# THE PLACE OF SHARI'AH IN THE GLOBAL FINANCIAL ARCHITECTURE ISLAMIC FINANCE IN THE UAE

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**Abstract:**

*The entire global financial architecture incorporates, besides capitalism, a parallel system based on its own principles and rules: Islamic finance. Amid the crisis of 2008-09, the banking system entered at the forefront of debates; even so, there is a gap when it comes about understanding principles of Shari'ah. This paper aims to unify the core principles of Islamic finance, it's operating tools, Shari'ah compliance approaches and Islamic finance in UAE. Formulated as an alternative to the conventional financial system, with the governing principles based on religious doctrines stated in Quaran and Sunnah, Shari'ah rejects riba (usury),gharar (excessive risk) and facilitates various types of transactions based on specific types of contracts. Although it started to gain territory in the last five decades, the Islamic finance growths with an average rate of ten percent per year.*

**Keywords:** *Sharia, Islamic finance, Islamic banking, UAE*

**JEL:** *A1, G2, K1.*

## 1. Introduction

Although Islamic finance registers strong growth rates over 15% per year, the average market share of this products still remains low for institutions offering Islamic financial services: banking sector – 26%, takāful (insurances) – 16% and capital market – 12% (IFSB Survey on SLOLR, 2012). Even so, according to IFSB Bulletin (2016) total assets held worldwide under Islamic banking has reached around US$1,3 trillion . Spred over more

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than 70 countries (Shamshad,2008), high demand of Islamic financial products is noticed all over the world, as a result of large diaspora of Muslim, keen on preserving their religious beliefs while participating in the financial market. Islamic financial hubs, like Bahrain, Dubai and Kuala Lumpur are now competed by west financial centers, such as London, Singapore and Hong Kong, which started the launch of sharia compliant products together with the conventional ones. (Hes et all., 2008). There are about 1.57 billion Muslims in the world, practicing different types of sects, of which the Sunni are the most frequent, covering about 90 percent of them (Pew Research Center, 2009). This aspect is important because depending on the sect, they have different schools and practice slightly different orthodoxy and ortopraxy, which are also reflected in the economic area. But considering the majority of the Sunni, we can mostly refer to their interpretation.

## 2. Shari’ah core principles

A description of Islamic finance presents a socio-economic environment deeply rooted in Islamic religious orientations, which base on doctrines stated in Quaran and Sunnah , but also a theocracy which tends to idealism (for example, by prohibiting general socio-economic activities like gambling or any activity connected to alcoholic beverages, procine food products or pornography or, considering market exemples, by excluding advantages of one party which are considered improper, like financial interest and excessive risk ), but also embraces capitalism outlines of free market. At the basis of Shari’ah core principles are the religious concepts of riba (al-fadl, a-nasiah), gharar and derivates, which are various types of interest-free money; for example, Islamic finance uses wakalah, murabahah, ijārah,muḍārabah, mushārakah and istisnā`. as types of possible contracts and in insurances area we find terms like takāful and tabarru. One of the objectives of this paper is to set the fundamental terms of Islamic economics by defining specificities of Shari’ah.

Regarding transactions in the economic system, Islamic finance rejects as much as possible the exploitation of asymetric information advantages, considering that each party of a transaction needs to respect high levels of transparency. Maybe, the most contrasting approach of Islamic economics and capitalism is the presence of the third party of a transaction. So, the capitalist market equilibrum, where aggregate supply equals aggregate demand, in order to set the price, is contrasted by an extra party of a transaction, represented by omnipresent and omniscient God, replacing the conventional role of supply and demand with his awareness of all transactions, determining the outcomes (Shafiel,2010). As a result, in Islam is considered that "God sets prices"( Eliade, 1957).

A basic explanation of riba can be "the act of taking advantage of those people who need money to meet their basic needs/necessities through the act of renting them money at a price called interest" (Yahia, 2010). It is widely understood as usury or financial interest, but it can also be explained like unearned wealth or unfair exchange between the parties. The interpreters of Islamic laws, Ulema (or religious scholars) agreed on splitting riba in two kinds: riba al-Fadl and riba al-Nasiah. The first one refers to unequal exchange of fungible goods, meaning selling commodity for commodity with an addition above the principal amount; this extra value is paid in kind and can lead to riba. The second type refers to usury over the loan, referring to the duration which is given to the borrowers for the pay-back of loan in return for extra over the principal amount. Fixation of positive returns in advance as a reward on loans for waiting is not permitted by the Islam (Zubair, 2015).

