

# THE CURRENT SITUATION OF DEVELOPMENT OF ISLAMIC FINANCE AND ITS POTENTIAL FOR FUTURE

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# THE CURRENT SITUATION OF DEVELOPMENT OF ISLAMIC FINANCE AND ITS POTENTIAL FOR FUTURE

## Introduction

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- Reasons for France's interest in Islamic Finance
  - Immediate short-term reasons: need for liquidity
  - Long-term reasons: interest for an alternative participating finance
  
- France: a *Sharia*-friendly legal and tax environment
  - Common principles
  - Adequate general legal structures
  - Dedicated law and regulations
    - Mutual funds
    - *Sukuk*
    - *Murabaha* transactions
    - *Ijara* transactions
    - *Istisna'a* transactions
  
- Practical implementations
  - Financing public authorities (State and local authorities) and State-owned companies projects
  - Financing of assets owned by public authorities (State, local authorities) and by State-owned companies
  - Equity contribution into innovative SME
  - Financing projects developed into the Euromed
  - Real-estate financing and remunerated savings accounts for individuals

# REASONS FOR FRANCE' S INTEREST IN ISLAMIC FINANCE

## Immediate short-term reasons: need for liquidity

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- Financial market crisis: credit crunch and lack of liquidity to finance the French economy
  - Will the credit and bond markets return to normal reduce interest for Islamic finance?
  - Developing the idea of a Great Sukuk to finance capital expenditure of the State and local authorities without making worse the French State's national debt.



# REASONS FOR FRANCE' S INTEREST IN ISLAMIC FINANCE

## Long-term reasons: interest for an alternative participating finance

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- Integrating factor of a modern and moderated Islam: France concentrates the largest Muslim population in Europe (6 million)
  - 3 times bigger than Muslim population in the UK;
  - French secularism: neutrality of the State as regard to religions, without being atheistic.
- Islamic finance: an alternative ethical source of financing
  - Simplicity and practicality vs. unnecessary complexity;
  - Long-term financing: matching maturity of long-term investment;
  - Participative financing in the performance of the underlying assets: the financier acts as a partner of the company (higher remuneration) and the remuneration due by the company is only based on the cash-flows generated by the financed assets (lower risk);
  - Asset-based financing: financing based on tangible assets (project finance, shipping, car fleet, aircraft, goods, machinery) vs. financial assets (derivatives, CDO etc.), which limits the risk of bubbles and of excessive leverage;
  - Transparency: *Sharia*-compliance of the financing provided that the use of funds be *Sharia*-compliant itself.



# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Common principles




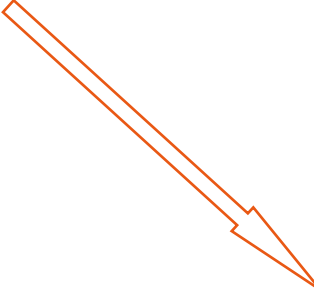
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- French and Islamic Laws: an analogous tradition sharing similar principles:
  - Prohibition of remuneration by the mere lapse of time: *Riba*;
  - Prohibition of speculation and uncertainty of situations: *Garhar, Maysir*;
  - Prohibition of investments into specific activities: *haram* activities.

# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Adequate general legal structures

- Existing legal structures suitable to Islamic finance concepts:

- Ijarah  Leasing regime applicable to moveable assets or real estate assets (*crédit-bail* regime of art. L.313-7 and seq.)
- Mudarabah  Participating loans (regime provided by articles L.313-13 and seq. of the French Monetary and Financial Code)
- Sukuk  Issue of bonds:
  - subordinated bonds (French Commercial Code, art. L. 228-97)
  - subordinated instruments (French Commercial Code, art. L. 228-37); and
  - ability to provide for an index-based remuneration (articles L. 112-2 and L. 112-3 of the French Monetary and Financial Code which allow for the indexation to the performance of the issuer of the interest paid to bondholders).

Implementation of a French equivalent to Anglo-saxon trust: ***Fiducie***.

- Outside these existing structures: freedom to contract subject to:

- Compliance with French rules of public order;
- Absence of tax discrepancy: conventional finance and Islamic finance need to be on an equal footing regarding tax law.

# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Dedicated law and regulations – Mutual funds

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- Mutual funds:
  - France: largest mutual fund industry in Europe;
  - All types of mutual funds are present:
    - Equity/ equity-indexed;
    - Debt/ debt-indexed;
    - Venture capital;
    - Real estate.
  - Recommendation of the AMF on 17 July 2007 authorizing mutual funds:
    - To have recourse to non-financial selection criteria (by developing, for example, index-based management on the basis of a *Sharia*-compliant index: Dow Jones Islamic Index, FTSE Islamic Global Index, S&P *Sharia* Index, etc.);
    - To clear the impure part of their dividends by making donations for the benefit of recognized public interest bodies (such as the *Institut du Monde Arabe*), up to a limit of 10%;
    - To have recourse to the services of a *Sharia* board, subject to the autonomy of the management company remaining intact.
  - Consequence: BNPP obtained approval for a *Sharia*-compliant fund in July 2007.

# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Dedicated law and regulations - *Sukuk*

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- Sukuk:
  - Recommendation of the AMF on 2 July 2008 for listing of the *Sukuk* on Euronext Paris:
    - Sukuk are assimilated to debt instruments and not equity;
    - Acknowledges that *Sukuk* issues may be structured either:
      - as asset-backed or;
      - as asset-based.
    - Provides information on level of disclosure to be set out in offering circulars.



# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Dedicated law and regulations - *Sukuk*

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- Tax treatment of *Sukuk* transactions and assimilated debt instruments such as indexed loans or bonds (Tax ruling of 25 February 2009):
  - Remuneration under *Sukuk* is assimilated to that of debt instruments for tax purposes:
    - is deductible from the taxable result of the SPV under similar conditions than interests; and
    - is exempted from withholding tax when paid to non French tax residents.
  - *Sukuk* are assimilated to debt instruments for tax purposes provided that they comply with the following requirements:
    - *Sukuk* must rank senior to any shareholders of the SPV;
    - *Sukuk* must not entitle the holders to any shareholders rights like voting rights in the SPV, right to liquidation surplus etc.;
    - Remuneration under *Sukuk* must be based on the assets' performance or on the results of the SPV and must be subject to a predetermined cap (Euribor, Libor), plus margin;
    - *Sukuk* must be redeemed at par or less (in case of sub-performance of the assets) but not more than at par.
- On 2 July 2009, NYSE-Euronext issued a practical guide establishing conditions of *Sukuk* listing on Euronext Paris.
- Remaining issue: the legal regime of *Sukuk* issuance under French law:
  - Setting up of a new specific legal regime or combining existing tools (securitization and *fiducie*, contractual mutual funds)?

# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Dedicated law and regulations – *Murabaha* transactions

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- No immediate taxation of the *Murabaha* profit (Tax ruling of 25 February 2009)
  - Assimilation of *Murabaha* profit realized by the SPV (financier) to interest payments and therefore taxation of such profit on an accrual basis over the life of the transaction, provided that :
    - the *Murabaha* contract provides that the asset is acquired by the SPV with the intention to retransfer it to the investor within a short period of time not exceeding 6 months;
    - the *Murabaha* contract mentions (i) the acquisition price by the SPV; (ii) the acquisition price by the investor; (iii) the distinction between the *Murabaha* profit corresponding to the remuneration for the purchase price being payable over the time and the consideration of the SPV for the intermediation service it provides. The *Murabaha* profit must be spread over the life of the agreement on a straight-line basis for accounting and tax purposes.
- Absence of withholding tax

If the SPV is not a French tax resident, *Murabaha* profit paid by a legal entity which is tax resident of France is exempted from withholding tax.

# FRANCE: A *SHARIA*-FRIENDLY LEGAL AND TAX ENVIRONMENT

## Dedicated law and regulations – *Murabaha* transactions

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- *Murabaha* over property:

The SPV may opt for the application of the real-estate dealer regime under which the acquisition by the SPV of the real estate is subject to reduced registration duties at a global rate of 0.815% (instead of 5.09%). The subsequent sale of the real estate by the SPV to the investor is subject to VAT on the margin generated by the SPV.

- *Murabaha* over shares in a property company:

Under the real-estate dealer regime, the acquisition of shares in real-estate companies by the SPV would not be subject to registration duties (instead of 5%). Only the subsequent sale to the investor would be taxable under the standard rules.



## FRANCE: A SHARIA-FRIENDLY LEGAL AND TAX ENVIRONMENT

### Dedicated law and regulations – *Ijara* and *Istina'a* transactions

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- Tax ruling is under preparation by the Ministry of Finance with respect to the tax treatment of *Ijara* transactions (rental, leasing, hire purchase) and *Istisna'a* transactions (equivalent to sale of property for future completion):
  - A useful clarification for project finance combining a construction phase (*Istisna'a*) and an operating phase (*Ijara*).



# PRACTICAL IMPLEMENTATIONS

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- Already relevant:
  - More than 2 Billion Euros of private real-estate financing since 2006;
  - 3 French Banks have Islamic windows in Gulf countries. 3 banks have been licensed in the UK and can offer Islamic products in France on the basis of the European passport;
  - The Scor owns a *Retakaful* reinsurance company in Malaysia.
  
- Financing of projects developed by public authorities (State and local authorities) and state-owned companies:
  - Highways;
  - Energy and sustainable development (utilities);
  - Grand Paris: 35 Billion Euros investment.



# PRACTICAL IMPLEMENTATIONS

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- Financing of assets owned by public authorities (State and local authorities) and state-owned companies:
  - Car fleet;
  - Real-estate;
  - French State commitment to buy 50,000 electric vehicles;
  - TGV trains;
  - Airbus.
  
- Equity contribution into innovative SME (70 clusters («*pôles de compétitivité* »))
  
- Financing projects developed into the Euromed
  
- Real-estate financing and remunerated savings accounts for individuals



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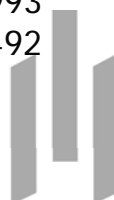
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