



LUXEMBOURG FINANCIAL SECTOR:
ADVANTAGES, EXPERTISE AND
OPPORTUNITIES IN THE CREATION
AND REGISTRATION OF MICROFINANCE
INVESTMENT FUNDS

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This study has substantially benefited from a number of contacts which we have been able to make with professionals working on a day-to-day basis in the microfinance and the microfinance investment fund sector: initiators and persons in charge of such funds; investment advisors; representatives of banks servicing such funds; consultants. Not all of them would wish to be named here and we have thus chosen not to name any of them. However, we wish to extend our warmest thanks to all of them.

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ADA (Appui au Développement Autonome) and ALFI (Association Luxembourgeoise des Fonds d’Investissement) have contributed to this study as advisors.

This document can be downloaded from www.microfinance2005.lu or www.attf.lu. Any comments can be sent to ATTF at contact@attf.lu.

Luxembourg Round Table on Microfinance

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CONTEXT AND OBJECTIVES

This study was sponsored by the Ministry of Finance through the “Luxembourg Round Table on Microfinance” set up within the framework of the United Nations year 2005 dedicated to micro-credit.

The work was conducted in parallel with another study aimed at proposing a quality label for microfinance investment funds. The overall objective of the two studies is to enhance Luxembourg as a domicile for microfinance investment funds, bearing in mind that microfinance has considerable development potential in the future.

Within the framework of this context, the study has a triple objective. It should provide answers to the following questions:

- What are the main reasons that investment funds in Microfinance are registered, or not, in Luxembourg?
- What are the advantages and the expertise offered today by the Luxembourg Financial Centre in this area?
- Which initiatives could be taken by the public and private sectors in order to boost the positioning of the Luxembourg Financial Centre in this area?

This study was presented during the Luxembourg Microfinance Week: Capital Markets – European Dialogue – Rural Finance, which was held from October 17th to 19th, 2005 in Luxembourg.

Luxembourg financial sector:
Advantages, expertise and opportunities in the creation and
registration of microfinance investment funds

EXECUTIVE SUMMARY

1. It is unanimously admitted, nowadays, that Microfinance constitutes a powerful tool to achieve poverty alleviation and economic and social progress, above all in developing countries.

As microfinance institutions based in developing countries mature and conduct their activity in a profitable manner, they are in need of supplementary financial resources, part of which are bound to originate from the financial sector of developed economies.

Microfinance investment funds play an increasing role in channelling such supplementary financial resources to microfinance institutions.

2. Generally speaking, Luxembourg offers an adequate legal, regulatory and fiscal framework for the incorporation of microfinance investment funds. The flexibility of the available legal vehicles, combined with a recognized regulatory framework and a favourable tax environment shape the Luxembourg financial sector's attractiveness. It further appears that service providers present in Luxembourg offer the skills which are required in order to respond to the somewhat specific needs of microfinance investment funds. Actually, the Luxembourg financial sector has already attracted several microfinance investment funds and a number of further projects are about to be launched.
3. Certain impeding – and potentially deterrent – factors do however exist and need to be addressed when it comes to defining initiatives aiming at rendering the Luxembourg financial centre even more attractive for this type of activity:
 - Both because microfinance investment funds are generally of limited size and because their profit margins remain modest, they are very cost sensitive, a factor which can handicap a financial centre with a developed regulatory framework generating, by definition, supplementary costs in setting up and running a fund.
 - Even though, at the end of the day, it represents only a rather limited financial burden for microfinance investment funds, the registration tax in place in Luxembourg is regularly put forward in all comparative studies when it comes to selecting the place for setting up an investment vehicle.
 - Because microfinance investment funds will not normally be in a position to qualify as UCITS and, as such, to benefit from a European passport, their distribution in foreign jurisdictions is subject to restrictions. Therefore, an incorporation in the main country of distribution may be preferred.
 - For funds with a geographical focus, it may be attractive to choose a place of incorporation located in the same region, notably where there exists a good regional network of double tax avoidance treaties.
4. It seems however that in most cases, these potentially deterrent factors are outweighed by the advantages which the Luxembourg financial centre is offering to those who want to set up a microfinance investment fund:
 - Not to speak about its overall reputation and the professionalism of its service providers with regard to investment funds generally speaking, the Luxembourg financial centre presently benefits from the fact that a number of investment vehicles dedicated to microfinance have already made their way to Luxembourg and, for that purpose, successfully passed the “test” of the regulator (“CSSF”) with, at the same time, investment managers specialised in microfinance being approved by the CSSF.
 - The broad range of investment vehicles provided for by the legal and regulatory framework, combined with the great flexibility offered by a number of these vehicles, notably when it comes to the definition of an investment policy, allow the Luxembourg financial centre to meet the somewhat specific needs of microfinance investment funds.
 - The major flexibility offered by the SICAR vehicle, just as the experience of Luxembourg service providers on certain matters which may be decisive for microfinance investment funds, provide considerable comparative advantages to the Luxembourg financial centre.
 - Further, and without prejudice to the above mentioned constraints regarding distribution, the fact that the Luxembourg financial centre provides for a recognised regulatory framework opens the door to the registration, and thus the distribution, of Luxembourg incorporated microfinance investment funds in other jurisdictions.

5. A number of measures, some of which are fiscal in nature while others aim at promoting the visibility of the sector, could further enhance the vocation of the Luxembourg financial sector to host microfinance investment funds.

Exempting this type of funds from the registration tax would be highly welcomed, both in as it would favour a type of funds which remains very cost sensitive and in as it would show the interest of the Luxembourg authorities in promoting this new market segment in Luxembourg.

On the other hand, there is need for the Luxembourg financial community to integrate its microfinance related activities into its overall communication and diversification policy. In this respect, the creation of a label for microfinance investment funds could be of particular interest.

In conclusion, a number of initiatives, certain of which are to be taken by the public authorities while others are to be taken by the financial community, should enable Luxembourg to confirm and to enhance its role as one of the major centres for the setting up of microfinance investment funds.

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1. SOME WORDS ABOUT MICROFINANCE

1.1. What microfinance is about

It is obviously impossible to, in the context of this study, enter into the details of microfinance.

In summary, microfinance originates in the finding that while a vast majority of the world's poor are deprived from any access to financial services, the fact to facilitate these persons' access to such services and in particular to microcredit, enables them to launch or further develop an economic activity and to thereby increase their revenue, their social situation and the educational level of their children.

Not only does microfinance enable its beneficiaries to improve their living conditions; it further allows them to become independent and to play their role as economic actors. It thereby enables people to regain dignity. Furthermore, at present, the majority of beneficiaries of microcredits are women and microfinance has shown to constitute a major tool in promoting women's rights.

While the present volume of microcredits has been evaluated at some 15 billion US dollars, the need for microcredits has been evaluated at no less than 100 billion US dollars²; some observers of the sector even put forward substantially higher figures.

While microfinance can promote altogether services, trade, production of manufactured goods and agriculture, it appears that the latter presently attracts the by far lesser part of microcredit, even though the vast majority of the world's poor make their living in agriculture. Agriculture thus represents a considerable growth potential for microfinance³.

While initially targeted mainly towards credit activities, microfinance can embrace, and indeed more and more embraces, other financial services such as savings, remittances and insurance.

1.2. Institutional aspects

At first sight, microfinance and investment funds would seem to be very far from each other. And indeed, microfinance institutions (MFIs) constitute an indispensable link between those two extremes. It is the MFIs which, in the field, grant microcredits and, possibly, render other financial service to their clients, the "micro-entrepreneurs".

While initially MFIs were mainly of an NGO-type with no commercial orientation, more and more of them achieve or aim at achieving profitability and adopt legal structures reflecting this evolution. This does not, by itself, mean that they depart from their original objectives, i.e. poverty alleviation and promotion of economical and social independence. It goes without saying, however, that sticking to such objectives needs to be monitored on a permanent basis.

As MFIs get more professional and profit-oriented, and as their business grows, they are in need of attracting supplementary funding. This is where investment funds can play their role in providing such supplementary funding to MFIs.

In her presentation at the recent international Paris Conference "*Broadening the access to microfinance. challenge and actors*", Mrs Maria Novak stated that "*The current portfolio of MFIs the world over is estimated at 15 billion dollars and the growth of microfinance at 15 to 30% a year, creating a demand for credit resources of about 2,5 to 5 billion dollars and 300 to 400 million dollars in additional equity capital a year*".

While part of these resources are and need to be local resources – more and more MFIs have turned towards collecting savings – another part is bound to come from abroad. This is where microfinance investment funds have an important role to play.