Afterwards, the basic principle of riba-free economics, is accompanied by gharar concept, which embodies negative connotations such as uncertainty, risk, speculation even unequal knowledge of a transaction/contract, where one of the parties doesn't really understands the implications or consequences of it. Shari'ah prohibits gharar because because its existence in the contract may deny the parties of equal bargaining power and lead to uninformed decisions; still, it can be found in two degrees: excessive or major (gharar fahish) or minor and tolerable (gharar yasir) (Mohd, 2012). The extreme case of gharar, which includes every form of wealth acquisition from pure chance (including the case when, in a transaction, one receives money, benefit or usufruct that is at the cost of the other party) is called maysir (Diaw, 2015).

## 3. Contracts used in Islamic finance

Islamic economic system operates with specific contracts, built around the principles described, used in financial sectors like banking, insurances, capital market, trade and others.

To institute the smooth circulation of wealth in society, the Shari'ah facilitates various types of transactions and strongly encourages Muslims to undertake and participate in necessary types of financial activities (Laldin, 2008). The Qur'an and Sunnah are not exhaustive, permitting new transactions to be introduced as long as they are compliant to the principles of the Shari'ah. Therefore, freedom of contract is guaranteed as long as it does not annihilate fairness as propagated (Kamali, 2000, pp. 69-70).

Like described by Laldin and Furqani (2013), the contracts can bedivided into three categories, the first one being exchange contracts (mu'awadat), which includes simple spot sales, sales that create debt, such as deferred payment sales, salam, istisna', ijarah, and reward for successful completion of a job (ju'alah). The second category would be partnership contracts (ishtirak),in which one party assigns work/capital/obligation to another party (or parties); this type includes agency (wakalah), partnerships (sharikah) contracts in the forms of mudarabah and musharakah, assignment (hawalah), and pledge or mortgage (rahn)and gratuitous (tabarru'at). The third category is gratuitous contracts, where ownership or possession (right of use) is transferred without compensation. This type includes loans ('ariyah and qard), deposits (wadi'ah), gifts (hibah) and guarantee/security (daman or kafalah). Considering the large variety of contracts, a short description of the commonly used ones is required.

A common type of contract used in Shari'ah is wakalah, mainly because in this type of agreement, an agency or institution offering Islamic financial services carries out the business in the behalf of customer. This action takes place in the specified terms of the contract, where a fee or no fee is charged to the principal. This type of contract can be used also in banking, where Wakil is the agent, for example the borrower of financial capital, who works in buying the assets financed by the lender. It's supposed that he holds the know-how in implementing the process, while the bank is only specialized in capital allocation. The same type of contract is also used with the depositors, but in import and export transactions too.

Murabahah, in accordance with Tripp, 2006, is a contract in which a lender buys goods on behalf of another party and charges that party a fee. In other words, is a resale contract, where the bank purchases commodities on the client's behalf and then resells them to the latter at a superior price.

According to Guide To Shari'ah-Compliant Investment And Financial Techniques (2006), lease financing, ijārah, represents an agreement where the owner rents a physical asset to end-users against fixed-rental for a specific period of time but with no option of ownership for the lessee.

Muḍārabah, as presented by IFSB in the glossary of Islamic Financial Services Industry Stability Report, May 2015, is "a partnership contract between the capital provider (Rabb-Al-Mal) and an entrepreneur (Muḍārib) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms".Tripp shortly describes it like a contract in which a lender puts up capital and a borrower invests time, energy and expertise

Mushārakah represents a contract where both the borrower and lender contribute with capital to an enterprise, or to awnership of a real estate or movable asset, sharing future profits or losses in proportion to each partner's share of capital.

Istisnā` is a contract of sale for goods which are about to be manufactured or constructed, where the manufacturer or constructer is obliged to deliver the objects to the customer. For example, the bank can be the financier, taking the title of the produced goods upon completion, then sells it to a third party.

A comprehensive explanation of Salam would be the one offered in Guide To Shari'ah-Compliant Investment And Financial Techniques (2006), representing a purchase where a buyer pays the seller the full negotiated price of a product deliverable at a future date, with full specifications about the quantity and the quality of the specified product. It is usually used for agricultural or manufactured products, the return rate depending mostly on the cash transaction rather than the time dimension.

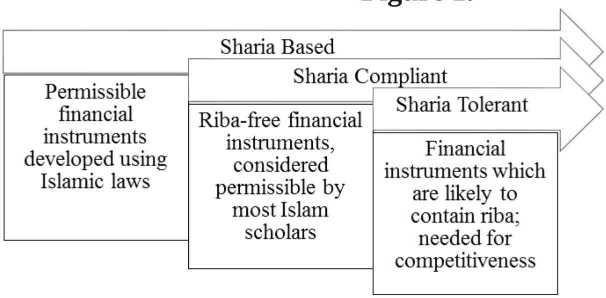
As for Takāful, IFSB, in the above mentioned paper, mentions that the term "is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a Takāful arrangement, the participants contribute a sum of money as wholly or partially Tabarru' (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the Takāful".

