Islamic Banking and Finance Review

Volume 6:1440-41H/ 2019
ISSN (E): 2413-2977
ISSN (P): 2221-5239

Islamic Finance: History, Theory and Development in Luxembourg

Dr. Sabbah Gueddoudj
Researcher, Lux-SIR (Scientific International Research)

Journal

This is an Open Access Journal

Published By
Institute of Islamic Banking (IIB)
University of Management and Technology (UMT)

https://iib.umt.edu.pk/ibfr/home.aspx

ibfr@umt.edu.pk

Research Paper Information

To cite this article

Gueddoudj, S. (2019). Islamic finance: history, theory and development in Luxembourg. *Islamic Banking and Finance Review, 6*, 01–22.

Crossref

Access this article online

Hassnain Ali

https://iib.umt.edu.pk/IBFR/Home.aspx

https://doi.org/10.32350/ibfr.2019.06.01

Contact Information

INSTITUTE OF ISLAMIC BANKING (IIB)
UNIVERSITY OF MANAGEMENT AND TECHNOLOGY
C-II, Johar Town, Lahore +92-42-3521-2801-10 (Ext – 3418)

Islamic Finance: History, Theory and Development in Luxembourg

Dr. Sabbah Gueddoudj[1]

Abstract

The aim of this paper is twofold. The first aim is to demonstrate that Islamic finance is an alternative to conventional finance in the western world. Often viewed as a religious service in non-Muslim countries, Islamic finance has been excluded from economic funding, unfortunately. This exclusion is partly linked to a lack of knowledge about Islamic finance in Europe. Most of the time, Islamic finance is associated with Islamic religion without taking into account economic concerns. An exercise of comparison between Islamic principles and various monetary schools of thought demonstrates that there are similarities between them and that Islamic finance cannot be perceived without understanding core economic and financial rules. The second aim of this paper is to evaluate the position of Islamic finance as ethical finance in Luxembourg and its various perspectives. The main conclusions are 1) Islamic finance should be studied through an economic prism, 2) Islamic finance in Luxembourg has steadily increased but, 3) its share in financial instruments is still very low despite the openness towards non-conventional finance funding in Luxembourg.

Keywords: ethical finance, financial stability, Islamic finance, monetary policy, schools of thought

JEL: B10, E10, E43.

"*Luxembourg with its tradition as a specialized financial center will continue its endeavors to establish an international hub for Islamic finance,*" Yves Mersch (former Governor of Central Bank of Luxembourg, Current Governor of European Bank)

Introduction

"*Economics is a science, which studies human behavior as a relationship between ends and scarce means and which have alternative uses*" (Robbins, 1935, p. 16). This definition of economics recognized by all scholars is important when someone wants to analyze Islam as an economic system or science and not as a religion. Modern and monetary economics deal with problems involving money, financial products and services. Therefore, Islamic economics can be viewed as modern

[1]Researcher, Lux-SIR (Scientific International Research)
*Corresponding author: chairmanship@lux-sir.com

economics in the sense of monetary economics. However, there are differences between these two types of economics, that is, modern economics and monetary economics. Firstly, Islamic economics is based on religious principles, which is not the case at all for modern economics. Indeed, non-Muslim countries manage their economies without taking into account any religious principles. There is a perfect dichotomy between the religious sphere and the economic sphere. Religion belongs exclusively to the private sphere in some countries. Islam is not only a religion but Islam also provides social and economic principles for building a society. Muslim countries follow these principles. Islamic principles are often perceived as non-economic principles by lay persons. However, a comparison of Islamic principles with famous western schools of thought shows interesting similarities between them.

Nowadays, the patronage of Islamic finance is constantly increasing. The evolution of Islamic finance is disparate in non-Muslim majority areas. Indeed, in Europe Islamic finance seems to be developing slowly except for some countries including the United Kingdom and Luxembourg. The latter has been one of the most dynamic countries to provide Islamic finance an optimal environment. Moreover, Luxembourgian government uses Islamic finance for public debt funding. It is the first euro zone country to introduce Islamic finance in the form of *Sukuk* in national public accounts. This point demonstrates the Luxembourgian government's will to integrate Islamic finance in its financial landscape like any other type of financial service.

The goal of this paper is twofold. The first is to demonstrate that Islamic finance is based on economic principles. We shall discuss the economic principles underlying Islamic financial instruments in order to show that these tools are not exclusively dedicated to Muslim investors but to all investors. The second aim is to explicate that Islamic finance should be viewed as ethical finance in non-Muslim countries since it incorporates the obligation to respect the planet and lives (animal and human lives) as all other monotheistic religions do. Ethical finance puts a strong emphasis on the relationship between the role of finance and the respect for nature.

This paper is structured in the following way. The first section presents the history of Islamic finance encompassing 1400 years and its economic principles elaborated by various schools of thought. It discusses shortly the introduction of Islamic finance in not only the Arab and Asian regions but also in Europe and particularly in Luxembourg. The second section evaluates the worth of Islamic finance in Luxembourg. It describes the Islamic finance mechanism as well as the industry funds since Luxembourg is an important investment fund center in Europe and the second largest in the world after the United States (Association of the Luxembourg Fund Industry (ALFI, 2017). The last section concludes with the perspectives offered by this kind of ethical finance.

2. History of Islamic Finance and its Comparison with Western Theoretical Principles

The first section has two aims. The first is to present briefly the history of Islamic finance and to scotch a number of ideas that generate concern. Indeed, Islamic finance is not a new discipline. It began 1400 years ago and even at that time, it was a modern approach of economics. Moreover, Islamic finance is not set apart from ethical finance. Indeed, it incorporates ethical finance. Similar to other concepts of theoretical economics, its principles are embedded in a moral and ethical paradigm. It is noticeable that Adam Smith's works summarized in his two pioneering books The Theory of Moral sentiments (1759) and The Wealth of Nations (1776) described economic mechanisms within a framework of moral and ethical principles.

Section 2 is useful to manifest how Islamic finance is widespread from Arabia to Europe and especially in Luxembourg. Moreover, it also provides the opportunity for exchanges and reflection about the link between western economic theories and Islamic finance principles. Note that the construction of the section is deliberately general. This generality may disturb discerning readers who specialize in the study of religions.