² Etude Brugger Duggal, «Micro Finance Investment Funds: Looking ahead», KfW Symposium November 2004.

³ Although, for a number of reasons (geographical remoteness of the beneficiaries; lower profit margins than in the trade sector; credit needs over longer periods combined with irregular cash flow) microfinance directed towards agricultural activities appears to be more difficult to be made profitable than microfinance directed towards trade activities in particular.

1.3. Limitations on microfinance

The enthusiasm about microfinance and its obvious merits must not lead to believe that microfinance alone will eradicate poverty and underdevelopment. In particular, microfinance does not dispose of the need for investing in education, health and infrastructure in developing countries. Similarly, microfinance does not dispose of the requirements of good governance, nor does it by itself resolve issues such as the terms of trade in North-South commerce. This is to say that while governments should promote microfinance where they can, microfinance will not dispense them from tackling other issues on their agenda.

Reminding that microfinance alone will not resolve the problems of poverty and social exclusion is by no means intended to minimise its merits and potential. Those merits and potential appear to be enormous and call for a reinforcement of microfinance related mechanisms and institutions. Here, microfinance investment funds have an important role to play.

2. AIMS OF THE STUDY

As defined by ATTF, the aims of this study consisted in the examination of the following issues:

- Which are the main reasons for which certain existing microfinance investment funds have been or have not been incorporated in Luxembourg?
- What can the Luxembourg financial center offer to an entity wishing to incorporate a microfinance investment fund? Which are the advantages and skills of which Luxembourg can presently prevail itself with regard to this market segment?
- Which orientations can and should be taken, at both a public and private level, in view of positioning the Luxembourg financial sector on the market segment of microfinance investment funds?

We however deemed it necessary to further get a feeling of the opportunities which the microfinance investment fund sector offers to the Luxembourg fund industry in particular and the Luxembourg financial centre at large.

3. THE CONTEXT: A SECTOR WITH SUBSTANTIAL GROWTH POTENTIAL IN THE MEDIUM TERM

3.1. While microcredit in particular and microfinance in general should not be viewed as a solution for all poverty related problems⁴, the merits of microcredit in reducing poverty and promoting social and economical development are presently undisputed. This is also the reason why the UN declared 2005 as the “International Year of Microfinance”.

3.2. Those who analyse the sector forecast that it will experience substantial growth over the next years .

On the one hand, the need for microcredit is unanimously viewed as being very important in volume⁵.

On the other hand, more and more MFIs succeed in conducting their activities in a profitable manner. As a result thereof, they gain the capacity to address the market in order to obtain the financial resources needed in order to expand their activities.

3.3. The emergence and consolidation of sufficiently mature MFIs constitute a prerequisite for the development of microfinance investment funds because it is (only) in such sufficiently mature MFIs that microfinance investment funds can invest their assets.

There is however an interaction here: less commercially oriented investment funds accept to provide MFIs with financial means and technical assistance enabling them to achieve the level of professionalism and profitability which is required in order for them to be in a position to address the ordinary capital market, and thus also more commercially oriented investment funds⁶.

3.4. Considering the foregoing, it is normal that while microfinance as such and MFIs have already experienced substantial growth, the microfinance investment fund sector remains relatively modest for the time being. This is so even more if one focusses on funds pursuing a predominantly commercial aim, i.e. funds which aim at procuring – apart from a social benefit – an attractive financial return to their investors⁷.

The market segment appears to be even narrower – at the time being – if one focuses on structures which are open to the public and which thus address the investment community at large and private persons in particular⁸.

Even though this is likely to change in the medium term, as the maturation process of a larger number of MFIs goes on, it furthermore seems that the identification of investment opportunities by microfinance investment funds often requires significant time. Launching a microfinance investment fund thus often requires a period of time during which the fund actually remains poorly invested in microfinance.

⁴ See above 1.3.

⁵ See above 1.1.

⁶ In his study «Microfinance Investment Funds», conducted for the Luxembourg NGO ADA and the German development Bank KfW and published in February 2005, Patrick Goodman classifies microfinance investment funds into three categories depending on their objectives, thereby distinguishing between «Commercial Microfinance Investment Funds», «Commercially oriented Microfinance Investment Funds» and «Microfinance Development Funds» (study, p.20). We shall revert in section 4 herebelow to this categorisation.

⁷ In his study, Goodman identified 43 funds in existence or about to be incorporated, including some 20 non commercial structures which he classifies among the «Microfinance Development Funds» and which are normally incorporated in the form of a foundation, a not-for-profit association or a co-operative structure.

⁸ In his study, Goodman identifies a little bit less than 10 structures which are open for investment coming from private persons (which does not mean that all of them may, legally speaking, be distributed to the public).

3.5. It appears that in general microfinance investment funds are of low size, often a size below the one commonly considered to be commercially critical, i.e. between 20 and 30 million EUR⁹. As for all funds of modest volume, this results in specific needs and constraints with regard to costs in particular.

3.6. It follows from all the above elements that the microfinance investment funds sector offers considerable growth perspectives, albeit these are middle term perspectives rather than short term perspectives.

Luxembourg has an obvious interest in positioning itself on this developing market segment even though, at this stage, the profits arising therefrom for the Luxembourg financial centre will remain modest. Strategy-wise this by the way fits with the ambition of the Luxembourg fund industry not to focus exclusively on UCITS funds.

An active involvement with the sector will also have a positive impact on the financial centre's image, showing its dedication to sustainable development related issues. It is an undisputed fact that there is increasing client demand for socially responsible investment products. Being able to satisfy such demand constitutes, and will constitute more and more, a competitive advantage for professionals of the financial sector wishing to meet the whole range of needs and demands of their clients.

⁹ It however appears that some commercial microfinance investment funds have, in recent times, experienced sustained growth as a result of which they substantially exceed these volumes. In particular, the Dexia Microcredit Debt Fund has now reached a volume of some 80 million Euros, whereas the responAbility Global Micro Finance Fund has achieved a volume of some 40 million Euros.

4. DEVELOPMENT ORIENTED AND COMMERCIALY ORIENTED MICROFINANCE INVESTMENT FUNDS: DISTINCTIVE AND COMMON FEATURES

4.1. Three types and generations of microfinance investment funds

In his study on “Microfinance Investment Funds”, Goodman notes that just as has been the case for MFIs, “*the first financial structures put in place in order to extend loans to MFIs were established by private donors and development agencies, again with a development objective in mind*” (p. 8). Goodman classifies vehicles of this type as “Microfinance Development Funds”, and out of some forty “funds” he identified in 2004, not less than twenty belonged to this category with most – but not all – of them being set up in the form of not-for-profit type structures.

In a second phase, vehicles have been put in place which, although initiated by development oriented entities (development banks and institutions; private foundations; NGOs ...), had among their objectives to provide a fair financial return to those funding them. Goodman classifies this type of funds as “Commercially oriented Investment Funds”. In order to be (legally) in a position to channel a return on investment to their founders, these entities opt for commercial type vehicles similar to those generally used for investment funds.

The third generation of funds identified by Goodman has been inaugurated in 1998, with the launch of the Dexia Micro-Credit Fund. These funds will be set up by actors coming from the “financial world” (banks, investment managers ...) rather than by actors coming from the “development world”. The objective of those setting up such funds is to enable their investor clients to participate in a project which is of interest not only for its financial return but also for its social return (“double bottom line”). In order to be in a position to be distributed among third party investors, these funds – which Goodman classifies as “Commercial Investment Funds” – will opt for legal vehicles enabling them to approach a larger range of investors.

4.2. Common requirements in terms of sustainability and quality

Whereas the differences between these three types of funds are undeniable (to an extent such that, for example, there will be hardly any reason for a “fund” of the first generation to turn towards Luxembourg as place of incorporation), the contrast with regard to their respective aims must not be exaggerated.

- As the sector becomes more and more professional, there seems to be unanimity about the fact that in order for microfinance to develop to an extent such that it can have a significant impact in terms of development and poverty alleviation, its sustainability in terms of profitability needs to be achieved at all levels in the chain (activities benefiting from microcredits; MFIs; funding structures of MFIs).
- On the other hand, microfinance investment funds (just as MFIs) will lose their credibility towards investors if they lose sight of the very preoccupation which has caused their emergence, i.e. combating poverty and promoting social and economic progress.

Any temptation to maximise profitability at the expense of quality at the level of the investments made will cause harm to the sector overall, in the medium and long run¹⁰. The Luxembourg financial community should thus, as far as possible, make sure that it participates only in projects which achieve a high standard in terms of quality¹¹.