## 4. Shari'ah approaches: as basic fundamentals, compliant or tolerant

In Islamic finance, the term shari'ah compliant has a specific meaning apart from shari'ah based and the newly coined shari'ah tolerant. If we were to establish a spectrum of compliance and adoption of shari'ah, shari'ah based would unquestionably and wholly embrace all Islamic moral economy principles; shari'ah compliant would be the middle ground where most Islamic legal scholars deem something to be within an acceptable range of permissibility within shari'ah; finally, shari'ah tolerant would meet the minimum Islamic legal requirements (Dar, New Horizon).

An example of sharia tolerant instrument would be the practice of pricing murabaha and ijarah financial instruments to an interest-based benchmark, like London Inter-Bank Offer Rate (LIBOR) and Federal Funds Rate (FFR) (Shafiel, 2010).

**Figure 1.**




## 5. Standardization and reglementation in Islamic finance

The Islamic financial instutution can be eighter full-flaged eighter with Shari’ah winodw. Short ago, economists stated a challenge faced by Islamic finance, related to marketability of compliant products. Some scholars agree on acceptance of certain products as sharia-compliant, while the others not. The topic in this case would be around acceptance of compliant products in a conventional regulatory framework, but also the need of standardization – made difficult because of the differences in laws and regulatory practices from one country to another. Y-Sing and Richter, in 2010, concluded that, this lack of standardization, may hamper the acceptance of shariah-compliant products and diminish their marketability. Also, Ainley (et all.) in 2007, stated that another channel that hinders marketability of shariah-compliant products is the lack of professionals with expertise in both Islamic finance and religion. Even though in the 2007-2010, the authors concluded that efforts were in place to standardize shariah-compliant products and market them to wider audience.

There are two major institutions in Islamic finance who regulates and supervise the corporate environment: the IFSB – Islamic Financial Services Board and AAOIFI – The Accounting and Auditing Organizaton from Islamic Financial Institutions. The last one is the oldest, established in 1991, in Bhrain, as an international autonomus non-profit corporate body, assisted by IDB and four major Islamic banking groups . The first standard belonging to AAOIFI, and maybe the most important, reffers to Shari'ah Supervisory Board: Appointment, Composition and Report, setting the responsibilities of the most important supervisory body in Islamic finance. It defines the SSB as follows: "A SSB is an independent body of specialised jurists in fiqh almua'malat (Islamic commercial jurisprudence). However, the SSB may include a member other than those specialised in fiqh almua'malat, but who should be an expert in the field of Islamic Financial Institutions and with knowledge of fiqh almua'malat. The SSB is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic Financial Institution in order to ensure that they are in compliance with Islamic Sharia Rules and Principles. The fatwas and rulings of the SSB shall be binding on the Islamic Financial Institution." (Alexakis, Tsikouras, 2009). In effect, the role of AAOIFI is to guide Islamic financial institutions' markets operation and financial reporting on Shari'ah principles and rules and to provide IF markets with standards and guidelines that can support the growth of the industry (as stated in the Vision section of the official website, 2016).

Although newer, the IFSB managed to offer a comprehensive framework for Islamic financial institutions. Founded in 2003, in Malaysia, it serves as an international standard-setting body of regulatory and supervisory agencies in order to ensure the stability of the Islamic financial services industry, by issuing global prudential standards and guiding principles for the financial system, including banking, capital markets and insurance sectors. It brings a substantial contribution with one of the latest publications, (April 2015), Core Principles for Islamic Finance Regulation (Banking Segment), by complementing not only AAOIFI contribution in regulating banking area but also BCPs (Basel Core Principles) . The paper sets the core principles basing on the lessons learned from the 2008 financial crisis, aiming mainly to provide a minimum international standard for sound regulatory and supervisory practices for the effective supervision of the IIFS; to protect stakeholders and consumers by assuring that Islamic institutions are Shariah compliant; to safeguard the linkages between the financial and real sectors, conferring systemic stability and to ensure that the Islamic financial entities acts in accordance with their fiduciary responsibilities in all their operations, especially in regard to investment account holders accounts. The 33 principles set serve as a benchmark for assessing the quality of the companies'regulatory and supervisory systems (CPIFR, 2015).