2.1 History of Islamic Finance

The history of Islamic finance starts with the revelation of the Quran 1400 years ago. The development of this finance is based on religious and traditional precepts. Indeed, some of its core principles were already developed in the framework of prior Abrahamic (A.S.) traditions. The modern transpositions of Islamic finance are letters of credits or banknotes, for instance. Indeed, throughout Islamic history many financial and transactional activities led to the generation of accounting reports.

Islamic finance services are based on permitted economic and commercial activities defined in the Quran as authorized *(halal)*. There are also some prohibited (*haram*) activities. The prohibited activities include *"riba"* (interest), accumulation of wealth and other non-ethical trade practices. While the authorized activities include moral directives in business, charity, consumption, social responsibility and community development. They constitute the basis of Islamic principles and they are immutable, that is, they do not change over time (Naqvi, 2003).

During the Middle Ages, from the mid-7th century to the mid-13th century, the development of Islamic finance supported economic growth. Commercial and financial activities flourished. All economic activities were governed by Islamic finance principles (Ghazanfar, 2000). This period is known as the 'Golden Age' of Islamic civilization. During this period the "inhabitants established trade routes which stretched from Gibraltar (*Jabal ul Tariq* in Arabic) to the Sea of China along which flowed trade based on the principles of Islamic commerce." According to Shaikh M Ghazanfar (2003), each and every commercial operation respected the equity between traders. Moreover, the development of financial innovation aimed at guaranteeing the integrity of money transactions. He adds, "One such device was the bill of exchange or letter of credit (*Suftajeh*), which became well established in state and private commerce." At that time, a "*Sakk*" was an international cross border banknote. This financial product may also be interpreted as a precursor of the present day stock market exchange.

Post-Roman European economy was a demonetized economy. It used furs and lumber for transactions with the Islamic Caliphate. To facilitate international trade, European countries started using coins (Iqbal & Mirakhor, 2013). This assessment is related to some archeological findings. Indeed, Islamic coins were discovered in Europe. During the 'Golden Age' of Islam, coinage developed rapidly and coins were present in several economies in Europe and in the Middle East, as well as in India. According to Herman Van Der Wee (2000), the re-monetization of European economies after the demise of the Roman Empire and the rebirth of the European banking system coincided with the period of trade with the Caliphate. The flow of Muslim coinage to Europe increased greatly. Early developments of financial products in Islamic world may have significantly contributed to the development of conventional finance products, as it was the case in other fields such as mathematics, astronomy, medicine, agriculture, etc. The modern conventional finance is related to Islamic finance since they both have the same roots, that is, a money-based approach.

From 1301 to 1922, that is, during the period of Ottoman Empire (more than six centuries), there was an explosion of trade activities and this boosted economic growth and the finance sector. In 1775, the first *Sukuk* appeared. The objective of the first bond fund was to finance budget deficits. The "Islamic bond" aimed at borrowing against future customs duties on tobacco (Ghazanfar, 2003).

Beginning in 1930, some Islamic banks started to tackle the question of interest rate. With the beginning of decolonization, Islamic countries began to develop their own finance based on *Shari'ah* principles. In 1970s, Saudia Arabia and other Gulf states promoted Islamic finance and invested actively in Muslim countries. In Asia, Islamic banks emerged. In 1973, the Philippine Amanah Bank appeared. In 1979, Pakistan created the Islamic banking system intended to gradually eliminate interest from all banking operations by 1985 (Ashfaq, Malik & Humayoun, 2010). In 1983, Islamic banking was initiated in Malaysia (Kuran, 1997).

In 1990, Malaysia introduced the first modern *Sukuk* (a kind of bond) and an interbank for *Sukuk* appeared in 2003. The goal of the Malaysian government was to make Malaysia a dynamic hub of Islamic finance and bring it on top regarding all financial innovations in this field.

With the passage of time, countries rated AAA such as Saudi Arabia and Bahrain developed innovative products to boost the finance sector and economic growth. In 2000, Islamic Development Bank started financing trade between Muslim countries. In 2014, this bank was the largest issuer of *Sukuk*. In 2001, the International Islamic Financial Market (IIFM) was created. Several countries (Bahrain, Indonesia, Sudan, Saudi Arabia, and Malaysia) with an advanced Islamic finance sector ratified the IIFM agreement. The principal aim of IIFM is to create an international secondary market for the trading of *Sukuk* and several other Islamic financial instruments. It has played a crucial role in the development of *Sukuk* since they have rapidly gained acceptance across national borders. IIFM has been a pioneering step in their popularization and legacy. It has strengthened cooperation between Muslim countries, reinforcing their economic ties and converging them towards harmonization with *Shari'ah* principles.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Islamic Liquidity Management (IILM) are important organizations dedicated to Islamic finance management. Islamic financial services are also widespread outside of the Gulf Cooperation Council (GCC) states and Malaysia.

In 2014, a sovereign *Sukuk* issued by the Organization of Islamic Cooperation (OIC) was launched in the United Kingdom, quickly followed by Luxembourg and South Africa. In Luxembourg, the development of Islamic finance is not encouraging despite the government's will and efforts. The Grand Duchy hosted the first Islamic financial institution in Europe in 1978 and the first insurance company (*Takaful*) compliant with the *Shari'ah* in 1983 (ALFI, 2017). This demonstrates the will of Luxembourg to be an active actor in the development of

Islamic finance. “As the world’s second largest global center for funds and host of the world’s leading securities exchange, Luxembourg is today a key center for the development of Islamic finance in Europe,” said Tom Theobald, Deputy Director General of Luxembourg for Finance (LFF). Unfortunately, Islamic finance is not prominent in the financial and banking landscape. Euris group tried to start Islamic banking in Luxembourg in 2013 but without success. Thus, no Islamic bank is situated in Luxembourg and this situation is unlike that in the UK and in South Africa. Moreover, Islamic funds have increased slowly but the share of Islamic funds with respect to all funds is still close to zero (CSSF’s Statistics). This means there are some obstacles in their development.

Nevertheless, the spread of Islamic finance in western markets over the last few decades is significant and investors, financial institutions and regulators assume that Islamic finance can be viewed as an alternative form of investment. According to Ernst and Young, Islamic banking assets grew at an annual rate of 17.6% from 2009 to 2013 and the prospect of growth was about 19.7% for 2018. This shows the worldwide democratization of Islamic finance and investors’ acceptance of Islamic finance products.