¹⁰ In her address to the previously mentioned Paris Conference, Mrs Maria Novak seemed to express some concern in this respect: «Today, we find ourselves in a rather strange situation. On the one hand, there is emphasis on the fight against poverty and the social impact of microfinance, the choice tool for reaching the Millennium Development Goals; on the other hand, there is the call for a strict business approach and a leading role for banks. At a time when businesses are signing on to (...) socially responsible investments, microfinance seems to be turning its back to its roots and speaks only of profits and market share. It would be unfortunate to separate the two sides of the coin – the social and the financial - because it is precisely in the marrying of the social and the financial that microfinance innovates. The actions of all actors need to be supported. It is only through the cross-fertilisation of the different experiences that microfinance can move forward.»

¹¹ As to this, it is interesting to note that after credit rating, social rating of MFIs is presently emerging (see, in particular, Micro-Credit Ratings International Ltd (M-CRIL)).

5. THE OPPORTUNITY IS NOT JUST ABOUT SERVICING MICROFINANCE INVESTMENT FUNDS

It has already been noted that while there is a substantial growth perspective for microfinance investment funds, the sector, for the time being, remains relatively modest in size (see above 3.4. and 3.5). We shall furthermore note, in section 9.2. herebelow, that in terms of profitability this segment of the fund industry may be less attractive for the service providers than the average.

However, it would be an error to, when appraising the opportunities which the sector offers to the Luxembourg financial community, ignore the links which the microfinance investment fund sector entertains with other activities which are of interest for Luxembourg.

On the one hand, microfinance investment funds must be viewed as forming part of the wider category of socially responsible investment funds. On the other hand, services to the microfinance sector are not limited to services to microfinance investment funds, as illustrated in particular by securitisation transactions.

5.1. Microfinance investment funds and socially responsible investment funds

While microfinance investment funds presently represent only a very small part of the fund industry, the figures speak a different language when one turns to socially responsible investment funds in general. Even leaving apart banks which offer no but this type of funds to their clients, it appears that for certain traditional banks, the segment of socially responsible funds presently represents a considerable part of their business¹².

Now, it is reasonable to consider that for any credit institution aiming at being significantly present on the market segment of socially responsible investment funds, the capacity to offer investment opportunities in microfinance investment funds is of importance.

5.2. Microfinance offers further opportunities to the financial centre: the example of securitisation

Securitisation transactions will play an increasing role in the financing of MFIs¹³ and Luxembourg should be in a position to offer its services for such transactions¹⁴.

The interaction with the sector of microfinance investment funds is obvious here, considering that the securitization of loans granted to MFIs facilitates the investment by microfinance investment funds. And depending on the characteristics of the securities issued in such securitization transactions, the problem arising from the rather illiquid character of investments in microfinance might, in the medium term, become less stringent.

There is thus a positive interaction between the development of the microfinance investment fund sector and securitization deals. And it is a fact that the Luxembourg financial sector can service both these activities.

¹² From information communicated by Dexia in particular, it appears that more than 10% of the assets under management of Dexia are said to be invested in accordance with socially responsible criteria.

¹³ Blue Orchard, an investment manager specialised in micro-finance, has participated in launching an 87 million dollar securitisation deal with underlying loans to 14 MFIs (most of them located in Latin America). While this transaction has been launched in the United States, similar transactions shall no doubt, in the future, be launched from other countries. Another micro-finance related securitisation transaction is already, at present, about to be launched out of Luxembourg.

¹⁴ As to the legislation enacted in Luxembourg with regard to securitization transactions, see also our memo *Summary of the law of 22nd March, 2004 on securitization*, on www.ehp.lu; (Legal topics; Corporate, banking, finance, securities and financial markets).

6. THE NEEDS IN A NUTSHELL: A GREAT AMOUNT OF FLEXIBILITY IN AN ENVIRONMENT WITH RECOGNISED SUPERVISION AND FAVOURABLE TAX TREATMENT

6.1. A great need for flexibility, in particular with regard to investment policies

6.1.1. In order to cope with the various needs of MFIs, microfinance investment funds need – subject to the policy which they pursue in terms of risks to be assumed – to be in a position to invest into equity, debt and possibly guarantees.

At present, funds which are primarily development oriented will typically invest into equity, while funds which are primarily commercially oriented will rather invest into debt. But both types of investments can also be made in parallel and in variable proportions.

There is further the need for the possibility to invest into other investment funds, including local funds.

6.1.2. At present, investment instruments issued by MFIs will nearly never be listed on a stock exchange or a regular market. Any fund intending to primarily invest into microfinance will thus have to be in a position to invest into assets which are not easily tradable and have an investment portfolio with limited liquidity, subject to adapted valuation mechanisms.

In particular, the possibility for investors to exit the fund must be framed in accordance with the fund's limited liquidity.

While the investment into debt instruments may allow for an increased liquidity thanks to an adequate diversification of the portfolio in terms of the number of loans granted and their respective due dates, investment into equity will normally result in high illiquidity such as the one which is typically encountered in private equity vehicles where investors often have to accept that they will not be in a position to exit the vehicle all over its life.

6.1.3. Microfinance investment funds wishing to be in a position to invest into foreign, possibly local currencies, will need to be able to hedge the currency risks resulting therefrom. It however appears that presently microfinance investment funds investing into debt instruments tend to extend loans in dollars and euros only, thus leaving it to the borrower to protect himself against corresponding currency risks.

6.1.4 One means of encouraging private institutional investors and, possibly, private individuals, to invest into microfinance, notwithstanding the increased risks commonly associated with this type of investment, consists in structuring funds with various risk tranches where certain investors – such as the promoters or managers of the vehicle as well as development institutions or other actors having a longer track record in investing into microfinance – accept a subordinated position in the fund, thereby reducing accordingly the risks incurred by other investors. Logically, these different risk profiles should be reflected at the level of the expected returns on investment.

Concerning investment risks, it by the way seems that the microfinance sector would be well advised to develop an enhanced communication and information policy: indeed, while microfinance is often – and somewhat instinctively – perceived as presenting a rather high risk profile, the reality seems not to support such perception. To the extent, further, that the microfinance sector appears to be largely decorrelated from the evolution of the formal banking sector and the overall formal economy, microfinance offers investors the opportunity to diversify their investment risks. Microfinance is, therefore, increasingly referred to as a “new asset class”.

6.1.5. One should also mention a double evolution which microfinance investment funds need to take into consideration when defining their investment policy:

On the one hand, certain MFIs enlarge the scope of their activities beyond microcredit (collection of savings; remittances; insurance ...) and increase the average size of their credits, servicing also small and medium enterprises. These MFIs are thereby led to conduct their activity under a regular banking (or similar) licence.

On the other hand, certain traditional banks downscale their activities and enter the microfinance sector, either directly or through dedicated subsidiaries.

In both cases, microfinance investment funds are, at some point in time, confronted with the question to which extend they want to continue or start investing into this type of mixed institutions: which is the amount above which credit does no more qualify as microcredit; which is the admissible mix of activities? These are questions which need to be addressed when defining an investment policy¹⁵.

6.1.6. Also, it must be noted that depending on the geographical area in which an MFI conducts its activity, the borders of microfinance are shifting. Whereas in certain developing countries of the third world, a credit of less than hundred dollars may be the general rule in microfinance, things may be quite different in such or such Eastern country where microfinance is also developing.

6.2. A need for a well supervised environment

As to this, the position and needs of microfinance investment funds are not really different from those of other investment funds.

The necessity to incorporate in a jurisdiction providing for adequate supervision and investors protection is particularly obvious for investment funds which aim at addressing a large range of investors, if not the public at large: the need to benefit from the investors' confidence and to be legally in a position to distribute the fund on a sufficiently broad basis, are factors which cannot be ignored.

However, it appears that even where such factors are of lesser importance – in particular where the investors are at the same time the initiators of a fund which does not aim at addressing the public – there is an increasing inclination to opt for a jurisdiction with recognized regulatory supervision.

For example, while a “pioneer” fund such as *Pro Fund* – with a small number of investors most of which were development institutions – was incorporated in Panama, similar funds do presently hesitate to incorporate in off shore financial centres. Increasing expectations with regard to good governance standards with which such investors need to comply are certainly part of this evolution.

It remains that for funds to which factors like regulatory supervision and investors' protection are not essential, other factors, such as the speed of setting up a fund, high flexibility and low costs remain very attractive. Certain financial centres which, without being straight forward off shore centres, offer a legal and fiscal environment imposing little constraints on fund initiators, may be viewed as very attractive. One may note that *Africap*, a fund recently incorporated on the model of *Pro Fund*, and with to a large extent the same investors, has chosen Mauritius as place of incorporation.

