Yves Mersch: Islamic finance – partnerships opportunities between Luxembourg and the Arab countries

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the 5th Economic Forum Belgium-Luxembourg-Arab Countries, Brussels, 17 November 2009.

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Excellencies, Governor, ladies and gentlemen, good morning,

I am very pleased to be here today, and I would like to thank the *Arab-Belgium-Luxembourg Chamber of Commerce* for inviting me and especially its general secretary Mr. Hijazin.

Based on the agenda of this 5th Economic Forum, I am looking forward to hearing and learning and to explore potential partnerships opportunities between Luxembourg and the Arab countries in the field of Islamic finance, which receives an increasing attention.

In this perspective, I welcome and consider as essential such conferences that promote greater awareness of important developments within international banking. Despite its traditional approach, Islamic finance is a key “innovation” in the financial area since the seventies and I expect that today’s conference will provide an excellent opportunity to exchange information and ideas on current issues relating to this important sector.

While efficient reactions to the global financial and economic crisis have been taken by government and central banks worldwide to stabilise the financial conditions of banks and reduce funding pressures, this unprecedented turmoil reinforces the need to revisit our economic and financial paradigm. The crisis suggests to some to deviate from markets driven economies and behaviours and to explore more ethical and humanistic values to drive sustainable value creation.

One stream in this context is Islamic finance promoting an alignment with the real economy. Based on its prohibition of leverage activities, its principles of justice and participation, Islamic finance is said to contribute to the reduction of the risk perception in the economy and hence its safe recovery. [1]

Specialists estimate the volume of Islamic investments to exceed USD 750 billions and the pool of investible assets in the countries of the Persian Gulf and South East Asia to reach USD 5,000 billions.[2]

In this part of the world, a non negligible part of the European population has ethical investment and placement needs based on the Shari’ah that have, so far, not yet appropriately been addressed by the conventional banking offering. As of today, more than 38 millions Muslims live in Europe, representing more than 5% of the population.[3] Government and financial institutions alike try to cater for these needs.

Intrinsic difficulties for Islamic financial institutions remain however related to the management of their liquidity and I will review how central banks, have engaged into different initiatives to solve these issues so far. I will also share with you some considerations on the challenges that may arise when introducing Islamic financial services into the European framework.

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[1] Chris Morris (2009) et al., “*Has the crisis shown the strengths or the weaknesses of Islamic finance?*”, IFM Global Market Monitor, 21 October.

[2] Gilles Saint Marc (2008), “*Finance islamique et droit français*“, presentation to the Finance Commission of the French Senate, 14 May, page 3.

[3] Luis Lugo (2009) et al., “*Mapping the Global Muslim Population*”, Pew Forum on Religion & Public Life, October.

As central bankers in Europe, we welcome a wide variety of banking approaches such as the Islamic one.[4] Our purpose is to focus on the implications for safety and soundness of institutions engaging in Islamic finance and ultimately their potential risk for the banking system. As a result, while banking authorities are committed to adapt and to be accommodating for Islamic finance within the European regulatory framework, it is crucial to continuously ensure a level playing field, requiring from Islamic financial institutions the same high licensing and supervision standards to those expected from conventional ones.

Although banking authorities in Europe are certainly not competent in religious issues and do not intend to replace the official Muslim scholars to take a position and interpret *Shari'ah* precepts, it is important that the banking and financial authorities become more familiar with the principles and practices specific to Islamic finance in order to make appropriate supervisory and regulatory judgments.

As early as 2005, the Banque centrale du Luxembourg was the host of an awareness programme co-organised in Luxembourg with the Islamic Financial Services Board. This was followed by various efforts, supported notably by the Luxembourg government, the fund administrators, the University in order to identify obstacles to solve and opportunities to enhance for the development of Islamic Finance in Luxembourg.

The Government has instructed the tax authorities to come up with proposals in order to have a level playing field and ensure tax neutrality for Shari'ah compliant transactions (essentially Sukuk and Murabaha).

I have participated, along with a number of my colleagues of other central banks, in several conferences both in Europe, the Gulf region and South East Asia, in an effort to stay abreast of developments in this market and to emphasize our continuing interest in this.[5]

This flexible approach for Islamic investment products and services out of Luxembourg originated in the late seventies, when the *Islamic Banking System Holdings Limited Luxembourg* was established as first Islamic financial institution in Europe. This was followed by the establishment of *Takafol S.A.*,[6] a life insurance company in December 1982.[7] Those initiatives paved the way for future successful Islamic development which was continuous since then. According to the most recent statistics, there are today 15 Sukuk listed in Luxembourg for a combined value of EUR 5 billions.[8] Luxembourg is the first jurisdiction in a non Muslim country[9] for the domicile of Shari'ah compliant funds with nearly 40 funds managed and promoted by leading global investment companies[1]. Earlier this year, a major German bank launched its new platform, domiciled in Luxembourg, called *Al Mi'ya*r to facilitate the issuance of Shari'ah compliant securities.