The interest in Islamic finance industry is due to its growth potential and the financial centers across the world should support this alternative type of finance. As the largest host of Islamic funds in the euro area, Luxembourg is an active participant in the development of Islamic finance in western countries.

To conclude this short historical subsection, some results are highlighted for the Luxembourgian case. Firstly, it is clear that the financial services industry in Luxembourg is turning to Islamic finance as a way to diversify as well as to attract capital and products. Secondly, this increasing trend seems to be solid and in the financial landscape there is cohabitation between conventional finance instruments and Islamic finance instruments. However, an in-depth analysis of the size of Islamic finance is required to be completed. Section 3 provides details about the development of Islamic funds industry in Luxembourg. Thirdly, the development of Islamic finance is promising and innovative products are forthcoming within the Fintech framework, since Fintech is mostly utilized in Asia.

The second subsection is devoted to explicate precise Islamic principles within an epistemological framework in order to demonstrate that Islamic finance has common roots with several other schools of economic thought.

2.2 Islamic Finance and Major Economic Schools of Thought

This section is a very concise attempt to define Islamic finance within an epistemological framework and compare it to the main and famous economic schools of thought.

The term 'epistemology' is derived from two Greek words *epistēmē* (knowledge) and *logos* (reason). Epistemology is the philosophical study of the nature, origin, and limits of human knowledge. It is a branch of philosophy akin to metaphysics, logics and ethics. Epistemology is not a new science; it started with the ancient Greeks and has continued to the present day.

The epistemology of Islamic finance brings up several questions. The definition of Islamic finance crosses interdisciplinary boundaries. Several definitions exist including the definition for practitioners and the definition for theoreticians. The definition of Islamic finance for practitioners deals with all trading and finance operations in line with the *Shari'ah*. The theoretical approach is the object of this section.

Islamic finance is based on economic principles. It is not rational to consider Islamic finance only in religious perspective. Islamic finance takes into account a wider framework. This section tends to highlight the theoretical analysis of Islamic finance.

It is well accepted that the classical school of economics is totally embedded in the morality-ethics sphere. The origin of the classical school of thought is traceable to Adam Smith's work. Any school of thought takes into consideration three elements including an author, a book and disciples. Adam Smith, who is famous for his book *The Wealth of Nations* (1776), constructed his approach within the framework of Christian morality. This latter was developed in his first significant book *The Theory of Moral Sentiments* (1759). All principles defined in this earlier work were used in his second book (17 years later). "*The Theory of Moral Sentiments"* is a philosophical work. Adam Smith proposed, as a first step, a classification of virtues based on morality. At that time, moral principles were religious in character. His works take into account Hume's approach. Hume rejected prior works about moral philosophy. His was the famous Mechanism approach where men react as machines. "I make the supposition that the body is nothing else but a statue or an earthen machine, that God has willed to form entire, in order to make it as similar to us as is possible… We see clocks, artificial fountains, mills, and other similar machines, which, being only made by men, nevertheless do not lack the force to move themselves in several diverse means. And it seems to me that I could not imagine as many kinds of movements in the latter as I suppose to be made by the hand of God, nor attribute to him only so much craftsmanship as we could think of" (Descartes, 1664). During the same period, some theoretical movements described man as depraved due to the original sin (Jansentism school of thought).

Moral philosophy is concerned with three issues. The first is the selfish hypothesis. All human actions are expressions of private interests. The second issue is moral judgment and the third issue is the character of virtue. The first issue is a part of the Mechanism approach. The second rejects the Jansentist idea about the depraved nature of men. Indeed, moral judgment takes into account passions and feelings. Both schools recognize them and have a common view on self-love. Among passions, self-love is the most forceful. It is the engine of all human actions and the chief source of human motivation for action (Mandeville, 1714). David Hume and Adam Smith rejected the idea of original sin and accepted the self-love hypothesis. According to Hume, men act selfishly but they are characterized by the will to live in a community. Smith wrote, "How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him." (*The Theory of Moral Sentiments*). For Smith, all human beings are "naturally attracted" to each other; they are unable to live alone because of the emotional faculty (sympathy). The ability to sympathize with our family or friends is not a virtue in the traditional sense. Indeed, the faculty of sympathy is a part and parcel of human beings. It is possible to rank sympathy. For instance, Smith and Hume assumed that sympathy is most naturally felt for our family and friends than for other persons. Nevertheless, they also supposed that the concept of morality has developed throughout the course of history. Moreover, this concept will continue to evolve through different periods and regions. To conclude this paragraph, we must bear in mind that the conventional economic epistemology has its roots in Adam Smith's work. It has been ignored for centuries that the epistemological framework is embedded in a moral and ethical system. This latter was largely described in Adam Smith's previous book titled "*The Theory of Moral Sentiments*" which was published a decade and half before his emblematic book of 1776 titled "*An Inquiry into the Nature and Causes of the Wealth of Nations*", more commonly known as *"The Wealth of Nations".*

The era of Karl Marx (1848-1885) was characterized by the decline of the 'Golden Age'. There was an increase in poverty among workers and capitalism was perceived as the origin and cause of this situation. Marxist school of thought assumes that there is a struggle between the master and the servant in each historical period. Moreover, history affects the economic environment. *The Communist Manifesto* was published in 1848 and it marks the starting point of the revolution (Marx, Engels, Moore & McLellan, 1992). The works of Karl Marx strived to demonstrate how the capitalist system will destroy itself since this system is full of contradictions. Despite the novelty of Marx's approach, the role of money in the economy is not clear and some parts of his work on monetary analysis are insufficient. This is not surprising since the Marxist framework was real. The aim of Karl Marx was to describe that the capitalist production system is destined to disappear because of its perpetual and infinite will to increase profit. Most of Marx's principles are real and do not require money as a good kept for itself. They facilitate transactions. It is for sure that there is a monetary vision in Marx's approach but it seems to be a draft. The study of Marx leaves the reader a bit frustrated because of the omission of money as a precautionary or speculative tool. He defined money as money-good. This approach is not the best way to define the value of money. Money is a multifaceted variable. Karl Marx neglected the role of hoarding and this is one of the limits of his work. Therefore, his conception of money narrows the scope of his monetary theory. Indeed, the notion of money-good is defined by the following relationships (it should be remembered that during this period money was based on gold). For the n-1 good producers the relation is G-M-G (Good-Money-Good), whereas for the gold money producer the relation is M-G-M. Marx assumed that the variable M is equal at the beginning and at the end of the relation. This assumption shows at the outset the drawbacks of the monetary analysis since money has no value, which is not the case in the monetary sphere. This money vision excluded the de facto role of hoarding. The value of money is measured by the interest rate. To converge towards Islamic finance, one may suppose that the interest rate is null in Marx's works. The latter introduced many points close to Islamic finance. They both try to define fair price and exclude the exploitation of the labor force. The weakness of the Marxian monetary theory is well-known and it has generated several debates about the role of money in the economy. The Keynesian approach provided for a great improvement in the money theory. The historical context explains the development of money and finance approaches. It should be noted that each financial crisis contributed in improving the monetary knowledge.