¹⁵ See, as to this, the criteria proposed in the study of M. Damien von Stauffenberg («Quality label for microfinance investment funds») for the identification of eligible MFIs.

6.3. A favourable tax environment

Here again, microfinance investment funds present little specificity compared to investment funds in general.

The tax aspect is multidimensional: taxation of the fund *per se*; taxation of the fund's revenues in the countries in which the fund is invested; investors' taxation; taxation of services rendered to funds (VAT in particular). In some of these respects, the existence of a good network of double tax avoidance treaties may form a necessary component of a tax environment attractive for investment funds.

While there may be further causes explaining this, it is quite significant that two microfinance investment funds addressing the public at large are based in the Netherlands, a country which has put into place a tax incentive scheme benefiting private individuals investing into socially responsible investment funds and, among these, microfinance investment funds.

7. THE LEGAL, REGULATORY AND FISCAL FRAMEWORK OFFERED BY LUXEMBOURG

7.1. General overview

There is a series of Luxembourg specialised laws which govern the setting-up and operation of investment vehicles of different types. Such laws also refer to the legal forms which such investment vehicles can adopt, referring in that respect generally to the Luxembourg law of 10 August 1915 regarding commercial companies. It is obviously not possible to discuss in this study in detail the numerous possible structures which result from a combination of the different types of funds and legal forms available.

We will therefore limit ourselves to a general description but concentrating on those aspects which may be of particular relevance in the structuring of funds investing in microfinance.

The investment vehicles described hereafter are all subject to the supervision of the Commission for the Supervision of the Financial Sector (Commission de Surveillance du Secteur Financier ("CSSF")), although the type of supervision may vary depending on the law by which they are governed. Also, the tax regime applicable to each of them may vary.

In addition to the general legal, regulatory and fiscal regimes, it may be relevant to specifically mention certain flexibilities afforded by the Luxembourg legislative framework which may be of particular relevance for structuring microfinance investment funds.

7.1.1. Types of Investment Vehicles

7.1.1.1. The law of 20 December 2002 (the "2002 Law") regarding undertakings for collective investment (UCIs) regulates investment funds which issue shares to the public by means of a public offer or private placement and which invest the proceeds resulting from the issue of the shares in a portfolio of investments in accordance with the principle of risk spreading. The law differentiates in its part I and in its part II between two types of investment funds: -

- Part I deals with undertakings for collective investments in transferable securities (UCITS) which invest exclusively in transferable securities, units of other investment funds, deposits with credit institutions, financial derivative instruments and money market instruments. The transferable securities (meaning shares, bonds and similar securities or instruments) and the money market instruments need to be listed on a stock exchange or dealt in on another regulated market, except that up to 10% of the assets of the UCITS may be invested in non-listed transferable securities. Apart from being required to limit its investments to the aforesaid securities and instruments, a UCITS has to comply with specific diversification and concentration limits imposed by part I of the 2002 Law which reflects the restrictions imposed by the directive EU 85/611, the so-called UCITS Directive. For example, a UCITS may not invest more than 10% of its net assets in securities of the same issuer (diversification limit) and may not acquire more than 10% of the securities issued by a single issuer (concentration limit). A UCITS must be open ended for redemptions, meaning that

shareholders must have the right to request the UCITS to redeem their shares at least twice a month. Once the UCITS has been authorised by the CSSF, the latter will issue an attestation confirming that the UCITS fulfils the conditions imposed by the UCITS Directive and upon filing of this attestation, together with supporting documents, with the competent authorities in other EU member countries, the UCITS is authorised to market its shares to the public in the relevant other EU member states.

- Part II of the 2002 Law deals with undertakings for collective investments which are not UCITS (Part II UCI). Part II UCIs are defined as undertakings for collective investments which invest in assets in accordance with the principle of risk spreading. By referring to *assets*, Part II of the 2002 Law does not restrict the eligible investments and, accordingly, a Part II UCI may invest in any type of assets, comprising unlisted securities and loans. The 2002 Law requires that the Part II UCI operates under the principle of risk spreading but does not impose any specific diversification or concentration limits. Accordingly, a Part II UCI may invest in non-listed securities, may invest a substantial portion of its net assets in one single issuer and is not limited as to the maximum percentage of the securities of one issuer it may acquire. The law does not impose on Part II UCIs any rules or restrictions as to the frequency at which shares have to be redeemed at the request of shareholders. Accordingly, a Part II UCI can be structured as closed-end investment fund where shareholders can exit only at the time of liquidation. Part II UCIs, once authorised by the CSSF, can be publicly distributed in Luxembourg but, unlike UCITS, they do not benefit of a European “passport” which would permit public distribution in other EU member countries. Part II UCIs can therefore generally be sold outside of Luxembourg only on a private placement basis in accordance with the local rules in the country concerned.

In summary, one can conclude that UCITS have to operate within fairly strict investment and liquidity constraints but offer possibilities for distribution to the public all over the European Union. On the other side, Part II UCIs are very flexible in terms of eligible investments and in terms of adapting the liquidity features to the targeted investments but can generally, in foreign jurisdictions, be distributed only to sophisticated or institutional investors on the basis of private placement rules.

7.1.1.2. The law of 19 July 1991 (the “1991 Law”) concerning undertakings for collective investment the securities of which are not intended to be placed with the public regulate investment funds which restrict their shares to one or several institutional investors and which invest the proceeds resulting from the issue of the shares in a portfolio of investments in accordance with the principle of risk spreading. The rules (and flexibility) applicable to these Institutional Investor Funds are almost identical to those applicable to Part II UCIs created under the 2002 Law as described above, with the sole main difference that, as aforesaid, the distribution of their shares is limited to institutional investors. The law does not comprise any definition of the term “institutional investor” but the CSSF has taken the position that this term comprises institutional investors *stricto sensu* (banks, insurance companies, investment funds, pension funds, governmental agencies, foundations), financial institutions investing on behalf of private investors on the basis of a discretionary management mandate and family holding companies. It is presently expected that the 1991 law will be revised by the end of 2006 in a manner such that the investment funds created thereunder can be sold not only to institutional investors but also to individual investors meeting some minimum sophistication or wealth requirements (in a similar manner as for SICARs (see below) where a minimum investment amount of 125,000 € is required). In a similar manner as for Part II UCIs regulated by the 2002 Law, Institutional Investor Funds can only be sold in other countries on the basis of applicable local private placement rules. The CSSF presently applies an accelerated authorisation procedure to Institutional Investor Funds¹⁶.

¹⁶ For more details on the 2002 Law and the 1991 Law, see also our memo *Outline of the rules applicable to Luxembourg collective investment schemes*, on www.ehp.lu (Legal topics, Investment funds and other investment vehicles).

7.1.1.3. The law of 15 June 2004 (the "SICAR Law") relating to the investment company in risk capital (SICAR) regulates investment companies the object of which is to invest their assets in securities representing risk capital. Investment in risk capital is defined by the SICAR Law to be understood as the direct or indirect contribution of assets to entities in view of their launch, their development or their listing on a stock exchange. The main differences between Part II UCIs governed by the 2002 Law and SICARs can be summarised as follows:

- the object of the SICAR must be to invest in risk capital, defined by the SICAR Law as "the direct or indirect contribution of assets to entities in view of their launch, their development or their listing on a stock exchange". The preparatory works of the SICAR Law clarify that this definition includes any type of contribution of assets, be it in the form of capital, debt or financing of the type "mezzanine" or "bridge";
- the shares of the SICAR can only be subscribed by "well informed investors" and the law imposes in that respect a minimum investment amount of 125,000 €;
- the SICAR is not required to operate under the principle of risk spreading, which implies that it can invest in a limited number, or even a single, target investment;
- it is submitted to a somewhat "lighter" regulatory regime in that the CSSF does not (as is the case for all funds created under the 2002 and the 1991 Law) require a "promoter" but only checks whether the manager has actual experience in risk capital investments.

In a similar manner as for Part II UCIs regulated by the 2002 Law and Institutional Investor Funds regulated by the 1991 law, the SICAR can generally only be sold in other jurisdictions under applicable private placement rules¹⁷.

7.1.2. Legal forms

Each of the aforesaid laws refers to the legal forms which the investment vehicles can adopt.