Some of the features of *Shari'ah*-compliant investment are designed to attract Western investors looking for socially responsible investment schemes and who are not only interested in the risk/reward relationship of their investment, but who are also concerned with

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4 Christian Noyer (2009), "*Global stability, the future of capital markets and Islamic Finance in France*", Euromoney Seminars, Islamic Paris Conference, Paris, 29 September.

5 "*3rd Islamic Financial Services Forum: The European Challenge*", jointly organised with the Financial Stability Institute and hosted by Banque de France on Islamic liquidity management, Paris, 3 March 2009.

6 Now denominated *Solidarity Takafol S.A*, based in Luxembourg.

7 Parker (2009), "*Luxembourg promotes as domicile of choice for funds*", Arab News, 18 May.

8 Amount and number as of 28 October 2009, source *Bourse de Luxembourg*. For information, on 12 August 2009, the Luxembourg stock exchange has listed a €1.5 billion Sukuk issued by Petroliam Nasional, Malaysian state owned Oil Company.

9 Luxembourg is the 4th domicile for Shari'ah compliant funds in the world with 7% of them following Malaysia (23%), Saudi Arabia (19%) and Kuwait (9%) – see Ernst & Young's *Islamic Funds & Investment Report 2009*, page 72.

issues of accountability and social responsibility. As you all know, based on the precepts of the Shari'ah, Islamic funds invest in ethical and non leveraged enterprises which for those reasons have a low risk profile.

Despite the relative success of Islamic financial services in Luxembourg regarding notably the investment funds and the Sukuk, not all of the regulatory challenges raised by these Islamic institutions have been resolved – challenges that arise from looking to introduce Islamic financial principles into a regulatory framework that was structured without these principles in mind. However, these issues are not specific to Luxembourg only and exist in the whole western countries.[10]

One example of issues that precisely fits into the role of a central bank is the absence of an appropriate market of Shari'ah instruments to facilitate the management of the liquidity needs of Islamic banks or Islamic financial institutions and funds.

The prohibitions of interest rate as well as the lack of a dedicated infrastructure and adequate instruments prevent the Islamic banks from developing a viable value proposition: rejecting leverage and speculative transactions, Islamic banks need to have greater amount of capital and to sustain a higher liquidity ratio than their conventional counterparts. As a result, their activities turn to be less profitable and less competitive compared to those of their conventional counterpart when addressing the same customer segment. The structural obstacles together with the lack of technical and contract standardization ultimately prohibit Islamic financial institutions from succeeding in the competitive financial landscape where consumers make rational choice not only driven by religious principles.

In order to facilitate the emergence of a resilient Islamic financial market in Europe, we have to adapt and shape the infrastructure and supervisory environment to allow efficient and cost effective trading and clearing for a significant number of investment-grade Islamic financial papers across the whole maturity spectrum. In this perspective, it is worth noting that in the current turbulent period, raising finance through Sukuk issuance appears to be cheaper than recurring to conventional bonds due to the burgeoning demand for Islamic instruments.[11]

To reflect the specific needs of *Shari'ah*-compliant finance, the AAOIFI *(Accounting and Auditing Organization for Islamic Financial Institutions)* and the IFSB *(Islamic Financial Services Board)* are working on developing international supervisory standards for instance to improve the corporate governance frameworks or implement capital adequacy and risk management standards for Islamic financial institutions.[12]

In closing, let me emphasize that, the *Banque centrale du Luxembourg* has applied for membership to *the Islamic Financial Service Board* and would be the first central bank in Europe to participate to this international standard setting organisation. We also second staff to become familiar with Islamic finance and study the before mentioned issues, notably liquidity management.

Despite the lack of detailed and scientific studies about the potential effect of Islamic finance on the price and financial stability, the resilience of Islamic banks to the recent crisis[13]

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[10] Cf. Gilles Saint Marc (2008), "*Finance islamique et droit français*", presentation to the Finance Commission of the French Senate, 14 May, page 3.

Cf. "*3rd Islamic Financial Services Forum: The European Challenge*", jointly organised with the *Financial Stability Institute* and hosted by Banque de France on Islamic liquidity management, Paris, 3 March 2009.

[11] Robin Wigglesworth (2009), "Islamic bonds spark rush of international interest", Financial Times, 10 November; "Has the crisis shown the strengths or the weaknesses of Islamic finance?", Global Market Monitor, 21 October.

[12] Norbert Hellmann (2009), "Finanzkrise taucht Islamic Banking in ein neues Licht", Frankfurt Börsen-Zeitung, 10 November.

[13] Durmus Yilmaz (2009), *"Islamic Finance: During and after the global financial crisis"*, Istanbul, 5 October.

practically demonstrates the positive diversification effect they could play, contributing therewith to a systemic equilibrium. Moreover, Islamic finance acts as a natural hedging scheme restricting excessive credit boom in so far as it links the supply of financing (what would conventional banks call credit) to the growth rate of the economic activity.

Thank you very much.