Several economists (orthodox, classic or neo-classic) believe that the main role of the banking system is to be an intermediary between borrowers and savers. To be precise, saving is required to finance investments, loans are based on deposits and the natural price of money. The intersection of demand and supply defines the equilibrium solution (interest rate) for the money market. Some economists reject this approach and try to define another paradigm for the monetary theory. One can cite John Law. The latter wrote the best known work *Money and Trade Considered with a Proposal for Supplying the Nation with Money* (1705). John Law was from the business and banking sectors. He was also familiar with mathematics, politics and commerce. The principles defined in his works were applied in France since it was highly indebted in 1716. His works converged towards the mercantilist school of thought in the sense that money was regarded as an economic engine but it differed with reference to the role of central banks. Indeed, according to this author the main role of central banks is to produce money.

Some economists reject the classical approach of market economy. Among them, there is John Maynard Keynes. His masterpiece *The General Theory of Employment, Interest, and Money* was published in 1936. To sum up, the novelty was the introduction of short-term analysis and the role of anticipations. For Keynes, private banks are not intermediaries for agents. Savings are not deposits and do not finance investments. The banks do not transfer deposits towards investments; they do not use their reserves. Banks create money from nothing. Indeed, bank credit is based on the promise of repayment. This latter does not create any wealth or economic growth. Credit increases the purchasing power and bank loans issued by commercial bankers give birth to deposits.

Interest rate plays an important role in Keynes' works. Indeed, this pivotal variable contributes to the financial health and economic stability of a society. According to Keynes, employment and production levels depend largely on interest rate. A high rate has negative impacts on firms, investments and debts. It dampens the economic outlook. Whereas a low interest rate boosts the economy. Nevertheless, due to a very low interest rate liquidity trap appears. This situation means that agents have an absolute preference for liquidity. It should be noted that interest is the price paid on borrowed funds. Most of the agents prefer to keep cash rather than investing cash in risky assets (risk adverse behavior). There is a preference for liquid cash because it is a safe asset. Interest is the reward of renouncing liquidity. Nevertheless, some extreme cases deserve to be analyzed. One example is the nullity of the interest rate. This question is very interesting for the recent period with the current monetary policy implemented by central banks since the crisis of 2007. There is a strong parallel between the analysis of the Great Depression of the 1930s and post-2008 global financial crisis. Keynes proposed some unconventional policies such as keeping the interest rate close to zero or equal to zero (1936). Unfortunately, he did not succeed in convincing the governments to apply such unconventional policies which is not the scenario, currently. One of the main attributes of Islamic finance is to propose credit without interest rate. The aim of this practice is based on an idea of fairness between borrowers and lenders. Indeed, according to Islamic finance the risks of losses and gains have to be shared between agents.

The description of the main schools of thought demonstrates that Islamic finance is fully embedded in a moral and ethical paradigm known as the classical approach. Nevertheless, other approaches such as Marxism and Keynesianism, which are liberated from any religious or moral percepts, have also some similarities with Islamic finance. The above subsection is not exhaustive and may lead to further developments later in a book format.

To conclude, since Islamic finance follows the great principles of economic theory and of ethics, it should be treated as any other type of finance. The recent trend of Islamic finance shows that it may join conventional finance as a means to diversify its investment portfolio.

3. The Worth of Islamic Fund Industry in Luxembourg

After describing Islamic principles based on an epistemological approach, the following subsections are devoted to present the historical background of Islamic finance and its place in the financial landscape of Luxembourg.

3.1 Historical Background

Islamic finance has grown rapidly in Western Europe and particularly in Luxembourg since 1978. The expansion of Islamic finance in Luxembourg is related to the government's willingness to offer the best environment to Islamic finance (Association of the Luxembourg Fund Industry (ALFI, 2017)).

