Setting up a banking institution in Luxembourg

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The European banking industry is currently undergoing major changes involving further regulatory requirements such as enhanced liquidity and risk management and greater tax transparency.

In addition, the European Commission has proposed a Single Supervisory Mechanism for banks led by the European Central Bank (ECB) in order to strengthen the Economic and Monetary Union. The move towards an integrated 'banking union' includes elements such as a single rulebook, common deposit protection and a single bank resolution mechanism.

This has had consequences for the Luxembourg market. Over the last year for instance, private banks have been busy adapting their business model in order to try to renew their client base and comply with the automatic exchange of information on EU residents' savings income, which is due to be applied as of 2015.

In this more stringent regulatory context, it is expected that a number of banks may be forced to close their doors in the coming years. Nevertheless, within an environment of European Union harmonisation, Luxembourg is well placed to attract new banks to its territory. Indeed, it is still attractive for banks to establish themselves in Europe and Luxembourg remains a central place to capitalise on 500 million European customers.

However, the rationale for attracting banks is changing. While the country may attract fewer private banks, we will review the reasons why it is still interesting to set up in Europe, and particularly in Luxembourg. We will do this by exploring two case studies: Chinese banks aiming at the commercial banking market and Shari'ah-compliant banks targeting the retail and commercial banking market.

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Current trends

In this rough environment, over the last year, the number of banks increased from 141 banks in January 2013 to 149 at the end of March 2014[1]. Most of these banking institutions located in Luxembourg are subsidiaries or branches of foreign groups and only five of them are locally headquartered entities.

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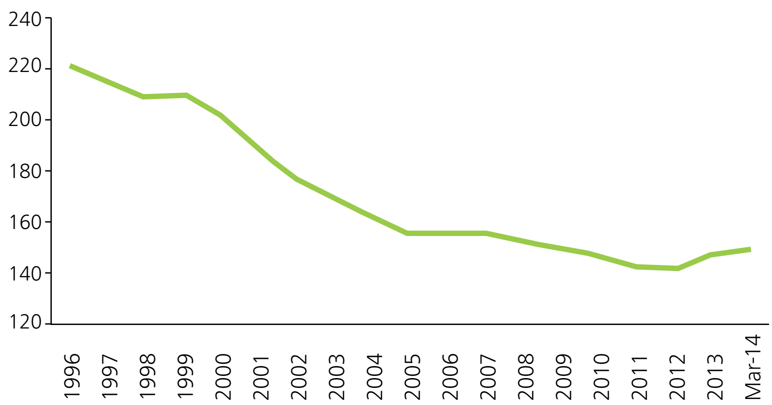
Evolution of the number of banks



Source:CSSF

We read about new banks being created almost every month in the press. As surprising as it may seem, it is not unexpected as the rationale behind opening these banks has changed. Banks are taking advantage of the opportunities to serve Europe, which are driven by external and foreign factors such as trying to serve the unbanked (e.g. Islamic retail banking), to develop trade in Europe (e.g. Russian and Chinese banks) or forward integrating into financial services (e.g. online service providers).

Luxembourg is one of the leading destinations for financial services providers thanks to its global hub status, its constant innovation and business culture. The financial market place in Luxembourg has a high degree of synergy and diversification, appealing to a wide range of investors, including international entrepreneurs and corporations.

Located at the very heart of Europe and benefitting from a AAA rating, Luxembourg is a unique gateway to access the European market. Luxembourg's success can be attributed to a series of positive, long-term government policies aimed at developing a business-friendly environment and diversifying the country's economy. Luxembourg offers these banks the opportunity to take advantage of the full banking license which does not require various application files to perform universal banking activities.

In this context, Luxembourg presents outstanding opportunities thanks to its highly skilled, multilingual and multicultural workforce, its stable political environment, its dynamic legal and regulatory framework and its extensive expertise and full range of diversified and innovative financial services.

1 Source: www.cssf.lu/en/statistics/banks/

Setting up banking operations in Luxembourg

Banking in Luxembourg may be carried out either by establishing a branch or a subsidiary of a foreign credit institution. Several foreign credit institutions operate in Luxembourg as both a branch and a subsidiary to take advantage of the benefits that accrue from combining the two structures.

