur Financier’) on sukuk.

Luxembourg offers a broad range of regulated or unregulated investment vehicles that may be structured in a Shariah-compliant manner. The choice between the regulated vehicles which include: (i) undertakings for collective investment in transferable securities (‘UCITS’); (ii) so-called Part II funds; (iii) specialised investment funds (‘SIFs’); and (iv) investment companies in risk capital (‘SICAR’), mainly depends on the target investors and investment strategy.

UCITS and Part II Funds, for example, are the only vehicles that may be marketed to both retail and institutional investors (SIFs and SICARs being reserved to sophisticated investors). UCITS are also the only vehicles benefiting from a European passport, allowing their easy distribution throughout the European Union, as well as simplified registration and recognition in a number of countries worldwide. This situation will evolve from July 2013, with the introduction of another European passport (restricted to marketing to professional investors) for managers of SIFs, SICARs and Part II Funds, falling within the scope of Directive 2011/61/ EU of the European Parliament and of the Council on Alternative Investment Fund Managers.

The most flexible vehicle in terms of investment policy is the SIF, which may invest in any kind of assets, provided that it does not invest more than 30% of its assets in securities of the same kind issued by the same issuer. This flexibility is important, as Shariah Funds have to combine the requirements pertaining to the relevant vehicle with Shariah principles. Whereas this is relatively unproblematic for SIFs and SICARs (contrary to SIFs, SICARs are not subject to any diversification rules but invest all their assets in risk capital), UCITS-compliant Shariah Funds have to verify the compliance of the relevant Islamic instruments with UCITS eligible assets requirements.

Compliance with Shariah principles requires the setting-up of specific mechanisms such as the purification of dividends, and the scanning of investments through a Shariah screen, usually carried out by a Shariah (advisory) board comprised of independent Shariah scholars. The role and practical details pertaining to the functioning of that board (which, in practice, is set up to assist the management body and investment manager of the fund in their respective roles) is described in the prospectus of the relevant product.

Shariah Funds may also require adjustments in terms of custody. Indeed, if it is generally accepted that the custodian of a Shariah Fund does not itself need to operate in a similar manner as an Islamic bank, the custodian is required to be in a position to exercise its activities towards the fund without violating any Shariah principle. The prohibition of interest income for the fund, for example, prevents the fund from lending or borrowing money with interest, and requires the setting-up of appropriate agreements to deal with overdrafts in a Shariah-compliant manner.

All regulated vehicles are subject to the supervision of the Commission de Surveillance du Secteur Financier, which only verifies compliance with Luxembourg laws and regulations, but does neither opine on the compliance of the investment policy and operations of the relevant vehicle with Shariah precepts nor approve the composition of the Shariah board.

From a tax perspective, Shariah Funds have benefited from the favourable regime applicable to Luxembourg funds/SICARs. Besides, the economic-based approach sustaining Luxembourg tax law has been, to a large extent, sufficient to encompass Shariah Funds (and Shariah-specific transactions) with a limited need for specific provisions. Nevertheless, the direct tax authority issued a circular detailing the main concepts of Islamic finance and their tax treatment on 12 January 2010. It was closely followed by the indirect tax administration on 17 June 2010, which issued a circular detailing the tax treatment of murabaha and ijara.

Recent trends confirm Luxembourg’s success as a domicile of choice for Shariah Funds. Amongst others, we have recently been asked to (i) assist one of the top US asset managers in the setting-up of the first Luxembourg sukuk-compliant Shariah Fund (to be launched soon), and (ii) to establish a SIF for the asset management arm of the family office of one of the largest merchant families in Saudi Arabia.

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