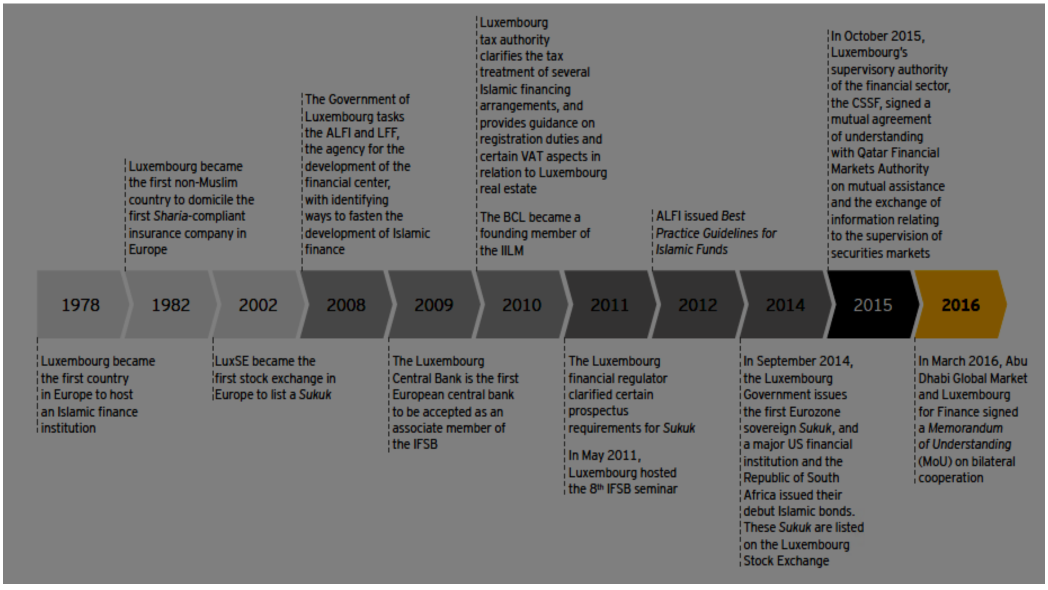

Figure 1. History of Islamic finance in Luxembourg, source: ALFI, 2017

Figure 1 presents the main steps taken for the development of Islamic finance in Luxembourg. Since 1978, Luxembourg has played an important role in promoting the development of *Sukuk*. It is the first European country to be the member of the International Islamic Liquidity Management (IILM). The Central Bank of Luxembourg was also the first European central bank to be the member of the Islamic Financial Services Board (IFSB). These institutions are the corner stone of Islamic finance. In 2008, the Association of the Luxembourg Fund Industry (ALFI) created a working group to analyze the Islamic fund potential and concluded that the fund market can offer Islamic finance a strong platform. ALFI produced several documents to describe the *Shari'ah* principles and to define the best practices for Islamic finance. Moreover, Luxembourg for Finance created a task force to explore the way for the Islamic fund industry so that it may use optimally the financial opportunities available in Luxembourg.

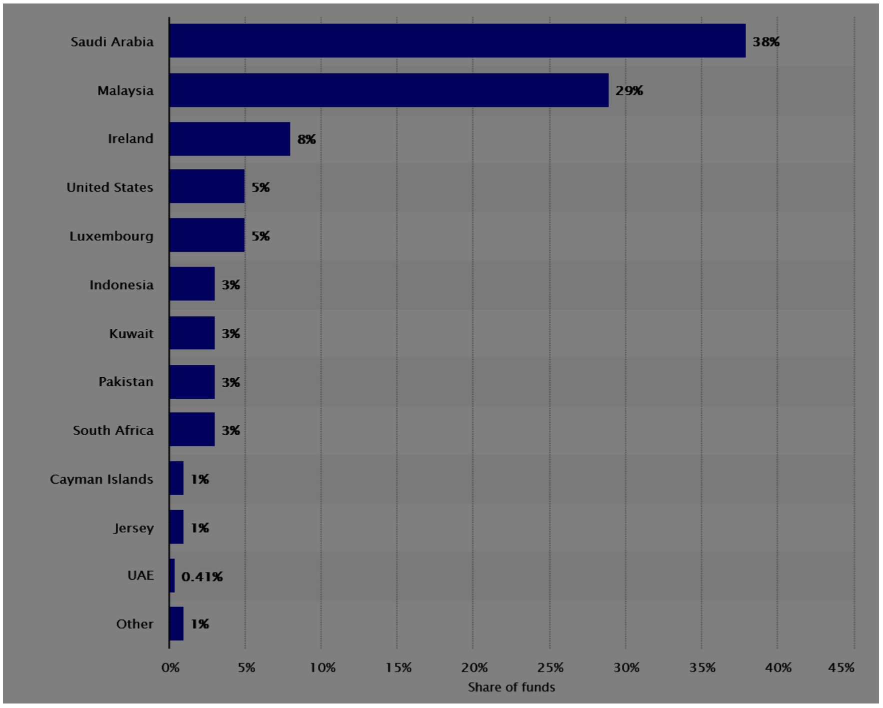

Figure 2. Distribution of global Islamic fund assets in 2016, by domicile, source: Statista, 2016

Indeed, over the years, there have been several government actions intended to reinforce the idea that Islamic finance may be viewed as a financial product similar to other conventional financial products. One of the most important steps in this regard was taken in 2014, namely the debts funding. Indeed, the Luxembourgian public debts peaked at 7.482 billion euros. In 2016, there was a fall in public debts. Within this period, there were four bank loans contracted to Spuerkeess at interest rates ranging from 4.318% to 4.935%. These loans expired either in 2017 or in 2018. The government also contracted an institutional loan in *Sukuk* (the equivalent of bonds in Islamic finance) of 200 million euros. The sum of all these loans represents 832 million euros; therefore, 24% of the debt are *Sukuk*. This action is a strong gesture towards Islamic finance.

Besides, owing to the flexibility of the Luxembourgian financial space, the country is now a hub for the *Shari'ah* compliant investment funds. A geographic comparison shows that Luxembourg is ranked at level 5, which is significant.

3.2 Characteristics and Perspectives

This last introductive section describes in detail the proportions of various Islamic financial instruments in Malaysia and in Luxembourg. Malaysia may be the best illustration for Islamic finance (see Section 2). The comparison with Luxembourg is interesting.

As already mentioned, to understand Islamic finance it may be useful to compare it to conventional finance and/or green finance. Indeed, some interesting findings deserve to be noticed when there is a comparison made with the conventional index. Since 2008, there has been a common trend for the volatilities of indices. This may be explained by the openness of the countries since the advent of financial globalization.

The comparison of the green index and the Islamic index shows that there is some similitude between them. Green finance is dedicated to renewable energy, environmental products, and policies that promote sustainable development. Both types of finances have increased significantly especially during the last two decades. The analyses based on regions demonstrate that Islamic finance is different. Indeed, in Luxembourg only Islamic funds have developed which is not the case in the United Kingdom, for instance.

The comparison with other countries shows that there are different schemes. Indeed, according to figure 3, growth in Islamic finance is significantly based on *Murabaha* in Malaysia. However, in Luxembourg, there has been a considerable development of Islamic finance in funds' industry (*Sukuk*). This kind of financial product is a real opportunity for the western countries. Moreover, it is also an excellent sopportunity for developing green finance. Indeed, Islamic principles exhort people to take care of the planet.

