

Islamic Finance Securitisation in Luxembourg

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Islamic finance constitutes one of the fast-growing fields in today's global financial markets. The involvement of Islamic investors in the securitisation industry and the development of Shari'a compliant securitisation transactions during recent years is an affirmation of the success of the marriage between securitisation and Shari'a compliant finance. Several Islamic securitisations have been implemented in Luxembourg, which has gained recognition as an international securitisation and structured finance hub.

Islamic securitisation follows the same principles as the conventional securitisation. However, several restrictions arising under Shari'a principles will apply, notably the prohibition of interest ("riba") and speculation, the exclusion of the industries involving alcohol, pork and gambling, etc. As Islamic finance rules prohibit interest-based financing, investors are allowed to support or invest on the basis of partnership, but not on the basis of interest.

It has now been almost five years since the law of March 22, 2004 on securitisation (the Securitisation Law) was adopted by the Luxembourg parliament, creating a flexible, lightly-regulated and tax-efficient regime for securitisation vehicles (the SVs). Alternatively, the investors may opt for a non-regulated ordinary commercial company (ie, what is often referred to as a *société de participations financières* or Soparfi). Both regimes have offered solutions suitable for Islamic investors.

Nature of Islamic securitisation and sukuk

"Sukuk" is the Arabic name for a financial certificate and can be analysed as the Islamic finance equivalent of bond. However, interest bearing instruments are not permitted and there cannot be a guarantee on fixed return. Sukuk is a kind of asset-backed security representing a common share in the ownership of the investment assets. The sukuk holders share the return generated by the sukuk assets and bear the losses in proportion to the certificates owned by them. Unlike conventional securitisations, Islamic securitisation and sukuk will require a higher connection with the securitised assets.

Securitisable assets

The collateral which is securitised in conventional securitisations comprise frequently of interest-bearing receivables and debt securities. Islamic finance does not permit the use of interest and as a consequence, interest-bearing assets would not normally be eligible for an Islamic securitisation. Shari'a compliant assets would include real estate, equity participations, ijara and murabaha contracts.

One of the driving factors of the popularity of the Securitisation Law is the wide range of eligible assets (other than interest-bearing assets) which can be securitised. Under the Securitisation Law, risks relating to the holding of assets, whether movable or immovable, tangible or intangible, as well as risks resulting from the obligations assumed by third parties or relating to all or part of the activities of third parties, may be securitised. During recent years the securitisation transactions in Luxembourg included diverse asset classes, such as residential loans, lease receivables, equity participations, real estate, commodities, whole businesses etc. Since March 2004, the use of Luxembourg SVs with a view to the securitisation of real estate have become increasingly popular.

In its 2007 Report, the Luxembourg Supervisory Commission for the Financial Sector (the CSSF) clarified the legal environment applying to SVs, by accepting inter alia:

(a) the possibility to securitise and repackage shares or units in UCIs, hedge funds, limited partnerships or other companies holding the securitised risks, provided that the SV is not actively involved in the management of the entities in which it has a participation (direct or indirect), and the SV does not provide services of any nature to such entities;

(b) the possibility for an SV to acquire goods or equipment and to make them available to an operational company against the payment of a rent, provided that such transaction is structured in a way similar to a leasing operation and that its purpose is the financing of the operational company.

Structuring

The Securitisation Law provides a high degree of structuring flexibility and a lightly-regulated regime. Luxembourg SVs are unregulated entities and are not subject to any authorisation. Only SVs issuing securities to the public on a continuous basis must be approved by the CSSF.

The acquisition of the securitised risks by a Luxembourg SV has to be financed through the issuance of securities (*valeurs mobilières*), the value or yield of which is linked to such risks. Both equity and debt securities may be issued in bearer or registered form. However, interest-bearing securities, as used in conventional securitisations, are not allowed under Shari'a. Sukuk shall represent a common share in the ownership of the investment assets. The holders have to share the return and bear the losses in proportion to the certificates owned by them.