## 6. Islamic finance in the UAE

The first attempt to adopt Shariah priciples was conducted in Egipt, 1963, when the Mit Ghamr financial company was founded as a co-operative organisation in which the depositors could take out small loans for productive purposes. Further more, in 1975, an international Islamic bank was established in Jeddah, called Islamic Development Bank. But a central role in the development of Islamic finance was played by the United Arab of Emirates, which hosted in 1975 the founding of the first Islamic commercial bank in the world: Dubai Islamic Bank – DIB. The DIBs main activity was buying imports on behalf of a merchant and resell them to the customer for a mark-up, based on Murabahah contracts. In 1998 the foundations were laid for the second Islamic financial institution, Abu Dhabi Islamic Bank and in 2002 UAE had a new pioneering role: the first bank in the world converted from a conventional bank to a full-flaged Islamic bank (National Bank of Sharjah or Sharjah Islamic Bank).

In 2014, for the first time, Central Bank of the UAE, treats aside the two operating finance systems from the Emirate's economy, offering research support in Islamic finance field in the Financial Stability Report. It serves as a major source of information in this section of the paper.

At present, the economy of the UAE consist of both Islamic and conventional financial companies; by the end of 2014, the Islamic financial services industry, without Takaful and Islamic capital market, consisted of 44 institutions of various types. As market share, this means about 17% (see Table 1): from the banking system assets, Islamic banks hold 17.5%, and from the banking system lending the share was 19.2%. The deposits riched USD 77.6 billion, accounting 20% of total banking system deposits. Over the last 12 years, the market share of Islamic entities has doubled.

**Table 1: UAE Banking Sector: Market Shares for Islamic and conventional banks**

| | % | | | | | % | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
| Islamic | 8.8 | 9 | 9.9 | 11.9 | 12.6 | 16 | 17 | 16 | 16 | 17 | 17 |
| Conventional | 91.2 | 91 | 90.1 | 88.1 | 87.4 | 84 | 83 | 84 | 84 | 83 | 83 |

Source:IMF, United Arab Emirates: Financial System Stability Assessment 2007 and Central Bank of UAE, Financial Stability report 2014

The Islamic bank assets have grown at a compund annual growth rate of 10.8% (from 2009 to 2014), reaching USD 110 bilion in December 2014, compared to conventional banks, which have registered a slower rate of 8.4%.

In terms of profitability, despite the weakness registered in the banking sector in 2008-09 due to global financial crisis, the Islamic banks registered strong growth from 2010 onwards:

**Table 2: Islamic banks profitability**

| | Dec. 2009 | Dec. 2014 |
|---|---|---|
| Return on assets - ROA | 0.7% | 1.6% |
| Return on Equity -ROE | 13.5% | 5.2% |

Another topic often debated in Islamic finance is credit risk management, understood as a possibility that a borrower will fail to meet his obligations, according to agreed terms. In this area, Masood, Al Suwaidi and Priya Darshini (2012) conducted a survey-based research, with 148 credit risk managers as respondents, from three Islamic and three non-Islamic banks. They reached the following conclusions: managers in Islamic banks are more open to internalize the latest techniques to manage their credit risk in UAE, including newer, sophisticated and robust techniques (like developing frameworks to study inter-bank exposure and use of derivatives); they are more likely to develop risk adjusted return on capital for risk pricing and give importance to cash flow. As a conclusion, albeit operating in the same financial background, Islamic and non-Islamic banks adopts different position regarding their customers. Islamic banks tend to be more cautious but also more open for internalizing improvements.

International Islamic finance societies provided important sources of capital in GCC region, including the UAE, contributing with a major impact to the development of Islamic finance. Due to political stability, developed infrastructure and supportive government, UAE can be considered a good linkage between Europe, Asia and Africa through Dubai's vision to become an Islamic economic hub but also through cross-border relationships. If the UAE maintains its economic growth, the Islamic finance sector continue to play a major role in financing national infrastructure, the residential property sector and wider corporate sector. (CBU, 2014)

## 7. Conclusion

Considering all presented aspects, Islamic finance can look like a parallel system with the conventional one. But even in Islamic countries we found mixed banking systems, where Shariah based companies are accompanied by conventional ones. This could be a good argument to consider them complementary to each other, and follow up the way Islamic finance conforms to international regulations and supervision, but still complies with Shari'ah principles, but also see how the companies in the system will deal with associated risks. A good example for describing the development of this sector is the case of UAE, where, in the last 12 years, Islamic banks had doubled the market share in the banking system, showing strong increase in profitability and awareness. Islamic finance faces strategic challenges mainly relating to regulatory framework, Shari`ah governance, consumer awareness and different legislation between countries.

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