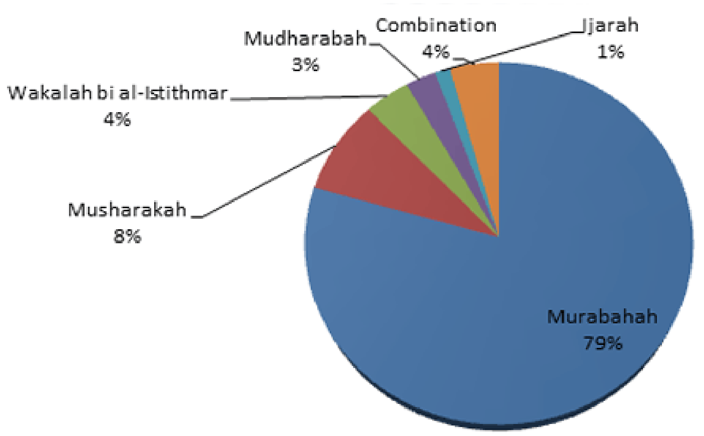

Figure 3. Proportions of Islamic financial instruments, source: Malaysia securities commission

With the growing interest in sustainable finance and green investment products, the importance of green finance and its significance for a more sustainable world has initiated important debates all over the world. In Luxembourg, the Climate Finance Task Force was created in 2015. It aims at monitoring and proposing solutions to economic actors. The main mission of this task force is to inform government on climate change and the arsenal needed to tackle this problem. Luxembourg is a leader in the development of green financial services and products and plays an important role in this sector (ALFI, 2017). According to Steven Libby, "*green financial went from a niche to a substantial market, with Luxembourg on the front seat. As the global financial industry awaked for the importance of sustainable services, in 2017, the global green bond market surpassed USD 150bn of annual issuance*."

This trend seems to be solid since green bonds also grow rapidly and green instruments may become more and more popular (Luxembourg Bankers Association (ABBL)). Islamic finance should be used to develop these sectors actively and to invest in the protection of the planet. This orientation may diversify green financial products. It may also bring a breath of fresh air to Islamic finance.

3.3 The Place of *Sukuk* in Luxembourg's Financial Landscape

According to the CSSF (Commission de Surveillance du Secteur Financier), "the legal and regulatory framework governing the Luxembourg financial sector is designed to be able to host actors and products from diverse traditions and cultures."

Islamic finance is based on a specific framework which defines its scope. The laws of February 13, 2007 and December 17, 2010 describe in detail the legal background.

The aim of this section is to show the active role of Luxembourg in the promotion of alternative ethical financial products. As already indicated, Luxembourg is a country that is open to financial innovations and is ready to create the enabling environment for any dynamic and ethical projects in finance. The most illustrative example is the securitization process of *Sukuk* issued by the Luxembourgian government. Figure 4 presents the mechanism of such a financial operation.

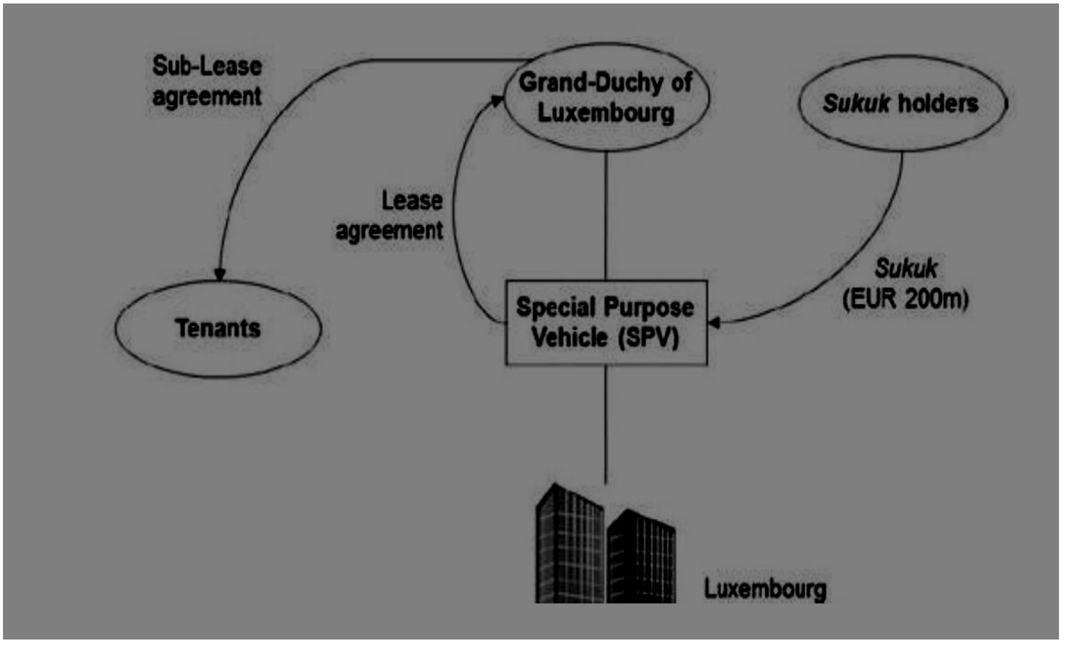

Figure 4. Sukuk and Luxembourgian public debts**,** source: sheila ainon yussof and razali haron, (2017) Q4.

For *Sukuk* operations, the government held two towers (Tower A and Tower B) in Kirchberg and a building named Gutenberg in Strassen and sold them to Luxembourg Treasury Securities SA in 2014. This entity was created on July 23, 2014. The principal aim of this entity is to provide financing to the government of the Grand Duchy of Luxembourg. The unique shareholder is the state. Therefore, to achieve the above goal, the entity raises funds by issuing financial instruments in the form of trust certificates (*Sukuk)*. The principal activity of Luxembourg Treasury Securities SA is to acquire real estate from the government using the proceeds received from the issuance of trust certificates. The second possibility is to enter into a lease contract with respect to the real estate asset so acquired and the disposal of real estate assets back to the government pursuant to a purchase undertaking or a similar arrangement. The third option is to act as the agent or trustee of the holders of the trust certificates and to hold real estate assets for the benefit of these holders. Of course, the list of instruments is not limited and can be expanded (ALFI, 2017). *Sukuk* has invested €200 million in the Special Purpose Vehicle (SPV). Later, it will receive the value back at maturity, that is, when the state will buy back the properties from the entity. *Sukuk* will receive a rental income based on a benchmark-linked profit (0.436%). They have a long investment period (5 years in this specific case, maturity: October 07, 2019).

The second example is the introduction of Islamic funds in Luxembourg. Indeed, Luxembourg hosted the first "Islamic" fund in Europe; it was also the first experience of an Islamic fund in a non-Muslim country. The first Luxembourg domiciled "Islamic" funds were launched in the early 1990s.