The 2002 Law and the 1991 Law specifically refer to the common fund (*fonds commun de placement* (FCP)) and the investment company with variable share capital (SICAV), but also provide that an investment fund may adopt any other legal form.

The SICAR Law refers exclusively to the limited partnership, the partnership limited by shares, the cooperative in the form of a public limited company, the limited company and the public limited company.

We will limit ourselves to describing hereafter only the most common legal forms.

7.1.2.1. Fonds commun de placement («FCP»)

The FCP is not a legal entity, but an unincorporated coproprietorship of assets which is managed, on behalf of the joint owners, by a management company who takes, on behalf of the FCP, all decisions relating to the investments and the operations of the FCP. In general, no meetings of unit holders are held and the management company takes all decisions on behalf of the FCP.

The FCP not being a legal entity, it may constitute an appropriate vehicle in circumstances where tax transparency is aimed at.

¹⁷ For more details on the SICAR Law, see also our memo *Setting-up a Luxembourg investment company in risk capital (société d'investissement en capital à risque, «SICAR»)*, on www.ehp.lu (Legal topics, Investment funds and other investment vehicles).

7.1.2.2. Société d'investissement à capital variable («SICAV»)

The SICAV is a public limited liability company with a variable share capital. Its articles provide that its share capital is at all times equal to its net assets, the share capital being automatically increased or reduced upon issue or repurchase of shares. The SICAV is the legal form which is generally used for open-ended vehicles. From the legal point of view, it is however perfectly acceptable to close a SICAV for redemptions, by an adequate provision in its articles of incorporation (although this is not possible for a UCITS, as discussed above) and also for new subscriptions, by an adequate resolution of its board of directors.

With respect to SICAVs, the 2002 law requires that all shares must be fully paid in upon subscription. A subscription in different tranches can therefore, in case of a SICAV, only be achieved by successive subscriptions (and not by means of partly paid shares) which may be ascertained at the initial subscription by means of subscription commitments.

7.1.2.3. Société d'investissement à capital fixe («SICAF»)

The SICAF is a limited liability company with a fixed share capital. To assure flexibility for a possible issue of further shares, the company is generally created with a maximum authorized share capital and the board of directors is authorized to issue further shares, thus increasing the issued share capital within the limits of the authorized share capital.

The structuring of the issue price of the shares so as to comprise a portion of par value and a portion of issue premium, permits to conduct a flexible distribution or capital repayment policy.

Through the issue of partly paid shares, the SICAF permits the payment of a certain portion of the issue price on application, the remaining amount of the issue price being payable in further instalments. Compared to the mechanism of subscription commitments, partly paid shares present the advantages that the company disposes of all means permitted by company law to enforce the payment of the non-paid in portion of the shares upon a capital call or drawdown from the board, such as temporary suspension of voting rights, freezing of dividend payments or compulsory repurchase of shares.

7.1.2.4. Société en commandite par actions («SCA»)

The SCA, a partnership limited by shares similar to the anglo-saxon type limited partnership, is an alternative structure to the SICAF in circumstances where the sponsor of the investment vehicle would like to be assured against any risk of (a) majority shareholder(s) taking over the control of the company. Indeed, in a SICAV or a SICAF, it is the shareholders who appoint the board of directors and it is the board of directors who, in turn, appoints the investment advisers or managers. Accordingly, (a) majority shareholder(s) could take control of the company by replacing, by a majority shareholders' vote, the board of directors.

The SCA has two different types of participants:

- (i) The «associé gérant commandité», subscribing to management shares who, by operation of law, is liable for any obligations that can not be met out of the assets of the SCA. The «associé commandité» is responsible for the management of the SCA.
- (ii) The «associés commanditaires», subscribing to ordinary shares, whose liability is limited to the amount of their investment in the SCA.

In the aforesaid structure, the sponsor or manager would usually subscribe to management shares through a limited liability company in order to limit its «unlimited» liability arising from holding such management shares and acting as manager. Investors would subscribe for the ordinary shares.

The «associé gérant commandité» may only be removed as manager of the SCA by an appropriate amendment of the SCA's articles of incorporation but such amendment would have to be approved by the «associé gérant commandité» thus assuring that a replacement is not possible without the manager's approval.

7.1.3. Prudential supervision

All investment vehicles described above are subject to permanent supervision by the CSSF. The scope of such supervision may vary depending on the specific law applicable to the relevant investment vehicle.

7.1.3.1. The CSSF performs its supervision at the time of creation of the investment vehicle, thereafter when it pursues its investment activity and finally at the time of its liquidation. At creation, the CSSF has to approve all constitutive documents, the choice of the directors (and investment managers), the central administration, the custodian and the auditor. During the life of the investment vehicle, any change of the constitutive documents as well as any change of director or any change of the aforementioned service providers requires prior CSSF approval. At the liquidation, the CSSF has to approve the liquidator and remains competent for the supervision until the close of the liquidation.

All aforesaid persons and service providers must be approved by the CSSF on the basis of their good reputation and professional experience. The custodian, which is responsible for the safe custody of the assets, must be a Luxembourg credit institution or a foreign credit institution (established in an EU member country or not, depending on the type of investment vehicle) having a branch in Luxembourg. The auditor, who is responsible for auditing the accounting information in the annual accounts, must justify of an appropriate professional experience.

In case of non-compliance with the applicable laws and regulations, the CSSF can withdraw its authorisation for the investment vehicle concerned.

7.1.3.2. For investment funds created under the 2002 Law and the 1991 Law, the CSSF requires that they are created at the initiative of a “promoter” which the CSSF defines as being “the entity which has initiated or originated the creation of the investment fund, which determines the scope of its activity and which benefits of its creation”. The CSSF considers that the role of the promoter is to “meet, where necessary, requests for indemnification resulting from irregularities or improper management or administration of the UCI”¹⁸. In order to ensure that the promoter can meet its aforesaid obligations, the CSSF generally requires for the promoter to be a financial institution with appropriate financial resources.

As regards the SICAR, there is no requirement for a “promoter”. Indeed, at the time when the SICAR Law was drafted, it was considered that investment vehicles of the *private equity* type are frequently created at the initiative of managers who, due to their limited financial resources, could not be approved as promoter in accordance with the aforescribed CSSF practice under the 2002 Law and the 1991 Law. The shares of the SICAR being restricted to “well informed investors”, it was considered that for this type of investment vehicle it is sufficient that the investment manager has appropriate professional experience and that it is not necessary for a financial institution to be involved to assume the role of promoter.

¹⁸ CSSF Activity Report 1990, p. 55 and 56

7.1.4. Tax considerations

7.1.4.1. Investment funds created under the 2002 Law and the 1991 Law are not subject in Luxembourg to any tax other than the subscription tax (*taxe d'abonnement*) provided for in article 129 of the 2002 Law. This tax is levied quarterly on the net assets on the last day of the relevant quarter at a rate of 0.05%. A reduced rate of 0.01% is applicable, inter alia, for cash and money market funds, Institutional Investor Funds set up under the 1991 Law and for investment funds governed by the 2002 Law (or sub-funds or classes of shares thereof) whose shares are reserved to Institutional Investors. Initially, the rate of the tax was 0.06% but successive reductions have been introduced since 1990 to arrive at the present rates mentioned above. Although this tax is sometimes criticised because no similar tax exists in other investment fund centers abroad, it has the advantage of being easy to understand and apply. Discussions are conducted by the professional associations and the investment fund industry with the government to progressively reduce the tax or to exempt from such tax those investment vehicles whose nature or investment policy so justifies on objective grounds.

Investment funds which adopt the legal form of an investment company have the benefit of the double tax avoidance treaties made between Luxembourg and about twenty countries. It concerns those countries in relation to which the Luxembourg tax authorities have specifically agreed with the local tax authorities that the double tax avoidance treaty would be applicable to such investment funds¹⁹. For a certain number of other countries with which Luxembourg has also entered into a double tax avoidance treaty, no such agreement has been reached.

7.1.4.2. For the SICAR, the SICAR Law provides for a tax regime fundamentally different from the one described above in relation to the 2002 Law. This law provides for a tax regime under which the SICAR is subject to general corporate income tax, but the income resulting from private equity investments as well as income resulting from the transfer, contribution or liquidation of these investments does not constitute taxable income. As a result, if a SICAR is fully invested in a portfolio of private equity investments, it will not be subject to tax on revenues resulting from such portfolio. Being subject to corporate income tax, the SICAR should have the benefit of double tax avoidance treaties concluded by Luxembourg without any need for a special agreement/consultation as is described above in relation to investment funds. The SICAR is, in the same manner as investment funds, exempt from wealth tax.

