

**Conference by the  
University of Luxembourg &  
Luxembourg for Finance**

**Malaysia- Luxembourg: A bridge for Islamic finance  
Luxembourg, 24th February 2010**

Speech & presentation prepared by Mr. Elie Flatter, Economist  
Prudential Supervision Department – Liquidity Surveillance  
Banque centrale du Luxembourg

Check against delivery

Disclaimer:

The views expressed in this paper are personal opinions of the author and do not necessarily reflect those of the Banque centrale du Luxembourg.

## Malaysia - Luxembourg: A bridge for Islamic finance



Distinguished guests,

Friends and colleagues,

Ladies and gentlemen,

It is an honour for me to join you for this conference and to speak to you.

I would first like to congratulate Professor Prüm, Dean of the University of Luxembourg as well as Luxembourg For Finance for organizing this event and to thank them for inviting me to present the involvement and the contribution of the BCL in the development of Islamic finance in Luxembourg.

My name is Elie Flatter and I am part of the team in charge of supervising the liquidity situation of various stakeholders of the Luxembourg financial system. Prior to joining the BCL, I have 4+ years of business advisory experience with Ernst & Young, managing project related to Islamic finance. This is the reason why Governor Mersch mandated me to coordinate the efforts of the BCL with respect to Islamic finance.

## Developing Islamic finance: a shared ambition

### Agenda

- ❑ Preliminary remarks – the BCL's mission
- ❑ The rationale behind the BCL's involvement in Islamic Finance
- ❑ The BCL's vision and role
- ❑ The BCL's implementation plan

This is the agenda of the different topics I would like to cover with you: starting from the role of the BCL, I would like to present the reasons behind the BCL's interest in Islamic finance, our vision and how the BCL intends to proceed.

## Developing Islamic finance: a shared ambition

### Preliminary remarks – the BCL's mission

#### The BCL

- Is independent
- But has (nevertheless) a keen interest in the enhancement and soundness of the financial centre
- Focuses on the stability of the financial system
- Welcomes market innovations and significant developments

Ladies and gentlemen, let me first remind you the mission of the BCL.

Like any national central bank of the Eurosystem, the BCL is by essence independent

One of the main tasks of the BCL is to ensure the stability of the financial system. To the extent that Islamic finance is an emerging player in international finance, the BCL, as many other central banks, has to focus on the implications for safety and soundness of institutions engaging in Islamic finance and ultimately on their potential risk for the banking system.

As a result, while public authorities are committed to adapt and to accommodate for Islamic finance within the European regulatory framework, it is crucial to continuously ensure a level playing field between various forms of finance (as highlighted by the previous speaker, the tax neutrality principles recently enacted by the Luxembourg Administration are a typical example of regulation pertaining to establishing a level playing field)

One needs also to keep in mind that ensuring a level playing field also involves requiring from the Islamic financial institutions the same high licensing and supervisory standards to those expected from conventional ones. This development of the financial sector is to be welcomed, but without compromising its soundness.

## Developing Islamic finance: a shared ambition

### The rationale for the BCL's involvement in Islamic Finance

- ❑ The regulatory framework that would allow the emergence and subsequently the supervision of Islamic financial institutions is not yet as robust and sophisticated as the one prevailing for conventional counterparts.
- ❑ A central bank's role in liquidity surveillance and management leads the BCL to analyse the functioning of Islamic monetary instruments as well as the dealings performed between the different market participants in a Shari'ah compliant manner

In various conferences and interviews, Governor Mersch has mentioned the merits of Islamic finance: Beyond the diversification effect, Islamic finance contributes to the reduction of the financial risk in the economy through its alignment with the productive and real economy, its prohibition of leveraged activities, its principles of justice and participation. As such, we think that Islamic finance is likely to contribute to our objective of ensuring financial stability.

The second reason why the BCL is interested in Islamic finance is the significant potential and prospect this type of finance has in Europe; the BCL cannot stay aside of such a major financial innovation that unavoidably will become a more prominent feature of the financial system.

Despite this, the regulatory framework that would allow a sustainable development of Islamic financial institutions and its prudential supervision is not as robust as the one prevailing for the conventional financial institutions.

Last but not least, our role in the financial system is twofold: on the one hand to supervise the liquidity situation of the market participants and on the other hand to provide liquidity to and absorb liquidity from them as and when required. Regardless of our level of intervention, the BCL needs to analyze the functioning of Islamic financial markets and their instruments and the potential challenges that may arise when introducing Islamic financial services into the Luxembourg framework.

## Developing Islamic finance: a shared ambition

### The BCL's vision and role

- ❑ The law of October 2008 gives the BCL specific responsibilities in the area of the supervision of the financial institutions' liquidity.
- ❑ The decision to become a member of the IFSB is of a strategic nature. It will allow the BCL to familiarise itself with the activities of Islamic banks and their specific supervision requirements.
- ❑ The BCL will contribute to the nation-wide effort of turning Luxembourg into a major centre for Islamic finance.

The law of 2008 provides the BCL with an enlarged scope of responsibility in the area of the supervision of the financial institutions' liquidity. Financial institutions is to be understood in a broad sense encompassing the various actors of the financial sector, e.g. banks, insurances companies, investment funds etc. The existing Islamic stakeholders of the Luxembourg financial market are 1 Takaful and nearly 40 Investment funds.

As you know, the BCL hosted the first European Seminar on Islamic Finance with the IFSB in 2005. Since then, the BCL has deepened its involvement in the Islamic financial sphere, participating to various conferences and in January this year, the BCL has been accepted as member of the IFSB. This strategic adhesion to the international standard setting authority for Islamic finance will allow the BCL to familiarise itself with the activities of Islamic banks and their specific supervision requirements.

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 of 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 to meet liquidity standards than their conventional counterparts.

Their activities turn to be less profitable and less competitive compared to those of their conventional counterparts 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 cost-efficient choices not merely 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.

## Developing Islamic finance: a shared ambition

### BCL's implementation plan

- ❑ Study visits to central banks where modern and efficient dual financial systems coexist so that the BCL gains experience in supervisory practices specifically for Islamic financial institutions.
- ❑ Identification of instruments, practices and solutions for managing liquidity in a Shari'ah compliant manner
- ❑ Participation in the IFSB working group entrusted with the task of preparing Guiding Principles on Liquidity Risk Management

The BCL would like to learn from example of central banks having developed successful Islamic financial markets. The BCL is in the process of reviewing various frameworks related to Islamic liquidity management and supervision.

Some jurisdictions have an Islamic liquidity management framework that exists in parallel to their conventional framework, while others, like the UK, have accommodated both Islamic and conventional banking within a common framework.

The BCL started analyzing the examples of Malaysia and of Bahrain in order to identify instruments, practices and solutions for supervising and managing liquidity in a Shari'ah compliant manner.

The BCL is participating in the IFSB standard setting working group on Liquidity Risk Management, as well as in a task force related to the supervision of Takaful. These cooperation initiatives among regulators augur well for the future development of Islamic financing. Strong legal and supervisory frameworks provide certainty among market participants (Islamic as well as conventional financial institutions as well as their customers) which is a key ingredient of a sustainable growth.

## Developing Islamic finance: a shared ambition

### Questions



Many thanks  
for  
your kind attention

7

With this I finished my presentation, I would of course be happy to answer your questions.

Thank you.