A Soparfi and an SV can be formed as a corporate body having a legal personality separate from that of their investors, whereas an SV may in addition be organised as a co-ownership of assets (without legal personality) - a so-called securitisation fund. The Soparfi and SV acronyms do not refer to specific legal forms, but merely to a specific set of legal, regulatory and tax provisions with the actual securitisation entity being formed either as: (a) a public limited liability company, (b) a private limited liability company, (c) a partnership limited by shares, (d) a cooperative company in the form of a public limited liability company, and (e) solely in respect of an SV, a securitisation fund. An SV formed as a corporate body or a securitisation fund may be compartmentalised, meaning that each compartment represents a distinct part of the assets and liabilities of the SV.

The securitisation fund deserves special attention. It is organised as a co-ownership, the joint owners of which are only liable up to the amount they have committed or contributed. The securitisation fund does not have legal personality and has to be managed by a Luxembourg-based management company in accordance with its management regulations. It may also be set up under a fiduciary arrangement, whereby the assets are being held by a fiduciary for the account of the investors. Given that securitisation funds constitute co-ownership(s) of assets, they provide a higher connection to the securitised assets and easily ensure compliance with Shari'a principles.

A securitisation fund governed by the Securitisation Law is transparent for tax purposes and will not be subject to corporate income tax, trade tax or net wealth tax in Luxembourg. Distribution of profits is not subject to Luxembourg withholding tax (except distributions falling within the scope of EC Savings Directive). Due to the lack of legal personality of the securitisation fund, investors may, where applicable, in principle (directly) claim treaty benefits from the jurisdictions in which the securitised assets are located.

A corporate type SV is subject to Luxembourg corporate income tax and municipal business tax. Obligations (engagements) vis-à-vis its investors and other creditors ((future) dividends, interest, etc.) are considered to be deductible "interest payments" for income tax purposes. The SV is exempt from the annual net wealth tax. Payments of dividends or interest are not subject to withholding tax (except payments falling within the scope of EC Savings Directive).

Listing of sukuk

The Luxembourg Stock Exchange (LuxSE) is one of the key European stock exchanges for sukuk listings. The LuxSE announced on March 13, 2008 that it listed its 14th sukuk. The Luxembourg Stock Exchange has been listing sukuk instruments since 2002 for a total amount issued of around US\$5.5 billion.¹ The listed sukuk issuers are from various jurisdictions, notably the United Arab Emirates, Bahrain, Cayman Islands, Pakistan, Qatar and Malaysia.

The LuxSE has two segments: (i) the EU regulated market (the Regulated Market) and (ii) a multilateral trading facility designated as Euro MTF (Euro MTF). Issuers admitted to trading on the Regulated Market may avail themselves of the passport procedure under the Prospectus Directive to have their securities listed on a regulated market of another EU member state. The Euro MTF was created in July 2005 following the adoption of the Luxembourg law of July 10, 2005 on prospectuses for securities (the Prospectus Law) implementing the Prospectus Directive, in order to offer an alternative market to issuers interested to list their securities outside the scope of the Prospectus Directive and the Transparency Directive.

Listing on the Euro MTF has been the "market of choice" for many foreign issuers. It is easier to list on this market and the LuxSE, which is the regulator approving the prospectus, is known to be very diligent in helping issuers to list expeditiously. The reporting and disclosure obligations (both financial and transparency) are not as stringent as the regulations arising

under the Prospectus Directive and the Transparency Directive do not apply to securities listed on Euro MTF.

Sukuk have been listed both on the Regulated Market and Euro MTF.

Conclusion

It is not just the innovative legal corporate framework that has positioned Luxembourg as a key jurisdiction for the set up of securitisation structures but also the Luxembourg tax regulations, which are flexible enough to encourage investors.

About Loyens & Loeff Luxembourg

Loyens & Loeff Luxembourg comprises more than 125 fee-earners and is committed to offering the highest standard of integrated tax and business law advice. The Luxembourg office is affiliated with Loyens & Loeff, which has over 900 fee-earners in 18 offices in the Benelux and the main financial centres of the world. ■

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1. Luxembourg Stock Exchange Press Release, March 13, 2008