According to CSSF, the number of *Sukuk* is about 58 and €4.88 billion worth of assets are under management for the period December 2017. The total net asset value is about €4.15 billion. The leading funds are HSBC Islamic Funds and SEDCO Capital Funds. They represent more than 50% of the net asset value (December 2017). This kind of financial asset can be invested in funds or in securitization vehicles. The two figures given below (Figure 5 and Figure 6) describe schematically the mechanism of an Islamic asset in Luxembourg. According to CSSF, specialized investment funds represent 45.5% of the total funds (March 2018). UCITS (Undertakings for Collective Investment in Transferable Securities) "Part I Fund" represents 54.5% of the total funds. Legally, most of funds are SICAV (*Société d'Investissement à Capital Variable*). They represent 93.2% of the total funds (March 2018). The rest of the sample comprises common funds.

These structures are common in Luxembourg and the number of Islamic assets is increasing. The success of Islamic finance in Luxembourg is attributable to the strategic openness of the country in dealing with specific financial services. Indeed, in 2017 ALFI published a document about "The best practice guidelines" for setting up and servicing Islamic investment funds. This document provided useful information about Islamic finance mechanisms. Moreover, the Luxembourg government promotes this kind of finance and does not hesitate to use Islamic finance for funding public debts in order to set an example for potential investors.

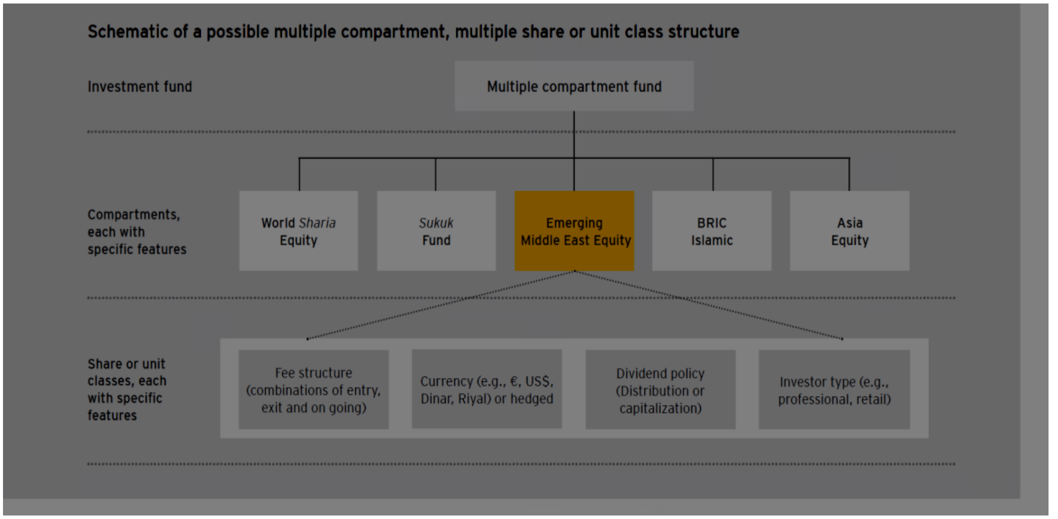

Figure 5. Structure of Islamic funds, source: ALFI, 2017

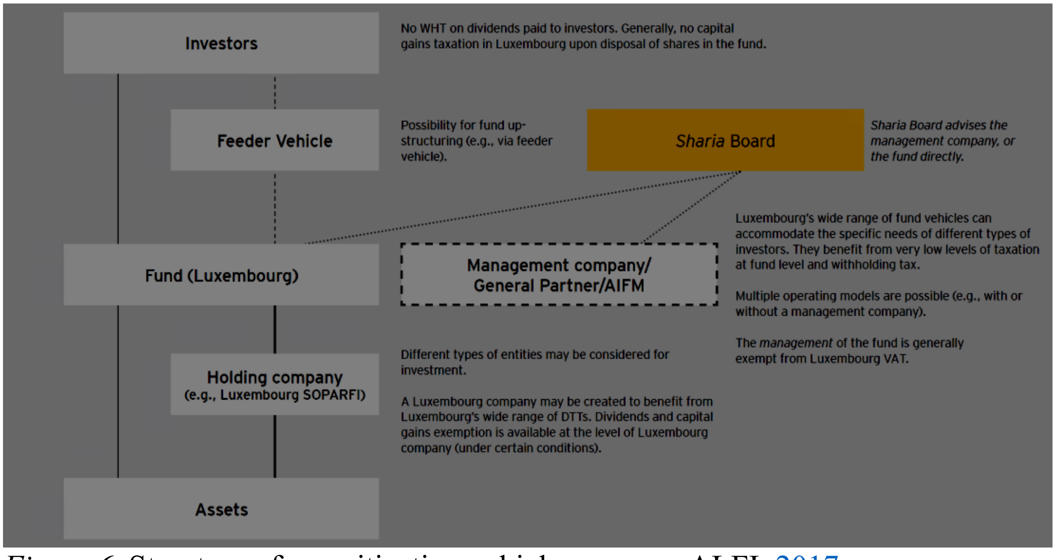

Figure 6. Structure of securitization vehicles, source: ALFI, 2017

4. Conclusion

Islamic finance is growing at a fast pace and it offers several financial services to the global financial industry. The relative spread of Islamic finance in the western world shows that investment actors, financial institutions and regulators consider Islamic finance as a better alternative to the conventional system. The difference between Islamic finance and conventional finance is the importance attached to the moral dimension in the former. Briefly, Islamic finance applies several principles. For instance, risks and profits have to be shared equally between the parties to a transaction to avoid any unfair situation. Therefore, it does not authorize speculation or uncertainty in transactions. Interest is banned since it is not acceptable to generate profit on physical money. Islamic finance does not invest in unethical activities prohibited by the *Shari'ah* principles (sale of alcohol, prostitution, weapons etc.). Lastly, transactions have to be asset-based or asset-backed. Islamic financial products are dedicated to the public and not only to Muslims. From a broader perspective, Islamic financial services are viewed as an alternative to the conventional financial products and are more and more perceived as a form of socially responsible and/or ethical investments.

Luxembourg is the first euro zone country to offer Islamic finance a suitable environment to develop. It should be noted that about 20% of the government debt is labelled as *Sukuk*. This is a good sign that demonstrates the will of the Luxembourgian government to perceive this kind of finance as an alternative to conventional finance. The current trend of Islamic finance in Luxembourg demonstrates that Islamic finance is an essential part of the financial landscape.