7.1.4.3. Investment funds governed by the 2002 Law and the 1991 Law as well as SICARs have the benefit of a favourable VAT treatment in that article 44 § 1 d) of the amended law of 12 February 1979 concerning VAT provides that the *management* of such investment vehicles is exempt from VAT. The term *management* is interpreted by the tax authorities as including not only investment management services but also administration services and custodian bank services.

7.1.5. Special considerations

It appears appropriate to complete the above description, by mentioning certain flexibilities which the aforesaid laws afford and which may be relevant for structuring an investment vehicle which meets the needs of those who are at the initiative of its creation.

7.1.5.1. The 2002 Law and the 1991 Law permit the creation of investment funds with multiple compartments where each compartment corresponds to a distinct part of the assets and liabilities of the investment fund and where the rights of creditors of one compartment are limited to the assets of that compartment. This permits the creation, within one single investment vehicle, of distinct sub-funds which may pursue different investment policies and whose shares can be subscribed by different types of investors. At this stage, the SICAR Law does not specifically provide for the possibility for a SICAR to be created with separate compartments but structures of that kind have been approved by the CSSF in specific circumstances. It is anyhow contemplated to proceed, in due time, to an amendment of the SICAR Law so as to specifically provide for the possibility to create SICARs with multiple compartments.

¹⁹ It concerns as at 3 November 2005 the following countries: Germany, Austria, China, Finland, Indonesia, Ireland, Malaysia, Malta, Morocco, Uzbekistan, Poland, Portugal, Romania, Republic of Korea, Singapore, Slovakia, Spain, Thailand, Trinidad and Tobago, Tunisia, Turkey, Vietnam (source: *Administration des Contributions Directes du Grand-Duché de Luxembourg*)

7.1.5.2. The different laws mentioned above permit the creation, within an investment fund or a compartment thereof or within a SICAR, distinct classes of shares. Such classes may have different characteristics, as regards the fee structure, the hedging policy, the type of targeted investors, the distribution policy or any other specificities.

7.2.

7.2.1. Assessment: Luxembourg offers an appropriate legal and tax framework for the setting up of microfinance investment funds.

In the light of the characteristics of the legal tools described above and our understanding of the specific needs of microfinance investment funds, it appears that Part II UCIs created under the 2002 Law as well as the SICAR are the most appropriate investment vehicles to undertake microfinance investments and invest in MFIs. This seems to be confirmed by practice to the extent that the currently existing Luxembourg microfinance investment funds are substantially all Part II UCIs and most projects presently in the set-up phase are also Part II UCIs or SICARs.

7.2.2. Part II UCI

In light of the general characteristics of microfinance investment funds, Part II of the 2002 Law appears to be an appropriate legal framework. Indeed, this law grants all flexibility in terms of the choice of the legal form of the investment vehicle and also affords sufficient flexibility as regards eligible investments and their limited liquidity and, at the same time, ensures protection of investors, mainly through the supervision performed by the CSSF and, last but not least, all in a favourable, substantially neutral, Luxembourg tax environment.

7.2.3. SICAR

The SICAR Law is an appropriate legal framework if the proposed investments qualify as “risk capital” within the meaning of the law, which should generally be the case in relation to microfinance investments.

Notwithstanding the fact that the term “risk capital” is defined in a broad manner by the SICAR Law and the related parliamentary documents (see 7.1.1.3. above), the proposed investments must meet the definition of risk capital to avoid potentially detrimental regulatory and tax consequences. For example, the question arises whether non-securitised loans to MFIs of a certain size, remunerated by interest at a rate close to usual market rates, could be considered as “risk capital” investments within the meaning of the SICAR Law.

The SICAR Law also allows investment managers and entrepreneurs without substantial financial resources to create, without the sponsoring of a sizeable financial institution, an investment vehicle for well-informed investors in a somewhat less demanding legal and regulatory framework than the one applicable to undertakings for collective investment under the 2002 Law and the 1991 Law.

The SICAR may also be the most appropriate choice in circumstances where the investment policy and, especially the proposed investments, are of a nature such that it is important for double tax avoidance treaties to be applicable.

Finally, the SICAR is not, as is the case for a Part II UCI, subject to the requirement to invest in accordance with the principle of risk spreading and may therefore constitute an appropriate investment vehicle if it is considered to invest in or provide funds to a limited number of MFIs.

8. RESTRICTIONS ON THE DISTRIBUTION OF MICROFINANCE INVESTMENT FUNDS

8.1. Because, presently, microfinance investment funds are hardly in a position to qualify as UCITS, benefiting from a European passport, they are suffering distribution restrictions.

As well Non-UCITS as SICARs, except if registered locally in a foreign jurisdiction, can be distributed outside Luxembourg only in accordance with private placement rules, which vary from jurisdiction to jurisdiction. SICARs further can only be placed, including in Luxembourg, with “well informed investors” as defined in the SICAR Law.

8.2. A distribution to the public outside Luxembourg requires a Part II UCI or SICAR to be registered with the local authorities. Experience proves this to be a difficult and longlasting exercise. This is not to say that it would be impossible to achieve: in particular, “responAbility Global Microfinance Fund”, a Part II UCI set up in the legal form of a FCP, has been able to register in Switzerland, although, we understand, at the expense of quite significant amendments of its original investment policy (concerning, in particular, eligible investment instruments).

8.3. It should however be stressed that these limitations with regard to distribution are not specific to investment funds incorporated in Luxembourg and that the only way to avoid them consists in incorporating a fund in the very country of distribution.

Further, where microfinance investment funds mainly target institutional investors, restrictions on distribution will be less constraining than where distribution to the general public is contemplated.

9. LUXEMBOURG SERVICE PROVIDERS HAVE THE CAPACITY TO MEET THE NEEDS OF MICROFINANCE INVESTMENT FUNDS

9.1. The required skills are available in Luxembourg

9.1.1. The services which those setting up a microfinance investment fund in Luxembourg, need to have available locally in order, in particular, to comply with regulatory requirements are mainly those of the custodian, the administrative and transfer agent as well as the domiciliary²⁰. Frequently, these services are provided by a single service provider or by different service providers pertaining to the same group of companies.

9.1.2. Considering the investments typically made by microfinance investment funds (loans, securities not listed on the stock exchange ...), the functions of the custodian and the administrative agent require somewhat specific skills which are however quite similar to those required in servicing other types of Part II UCI already present in Luxembourg, such as certain private equity funds and real estate funds. This is so in particular with regard to investment valuation methods for debt and securities not listed on the stock exchange as well as with regard to legal and operational aspects specific to the acquisition of such types of assets. These skills are thus available on the spot with those service providers at least which have an extensive and diversified activity in the sector of investment funds.

9.1.3. The fact that the skills required in order to service microfinance investment funds are not fundamentally different from those which a number of Luxembourg based service providers have developed in servicing other types of funds constitutes a critical advantage. Considering indeed the rather modest profit perspectives in servicing microfinance investment funds (see section 9.2. below), it would be hardly possible to develop such skills exclusively for that purpose.

9.2. Service providers should be in a position to offer their services at (financially) acceptable conditions

9.2.1. Notwithstanding the fact that the microcredit sector has proved to be profitable, the profit margins which it allows to generate remain rather modest and, at any rate, below those commonly expected from activities with which microfinance is otherwise, rightly or wrongly so, compared, such as private equity and, possibly, venture capital.

Furthermore, microfinance investment funds are typically rather small sized while at the same time requiring quite labour-intensive custodian and administrative agent services (compared, in particular, to UCITS investing in listed securities).

A “normal” pricing structure, i.e. a pricing structure similar to the one in place for comparable funds, might thus prove to be problematic, albeit transaction based (rather than NAV based) is commonly practised in other sectors, such as real estate investment funds (where, however, single transactions would typically be considerably more important in volume than those entered into by microfinance investment funds).

²⁰ As is the case for the fund industry at large, investment managers will generally be located abroad without prejudice to the need for them to be acceptable to the CSSF in order for the fund to get regulatory approval.

9.2.2. As a matter of fact, the service providers' interest in servicing microfinance investment funds does not, at present, seem to be primarily profit driven: while the sector experiences considerable growth, the number of microfinance investment funds remains modest and we have not gained the impression that the business community would expect it to become critical for it in terms of profitability and market share.