The standard procedure when applying for a banking licence is to submit an application file to the Ministry of Finance, which will seek advice from the CSSF.

Upon receipt, the CSSF will examine the application file and may address additional queries to the applicant in case clarifications are required. In terms of timing, the whole process takes roughly six months, but this might vary depending on the complexity of the credit institution and the quality of the application file.

The authorisation procedure is described in part 1 of the amended law of 5 April 1993. In consideration of the complexity of the procedure, credit institutions usually request the assistance of advisory firms.

Indeed, before setting-up a bank in Luxembourg, one may potentially wish to consider implementing an alternative lighter legal structure such as an investment fund or a Professional of the Financial Sector (PFS).

Once it has been confirmed that a bank is the most relevant structure to be set up, a market opportunity assessment should be carried out focusing on the strategic market entry perspective. The objective is to provide an overview of the opportunities on the market and the resources required to serve it. Subsequently, a business case should be developed focusing on the bank's business and operating model.

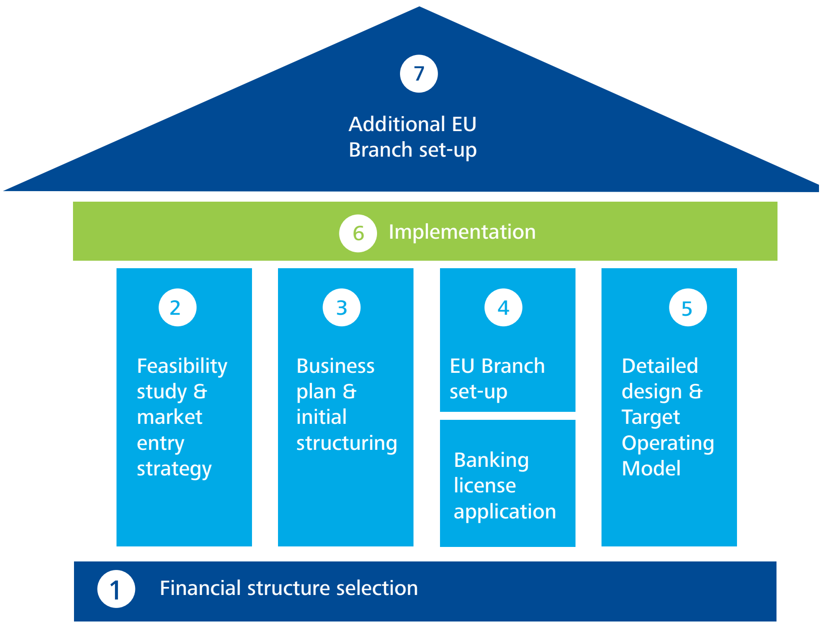
A detailed business plan of the bank's activities should then be finalised. In parallel, the drafting of the entity's statutes, the selection of the premises and the definition of the governance should be initiated.

These documents will then help with the completion of the banking license application file to be submitted to the CSSF in Luxembourg before approval from the Minister of Finance. The application file will depend on the type of entity to set up, which will be either a branch or a subsidiary.

Once the license has been granted by the Minister of Finance, the promoters should finalise the target operating model of the bank before launching the implementation phase.

Finally, when the form of subsidiary has been chosen and is operating in Luxembourg, it may consider opening branches in other EU countries by notifying the CSSF of their ambitions and starting to draft the relevant documentation, including a programme of operations.