To conclude, Islamic finance provides opportunities and challenges for global financial stability. From the perspective of central bankers, Islamic finance is seemingly a complement of conventional banking and capital markets and not a substitute. *Shari'ah* compliant financial products should ensure the stability of the financial system through portfolio diversification. The next step is the shortcoming in standardization and liquidity management which must be resolved.

References

ALFI. (2017). *Islamic Fiance*. Retrieved from https://www.alfi.lu/getattachment/238f6e83-ce2d445fb23d8808e6942d9f/alfi-lff_brochure_islamic_finance.pdf

Ashfaq, A., Malik, M. I., & Humayoun, A. (2010). Banking developments in Pakistan: A journey from conventional to Islamic banking. *European Journal of Social Sciences*, *17*(1), 12-17.

Descartes, R. (1664). L'Homme, Paris. (In French.) Digitized photographic reproduction. Retrieved from https://www.biusante.parisdescartes.fr/sfhm/hsm/HSMx1987x021x004/HSMx1987x021 x004x0381.pdf

Iqbal, Z., & Mirakhor, A. (2013). *Economic development and Islamic finance* (Series on Directions in Development). Washington, DC: The World Bank.

Ghazanfar, S. M. (2000). The economic thought of Abu Hamid Al-Ghazali and St. Thomas Aquinas: Some comparative parallels and links. *History of Political Economy*, *32*(4), 857-888.

Ghazanfar, S. M. (2003). Review of Medieval Islamic economic thought: Filling the "Great Gap" in European economics. In S. M. Ghazanfar (Ed.), *Islamic Studies Series. London/New York:* Routledge/Curzon, 2003.

Keynes, J. M. (1936). *The general theory of employment: Interest and money*. London: Macmillan.

Kuran, T. (1997). Islamism and economics: Policy implications for a free society. In Sohrab Behdad & Farhad Nomani (Eds.), *Islam and Public Policy* (International Review of Comparative Public Policy, v. 9). Greenwich, Conn.: JAI Press.

Mandeville, B. (1714). *The fable of the bees, or, private vices, public benefits*, Oxford: Clarendon Press.

Marx, K., Engels, F., Moore, S., & McLellan, D. (1992). *The Communist manifesto.* Oxford: Oxford University Press.

Naqvi, S. N. H. (2003). *Perspectives on morality and human well-being: A contribution to Islamic economics*. Markfield, Leicestershire, U.K.: The Islamic Foundation.

Robbins, L. (1935). *An essay on the nature and significance of economic science*. London: MacMillan.

Smith, A. (1759). The theory of moral sentiments (v. 1). In W. B. Todd (Ed.), *The Glasgow Edition of the Works and Correspondence of Adam Smith.* Oxford: Clarendon Press.

Smith, A. (1776). An inquiry into the nature and causes of the wealth of nations. In W. B. Todd (Ed.), *The Glasgow Edition of the Works and Correspondence of Adam Smith.* Oxford: Clarendon Press.

Van der Wee, H. (2000). *European banking in the middle ages and early modern times (476–1789)*. In H. Van der Wee, & G. Kurgan-van Hentenryk. (Eds.). *A History of European Banking* (2nd ed). Antwerp, Belgium: Mercator.

Yussof, S. A., & Haron, R. (2017). The ASEAN market: Cross-Border collaboration in Islamic Finance between Malaysia and Thailand. *Islamic Banking and Finance Review*, *4*, 21–39.

Appendix

Table 1

Summary of Structures Commonly used for Islamic Finance

	UCITS and UCI	SIF	SICAR
	Undertakings for Collective Investment in (Transferable Securities)	Specialised Investment Fund	Investment Company in Risk Capital
Applicable regulation (see glossary for full legal reference)	2010 UCI Law Part I (UCITS) and Part II (UCI), respectively, as amended	2007 SIF Law, as amended	2004 SICAR Law, as amended
Supervision by the CSSF	Yes	Yes	Yes
Eligible assets	Restricted for UCITS. Flexible for UCI.	Unrestricted	Unrestricted, as long as in risk capital
Risk diversification rules	Yes	Limited	No
Eligible investors	All types	Well-informed investors	Well-informed investors
Tax treatment	No tax except for an annual subscription tax of 0.05% on the Net Asset Value (reduced rate or exemption available)	No tax except for an annual subscription tax of 0.01% on the Net Asset Value, except if exempt	Corporation taxes at a combined rate of 27,08%[7] but full tax exemption on income from securities invested in venture capital
Required service providers	Auditor, Administrator, Central depository	Auditor, Administrator, Central depository	Auditor, Administrator, Central depository
Practical application for shariah compliant products	To be reviewed on a case by case basis	No limitation	No limitation
Benefit from tax treaties	Yes if in the form of a SICAV[8]	Yes if in the form of SICAV[8]	Yes[8]
EU passport	Yes[9]	Yes[10]	Yes[10]

RAIF	Securitisation Vehicle	SOPARFI	SPF
Reserved Alternative Investment Fund	Vehicles for Securitisation Transactions	Company dedicated to holding, managing and financing subsidiaries	Family wealth management company for the holding of financial assets
2016 RAIF Law	2004 Securitisation Law, as amended	1915 Companies Law, as amended	2007 Law on SPF
No	No[11]	No	No
Unrestricted	Unrestricted	Unrestricted	Financial assets
Limited	No	No	No
Well-informed investors	Unrestricted	Unrestricted	Individuals and their intermediaries
Follows SIF or SICAR tax treatment (if invested in risk capital).	Corporation taxes at a combined rate of 27,08%[7], but any distributions made or declared to be made to investors are tax deductible	Corporation taxes at a combined rate of 29.22%. Net worth tax at 0.5%	No corp. tax unless 5%+ of dividends received from companies not subject to the equivalent of Lux corporate tax. Annual subscription tax of 0.25% with a maximum of EUR125,000
Auditor, Administrator, Central depository	Auditor	Auditor	Domiciliation agent and/or auditor
No limitation	No limitation	No limitation	No limitation
Yes, if in the form of a SICAV	Yes[8]	Yes[8]	No
Yes	No[12]	Yes[10]	No

Source: ALFI, 2017