Innovation and Islamic Finance: Is it Time to Standardise the Islamic Finance Industry in the United Arab Emirates?

Azlin Ahmad
a.ahmad@tamimi.com - Abu Dhabi, UAE

December 2016 – January 2017

One of the key challenges of any Shari'ah compliant product is to structure products that commercially mirror or duplicate the commercial terms of those offered in the conventional market, while at the same time meet the relevant Shari'ah requirements.

Al Tamimi & Company has assisted several banks in Dubai and Abu Dhabi to develop their Islamic retail and wholesale products for financing across the spectrum, from property financing to Islamic overdrafts. For each new product, the process from conceptualisation to the realisation is a rigorous one. We normally work hand in hand with the banks to ensure that their commercial needs are satisfied and that the structures comply with the stringent requirements imposed by the relevant bank's Shari'ah board. In the UAE, due to the conservative standards imposed by the various Shari'ah boards, each product is keenly scrutinised to ensure that the integrity of the product, and, as an extension, the reputation of Shari'ah compliant products in the UAE, is preserved.

The following Shari'ah requirements must be observed generally:

- the charging of interest, including default interest, is prohibited;
- each financing structure must be based on a genuine underlying transaction; and
- speculation and uncertainty are forbidden.

The above guidelines, together with other Shari'ah regulations, have necessitated innovation by the key players in the market. This is how financing products, such as *ijarah* (lease financing) and *murabaha* (financing underlined by a sale and purchase of goods), came into being. From these basic building blocks, various spin-off products have also been developed, for example, forward *ijarah*, for properties under construction, and commodity *murabaha*, to cater to the working capital needs of a corporate borrower.

Of late, many banks are developing new Islamic products even further in order to compete with the products offered by conventional banks. For example, some banks have recently introduced credit card and overdraft structures that replicate those offered by the conventional banks. This is achieved by a combination of multiple products (such as a commodity murabaha coupled with a *wakala*) that form a cohesive new product capable of matching the terms offered by the conventional market. One such example of this is in relation to calculating profit on a daily rest basis.

Innovation is a crucial aspect in the development of new Shari'ah products. The rolling out of a brand new Shari'ah product requires a sound understanding of banking and Shari'ah requirements.

Is it time for consistent Shari'ah standards?

Many concerns have been raised by the lack of consistent standards in Islamic Finance. Some of are the view that it would be better to allow market forces to evolve naturally and correct any deficiencies. However, it is widely agreed that there is a strong need for a basic set of agreed minimum standards for Shari'ah financing, not least because of the international shortage of qualified scholars, which in turn leads to an adverse impact on costs and timelines. For example, additional time is usually spent to obtain Shari'ah approval for both products and financing documentation, and the impact of this is especially felt in a syndicated financing transaction where Shari'ah approvals are required by all the participating banks.

Inconsistent Shari'ah pronouncements (*fatwa*) can be issued by different scholars, which result in divergent approaches on issues such as selling down in the secondary market and cross border financing. The lack of unified standards also impacts on other matters, such as financing structures, legal documentation, corporate governance, and ancillary Shari'ah services, such as trading platforms and accounting and tax treatments.

Hence, the formulation of binding Shari'ah standards should prevent standard structural and contractual provisions from requiring approval at each transaction. A further advantage would be the ensuring of defined parameters in the formulation of any new Shari'ah product so that there is a common starting platform for all banks. An objective set of Shari'ah standards would also lend predictability, credibility, and consistency.

The Accounting and Auditing Organization for Islamic Financial Institutions ('AAOIFI'), has formulated accounting, auditing, governance, and Shari'ah standards for Islamic financial institutions ('AAOIFI Standards'). The AAOIFI Standards have, over time, become a resource for many Shari'ah bankers and advisors alike. The appeal of such standards is that they set out the most common Shari'ah structures, together with the minimum expected standards, and the Shari'ah justifications behind these structures. To some extent, the AOOFI Standards have narrowed the divergent approaches in many of the key issues previously debated by the scholars. However, being merely accounting standards, they are not legally binding and have no force of law in the UAE.

There are currently plans to create a Shari'ah board at the federal level within the UAE, with the aim of unifying the Shari'ah standards within the country, bringing the UAE in line with other jurisdictions, like Malaysia, that have similar systems in place.

Innovation v Standardisation

Standardisation of basic Shari'ah standards is the next natural step in the evolution of Islamic finance in the UAE. The market has already come a long way. For example, many transactional structures now adopt the Loan Market Association ('LMA') style of documentation, although the LMA has yet to develop a complete Shari'ah compliant documentation suite. In terms of structures, the divergence from bank to bank is narrowing. Documentation is becoming more streamlined and sophisticated. However, there is still some way to go before complete standardisation is achieved.

The implementation of national and global Shari'ah standards is not without its challenges. Given that there is no legal requirement for Islamic financing documents to be Shari'ah compliant, any formulated standards should also be consistent with the laws of a jurisdiction in order to be legally effective from the outset.

It would be ideal if standardisation could achieve: 1) a clear minimum position on the common legal issues in Islamic banking documentation; 2) an agreed position or alternative where the products are not fully compliant with local laws (for example, where the structure involved beneficial ownership or trust arrangements); and 3) common standards which apply to all banks in order to ease selling down, restructuring, and refinancing.

With the above minimum framework in place, the industry participants would be able to work within a defined set of parameters, which removes the need to constantly revisit the same issues. This in turn, will allow new products and structures to be developed, but within a more controlled and standardised infrastructure.

Conclusion

Many UAE banks offer Shari’ah compliant products or are Islamic-only financial institutions. Competition is strong for each bank to differentiate themselves from their rivals, including by being the first in the market to offer a new Islamic financing product.

The development of new products is still very much left to self regulation by the banks involved, and efforts to standardise this industry should strike a balance between providing a predictable Shari’ah infrastructure and allowing innovation to create new products and structures.