In fact, the decision of service providers to become active in this field seems to be driven by other factors. Sometimes, there is the *ad hoc* readiness, possibly favoured by image related considerations, to cooperate in a project perceived as being "philanthropic" and as carrying a critical social benefit. Sometimes there is a strategic decision reflecting an overall long term policy where sustainability as such and the clients' demand for more sustainability and related investment opportunities are central. Also, the decision to service a microfinance investment fund may be determined by the fact that such fund has been set up by the very banking group to which the service provider belongs or by the fact that the initiative comes from an existing client of the service provider.

The fact that the growth of the microfinance sector coincides with the creation, in Luxembourg, of a new investment vehicle – namely the SICAR – which will often prove to be the most adapted to the needs of a microfinance investment fund, may also enhance the service providers' interest in servicing such funds, as they may wish to affirm their presence on the new SICAR market segment.

9.2.3. The above developments should not result in a misunderstanding: servicing microfinance investment funds is viewed by those concerned in the financial community as an economic activity which has to be (and can be) sustainable in a cost/benefit perspective, even though reduced profit margins may, at least on a temporary basis, be considered to be acceptable.

It should also be noted that lacking a sufficient track-record, it is difficult, at this stage, for service providers to make a reliable evaluation of the profitability of their involvement in the sector.

9.2.4. Finally, while the required skills are available on the spot and while there is interest in getting active in the sector, this does not mean that a large number of service providers would rush toward this new market segment. Certain promoters of microfinance investment funds may have been somewhat disappointed by the little interest shown by certain service providers in responding to their demand for a service offer. And except if the sector were to grow very fast in the short term, it is reasonable to forecast that a limited number of service providers will – as per a deliberate choice – hold a pioneering position in the market, whereas many others will rather abstain, merely observing how the market develops.

At this stage, we would like to raise an issue which often remains unaddressed: the emergence of a so-called ethical financial sector – of which microfinance investment funds form an integral part – represents a serious challenge to the financial world and those who work therein. A single-dimensional approach in which the financial return (which is generally easily measurable) constitutes the only relevant criteria of efficiency and success is superseded by a pluridimensional approach where the criteria of social return (which, on top, is much more difficult to measure) becomes of critical importance. Not only does this render the activity of those who work in the financial sector more difficult and complex. It also affects the very essence of the activity just as it confronts those who make their living in the sector with difficult issues such as this one: if one part of the financial activity is said to be "ethical", how about the remaining and by far major part of this activity? This is probably, among other reasons, why the very concept of "ethical finance" may cause mitigated feelings among professionals of the financial sector. And this is one of the reasons why the decision to get involved in this sector is of a somewhat strategic nature, just as it is political – in the broader sense of this word.

10. LUXEMBOURG APPEARS (ALREADY) TO BE WELL POSITIONED ON THE DEVELOPING MARKET OF MICROFINANCE INVESTMENT FUNDS

10.1. The present picture: in proportion, a significant number of microfinance investment funds have opted for Luxembourg

In his 2004 study, Goodman identified nine microfinance investment funds which he ranged in the category of “Commercial Microfinance Investment Funds”²¹. Among these, three were incorporated in Luxembourg²², two in the Netherlands, three in the United States and one in the Caiman Islands. The characteristics of the two Dutch funds²³, being funds targeting mainly individual investors residing in the Netherlands and benefiting, in this context, from a Dutch tax incentive scheme, are decisive of these funds having been incorporated in the Netherlands.

At the European level in particular, it thus appears that Luxembourg holds, from the very start, a strong position on this newly arising market segment²⁴. The recent evolution confirms this trend. Indeed, a number of new projects have just been launched and the SICAR in particular appears to confirm that it is capable of meeting the expectations and needs of those setting up microfinance investment funds²⁵.

10.2. The reasons for choosing Luxembourg as place of incorporation of a microfinance investment fund

10.2.1. At a very general level, the reasons prompting the initiator of a microfinance investment fund to opt for Luxembourg as place of incorporation are not really different from those applicable to investment funds generally speaking: recognition of Luxembourg as a financial centre having extensive experience and skills in investment funds, offering recognized supervision and yet a big amount of flexibility; large range and flexibility of available investment vehicles; attractive tax environment.

10.2.2. At a more specific level, the following comparative advantages can be identified:

10.2.2.1. Fact that a number of microfinance investment funds have already been incorporated in Luxembourg and have thus successfully overcome the “test” of the licence to be obtained from the regulator who is thus acquainted with the specific nature and needs of this type of vehicle (precedent phenomenon).

10.2.2.2. Fact that investment managers specialised in investment funds have already been approved by the CSSF upon scrutiny of their legal status, financial capacity and experience.

10.2.2.3. Great flexibility of the SICAR vehicle, combined with a particularly attractive tax regime altogether with regard to the registration tax (exemption), VAT, the taxation of its revenues and the possibility to benefit from the application of double tax avoidance treaties.

²¹ As for this classification, see section 3 above.

²² Axa World Funds – Development Debt fund; Dexia Microcredit Fund; Responsibility Global Microfinance Fund

²³ Triodos Fair Share Fund and ASN-Novib Fund. In the meanwhile, a third fund, the Oeko-Kredit Fund, with characteristics comparable to the two previous ones, has been added to the list.

²⁴ And it is of some interest to note that Luxembourg has also played a major role when it came to analyse the sector, and this even prior to 2005 being declared by the UN to be the International Year of Microfinance. In particular, the study made by Goodman at the initiative of ADA as early as in 2003, has been referred to as «pioneering study» (Brugger and Duggal, see above note 3).

²⁵ During the third trimester of 2005, two new vehicles at least have been approved by the CSSF, namely one Non-UCITS incorporated as SICAV (*Saint Honoré Microfinance*, initiated by *Compagnie Financière Edmond de Rothschild Banque*) and one SICAR (*La Fayette Investissement*, initiated by *Horus Development Finance*). A number of other projects are about to be launched.

10.2.1.4. Outstanding experience of certain Luxembourg service providers with regard to pooling, a technique which facilitates the management of investments and thus reduces management costs when there is the necessity to issue, for the purpose of the distribution of the fund, various classes of shares representing different risk tranches, thus enabling investors of different types and with different objectives (development objectives/commercial objectives; see above section 4) to participate in a common project.

10.2.1.5. Fact that, while microfinance investment funds do not generally qualify as UCITS (a status which would enable them to be distributed throughout the EU), the existence of a regulatory framework and effective supervision by the CSSF may render possible registration and thus distribution to the public in certain foreign jurisdictions, such as the Netherlands or Switzerland (example: “responsAbility Global Microfinance Fund” which has achieved registration in Switzerland). As to this, Luxembourg offers an obvious advantage in comparison with jurisdictions where comparable supervision does not exist or is not recognized in the same manner by the country in which distribution is contemplated.

10.3. Potentially deterrent factors

10.3.1. We have come across of only one case where, while Luxembourg had initially been envisaged as country of incorporation of a microfinance investment fund – under the form of a SICAR – another jurisdiction was finally preferred. In the case at issue, the reasons for this choice were mainly tax related and, in the meanwhile, have, at least in part, shown to have lacked justification²⁶.

10.3.2. Some uncertainty as to the position foreign tax administrations will adopt towards SICARs when it comes to the application of double tax avoidance treaties can cause concern to promoters interested in this type of vehicle.

10.3.3. Even though the registration tax payable by investment funds constituted pursuant to the 2002 Law and the 1991 Law²⁷ would *prima facie* seem to constitute a rather negligible burden, considering the investment policy (comparable to private equity) of microfinance investment funds, it remains that it constitutes a deterrent factor highlighted in any comparative study made by fund promoters when choosing the place of incorporation of an investment vehicle.

10.3.4. For investment funds with a geographical focus, it may, for a number of reasons, be attractive to have the fund incorporated in a jurisdiction located in the same geographical area. One of these reasons can consist in the existence of a good regional network of double tax avoidance treaties. To note for example that two microfinance investment funds with a clear focus on Africa, namely *Africap* and “*Investisseur et Partenaire pour le Développement*” have chosen Mauritius as place of incorporation²⁸.

10.3.5. The cost factor, which is in direct relation with the choice of a jurisdiction offering a more regulated environment, must not be underestimated. However, while cost is a critical factor for microfinance investment funds – both because of their modest size and because of their relatively low profit margins –, their freedom to choose poorly regulated (and possibly substantially less costly) jurisdictions is progressively narrowing down (see above section 6.2.).

10.3.6. The small domestic market in Luxembourg with, as a result, the predominantly international orientation of the Luxembourg fund industry, results in a limited potential of distribution towards the general public because distribution in other jurisdictions is in principle restricted to UCITS (see above section 8) and because at present microfinance investment funds will not, in principle, be in a position to cope with the requirements of EU Regulation governing UCITS.