Steps to set up a bank in Luxembourg



Case studies

Chinese banks

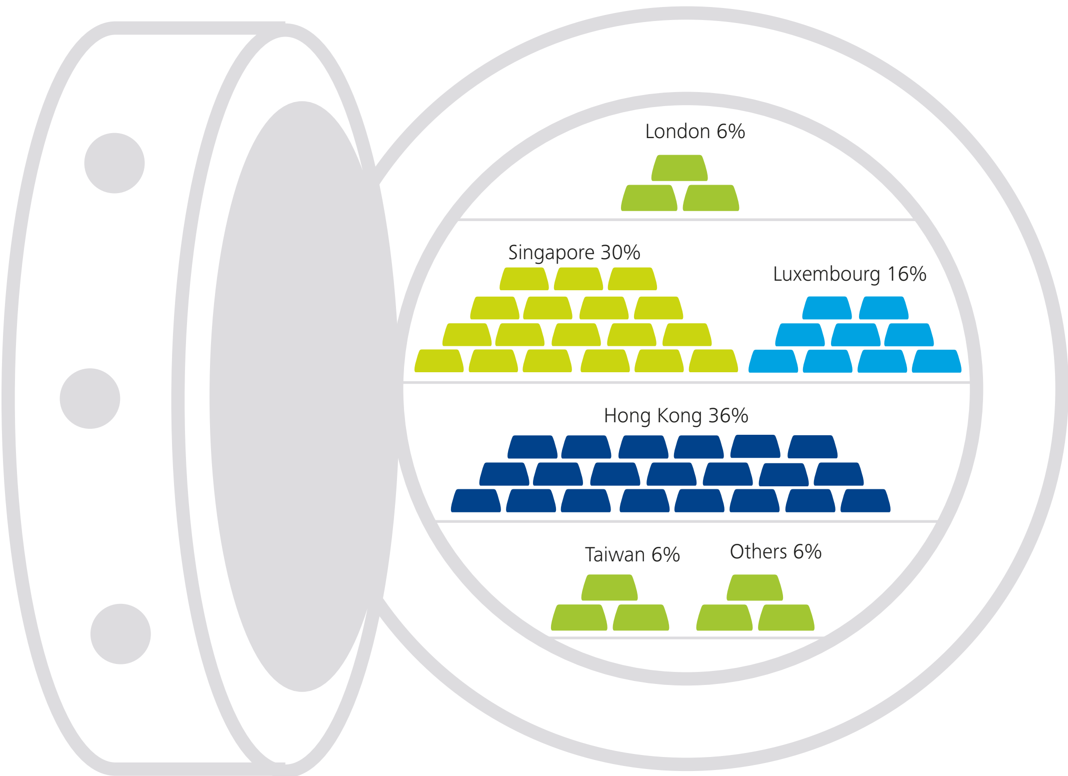
One key area of diversification for the country is to address the needs of Chinese banks eager to enter the EU single market. The most recent and notable example is that of China Construction Bank (CCB), ranked in the top five among listed banks in the world in terms of market capitalisation, which set up both a branch and a subsidiary in Luxembourg in October 2013.

Luxembourg is currently hosting the European headquarters of three of the largest Chinese banks, including Bank of China (BoC), Industrial and Commercial Bank of China (ICBC) and, as previously mentioned, CCB. Dialogues are ongoing with other Chinese financial institutions envisaging setting up a presence in Luxembourg in order to penetrate the European market.

Moreover, Luxembourg has been classified as the centre for international RenMinBi (RMB) business in the eurozone, as it is the largest pool of RMB deposits and funds as well as the leading centre for RMB-denominated bonds and cross-border RMB business in the eurozone. In this respect, the Luxembourg Stock Exchange is leading the international eurobond listings and possesses one of the largest numbers of RMB listed bonds and volumes in Europe.

In addition, the growth of Asian trade and investments in the EU gives rise to trade finance and corporate loan opportunities. Strong economic growth in China allows local banks to look for alternative investment opportunities to diversify their source of income by expanding and setting foot in EU-markets.

Breakdown of worldwide RMB-denominated bonds listings by exchange (Feb 2014)



Islamic banking[2]

Although five Islamic banking institutions have been set up in England, no such bank is currently fully operating in continental Europe yet. However, the potential customer base amounts to around 20 million Muslims living in the European Union, in addition to customers potentially attracted by a new and ethical way of banking. Indeed, it is estimated that around 20 million Muslims live in continental Europe and this number is expected to grow rapidly. The European market presents vast potential for Islamic banking as 60% of Muslims are under the age of 30—the group considered as the most active consumer of financial services (Housby, 2011). Furthermore, the savings rate of European Muslims is considered to be relatively high. As of today, however, no full-fledged Shari'ah-compliant bank has been established in continental Europe.