²⁶ At the time, there was uncertainty as to whether unsecured loans granted by a SICAR would be accepted by the tax administration as amounting to «securities» in the sense of article 166bis paragraph 5 of the law of December 4, 1967 on income tax (as amended by the law of 15 June, 2004 creating the SICAR vehicle) and whether, therefore, income generated by such loans could get the benefit of the favorable tax regime provided for by the law. Since then, it seems that, in practice, the tax administration has adopted the position that income generated by loans granted by a SICAR get the benefit of the favorable tax regime subject to the loans qualifying as «risk capital» and presenting a minimum level of assignability.

²⁷ At a rate of 0,05% p.a. on the net assets, reduced to 0,01% p.a. for the funds/classes reserved to institutional investors.

²⁸ See list in appendix of the study by Goodman.

Thus the distribution in other jurisdictions will normally be subject to the restrictions of a private placement. This may cause the promoter of a fund to rather incorporate it in what is expected to be the main country of distribution.

10.3.7. One may wonder which might be the impact of the “image” of the Luxembourg financial centre abroad. Qualifications such as “profit oriented”, “tax heaven” or “skills in fund domiciliation” are no doubt more representative of this image than qualifications such as “sustainable development”, “ethical banking” and “socially responsible investment funds”.

It is difficult to say to which extent this image factor might act as an impediment to the choice of Luxembourg as place for setting up a microfinance investment fund. The professionalism of those working in the sector, and namely of the initiators of microfinance investment funds, is likely to minimise, if not to eliminate, this type of considerations. At any rate, the fact that a number of microfinance investment funds have already made their way to Luxembourg should help in overcoming possible resistances. Subject obviously to the Luxembourg financial centre proving capable of making and willing to make socially responsible investment an integral part of its image.

10.4. No decisive obstacles

In any case, the analysis and contacts made for the purpose of this study have not caused us to identify such or such element which would *decisively* disadvantage Luxembourg as place for setting up a microfinance investment fund.

11. WHICH POSSIBLE IMPROVEMENTS?

11.1. Overall assessment

It appears from the analysis herebefore that the existing Luxembourg legislative, regulatory and tax environment is, generally speaking, adequate for the hosting of microfinance investment funds.

Without minimizing certain singularities of this specific type of funds, it can be said that, generally speaking, the comparative advantages offered by Luxembourg for the incorporation of investment funds in general do operate also for microfinance investment funds. This is so even more since Luxembourg has introduced the new SICAR vehicle which, without being the only vehicle eligible for microfinance investment funds, appears to be, in many cases, particularly adapted to the specific needs of such funds.

Considering this globally positive assessment, proposals aiming at improving the existing framework either are of a punctual character, or aim at increasing the Luxembourg financial centre's visibility as an adequate place for setting up microfinance investment funds.

11.2. Exemption of microfinance investment funds from the registration tax

Considering the cost sensitivity of microfinance investment funds (see above section 9.2.), *any* measure resulting in the reduction of the cost incurred in incorporating and operating funds of this type shall be highly appreciated. This is so particularly in the early stages of the life of a microfinance investment fund, considering that this type of fund will require relatively more time to get invested and, thus, to gain a size considered as "critical" for any investment fund from a cost perspective.

An exemption of all microfinance investment funds (i.e. including those not opting for the SICAR vehicle) from the registration tax would thus be highly welcomed, even though its financial impact would be rather modest. This measure – possibly combined with others – could also serve an increased visibility of the Luxembourg financial centre as a jurisdiction being particularly "friendly" towards microfinance investment funds. As a matter of fact, a "proposal of law" (*proposition de loi*) has recently been filed with the Luxembourg Parliament, aiming at exempting microfinance investment funds from the registration tax²⁹. While there would be need for defining more precisely the concept of "investment in microfinance institutions" as used in this proposal of law³⁰, there is no doubt that if this initiative could materialize during the International Year of Microcredit or shortly afterwards, this could, image-wise, have a considerable impact.

Further, considering the currently still limited aggregate net asset value of the microfinance investment funds incorporated in Luxembourg, an exemption of these funds from the registration tax would have limited negative impact on the tax income of the Luxembourg government.

²⁹ *Proposition de loi* n° 4580 filed by member of Parliament Ben Fayot on 31 May 2005.

³⁰ As to this, see in particular the criteria put forward in the previously mentioned study by M Damien von Stauffenberg which have the merit of being easily applicable and, where need is, verifiable.

11.3. Tax incentive scheme for private investors

The creation, for the benefit of Luxembourg tax residents, of a tax incentive scheme favouring the investment in microfinance investment funds would also be highly appreciated.

It would no doubt encourage individual investors to get involved with microfinance and, to a certain extent, help certain microfinance investment funds in overcoming the hurdle of achieving a critical size. It would also show that Luxembourg is interested in microfinance not only when it comes to servicing microfinance investment funds.

The Luxembourg experience with the so called “loi Rau” constitutes a precedent for this type of tax incentive scheme. The government’s concern that this law was no more compatible with EU law in as it exclusively favoured investment in the Luxembourg economy in granting fiscal residents a tax advantage when investing into resident companies, a concern which caused the government to gradually abolish this law, would not similarly apply to a tax incentive scheme favouring the investment in microfinance investment funds incorporated in Luxembourg.

The system put in place in the Netherlands confirms the feasibility – both legal and practical – of such a mechanism. The success of the Dutch system further confirms its usefulness.

11.4. Further develop the network of double tax avoidance treaties

While this is a task the interest of which goes by far beyond the specific interests of microfinance investment funds, Luxembourg should pursue its efforts to further develop its network of double tax avoidance treaties while making sure, from the start, that those newly entered into will be applicable to all types of investment funds incorporated in Luxembourg.

11.5. Creation of a label for microfinance investment funds³¹

At a time where the labelling of socially responsible investment is developing fast, the creation, in Luxembourg, of a label for microfinance investment funds would be of interest in a number of respects:

- On the one hand, the creation of tax incentive schemes in favour of Luxembourg tax payers is, to a certain extent, dependant upon the existence of a labelling process which can help in identifying investment funds eligible for such scheme³².
- On the other hand, the creation of a label for microfinance investment funds would favour the process of monitoring the ongoing compliance with quality requirements and sticking to the original objections (double bottom line) (see above section 3.2). The ongoing credibility of the microfinance sector and of the Luxembourg financial centre would be enhanced thereby. Obviously, this is so only if the criteria and process for granting the label reflect high standards and if any temptation to launch a label merely for advertising purposes is resisted against.
- Finally, and without prejudice to what has just been said about the necessity to stick to high standards, the creation of a label for microfinance investment funds would enable the financial centre to give more visibility to its microfinance related skills and activities.

³¹ As to this, see the previously mentioned study by M. Damien von Stauffenberg and the report by Mrs Natalie Dogniez on the conclusions of the working group instituted with ALFI on a «Proposal for recognition of Socially Responsible Investment Funds».

³² We do not, however, believe that the exemption of microfinance investment funds from the registration tax is dependant upon the creation of a label.

11.6. Available skills need to be made known to the outside world – the visibility of the sector needs to be promoted

To a very large extent, the (potential) initiators of microfinance investment funds are not acquainted with the Luxembourg financial centre. Further, within the Luxembourg fund industry, microfinance will by definition count for a very small market share only. Therefore, it is necessary to enhance the visibility of the financial sector's involvement with microfinance and for service providers active on this market segment to be easily identifiable from the outside.

If, therefore, the Luxembourg financial sector really intends to increase its involvement with microfinance, this activity needs to become an integral part of its communication strategy.

The visibility of the sector could further benefit from the issuance, by the CSSF, of a circular letter related specifically to microfinance investment funds, as has been the case for hedge funds (circulaire CSSF 02/80 of 5th December 2002).

12. CONCLUSION

When we started working on this study, we had no preconceived opinion about what would be our conclusions. The sector of microfinance investment funds being only in the early stages of its development, we did not from the outset know the response to the central question, i.e. this one: to which extent is Luxembourg an adequate place for setting up of microfinance investment funds?

Both the analysis of the existing legal framework (together with the needs of microfinance investment funds) and the observation of the developments in the market place lead us to an unambiguous conclusion: Luxembourg is indeed in a position to become one of the major jurisdictions for the incorporation of microfinance investment funds.

Beyond the existence of an adequate legal framework, the availability of the necessary skills with Luxembourg service providers, combined with latter's readiness to become active in this field is critical to the financial centre's success in the new market segment of microfinance investment funds.

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