While we have been experiencing growing interest from Middle Eastern and Asian firms for setting up Islamic banks in Luxembourg, one may wonder why such a small country in the middle of Europe, with only around 12,000 Muslim residents, may be the location of choice for such endeavours.

First of all, the Luxembourg government is encouraging such initiatives and Luxembourg is already the domicile for numerous Islamic investment funds. It is making sure that the regulatory environment addresses the specific requirements of Islamic finance. In addition, the local banking industry is mature and unlike in some other European countries, Luxembourg's regulatory authorities may grant a 'universal banking license' allowing financial institutions to carry out activities such as private, corporate or retail banking. Since Luxembourg is a member of the European Union, once a bank receives the license to conduct operations, it is allowed to perform banking activities in the 27 other member states without having to go through another full license application process. Banks may therefore decide to develop activities outside of Luxembourg on a purely cross-border basis or by establishing a branch in the target country, taking advantage of the 'European passport'. For instance, an Islamic retail bank licensed in Luxembourg may decide to open a branch in Paris in order to offer retail banking services to local Shari'ah-sensitive customers.

Therefore, establishing a presence in Luxembourg and obtaining the universal banking license opens access to an untapped market of 20 million Muslims residing in Europe, in addition to the many non-Muslim customers interested in the ethical values of Islamic banking.

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2 *Source:* "An untapped market of 20 million European customers?", *Said Qaceme, Islamic Finance News, December 4, 2013*

Impact of regulations

Banks in Luxembourg have to comply with the amended law of 5 April 1993, which is supplemented by various national regulations and circulars issued by the CSSF.

Since January 2014, the law is also impacted by the introduction of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV). The CRR/ CRD IV package implements the new global standards on financial institutions' capital (Basel III agreement) in the EU legal framework. This new framework impacts financial institutions in several ways:

- **Corporate governance:** by imposing additional requirements on the composition of the boards of directors, their functioning and their role in risk oversight and strategy in order to improve the effectiveness of risk oversight by boards
- **Liquidity arrangements:** by setting out a new fully-fledged prudential framework for liquidity risk, mirroring the existing pillar I and pillar II approaches for capital requirements
- **Capital requirements:** by requiring more stringent capital requirements through the calculation of credit risk

In addition, the SSM will be introduced in the eurozone. As a consequence, Luxembourg banks shall deal with the new SSM, empowering the ECB with the supervision of banks operating in the eurozone. This will be directly applicable to banks with the following characteristics:

- The bank's assets exceed €30 billion. This criterion is to ensure that the largest banks in the SSM countries are supervised directly by the ECB
- The bank's assets exceed €5 billion and account for 20% of the GDP of the Member State in which it is located. Due to the 20% of GDP requirement, this criterion only applies to SSM countries with a GDP of less than €150 billion (e.g. Luxembourg)

Finally, with effect from 4 November 2014, the issuance of a banking licence in Luxembourg by the CSSF will require the co-decision from the ECB in the form of a second opinion. Since this co-decision will require a collegial agreement among some of Europe's largest countries, setting up new banking institutions may entail more time and effort.

Setting up a bank in Luxembourg offers many advantages. The banking license application process is relatively lengthy but straightforward

Conclusion

Setting up a bank in Luxembourg offers many advantages. The banking license application process is relatively lengthy but straightforward. The timeframe for acquiring a license may vary depending on the complexity of the project but also on the approach taken by the promoters.

Although interactions with the local regulator are encouraged throughout the process, it is paramount to select to the relevant structure at the outset, bearing in mind the opportunities for entering the EU single market centrally from Luxembourg thanks to the 'passport' and the 'free provision of services' regulations.

This is particularly interesting for non-European banks and the Luxembourg government is particularly keen to develop the presence of Chinese banks and Shari'ah-compliant financial institutions on its territory.

Finally, the recent regulatory developments have impacted the European banking landscape.
In particular, the upcoming single supervisory mechanism will empower the European Central Bank to review and potentially overrule national recommendations of the CSSF. This may have some influence on the authorisation process as new procedures may be imposed by the SSM.