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Islamic Finance A UAE Legal Perspective



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ISLAMIC FINANCE

1. INTRODUCTION

Almost three decades ago, the concept of Islamic finance was considered wishful thinking. Today, more than three hundred Islamic financial institutions are operating worldwide, estimated to be managing funds in the region of US\$ 200 billion. Their clientele are not confined to citizens of Muslim countries, but are spread over Europe, the United States of America and the Far East. Muslims now have the opportunity to invest their financial resources in accordance with the ethics and philosophy of Islam.

The first thorough studies devoted to the establishment of Islamic financial institutions (referred to hereafter as 'Islamic Banks') appeared in the 1940s. Although Muslim-owned banks were established in the 1920s and 1930s, they adopted similar practices to conventional banks. In the 1940s and 1950s, several experiments with small Islamic Banks were undertaken in Malaysia and Pakistan. The first great success was the establishment of an Islamic Bank in the Egyptian village of Mit Ghamr, in 1963. Other successes include the establishment of the Inter-Governmental Islamic Development Bank in Jeddah in 1975, and a number of commercial Islamic Banks such as the Dubai Islamic Bank, the Kuwait Finance House and the Bahrain Islamic Bank in the 1970s and 1980s. Commercial banks have also realised the potential of this new field, and a number of major worldwide institutions have grasped Islamic banking as a significant mechanism for more diversified growth.

This brochure aims to provide a general overview of Islamic finance. It describes the fundamental principles of Islamic finance, the main financing techniques, the services usually offered by Islamic Banks and relevant laws and regulations for establishing such Islamic Banks.

Background

Islam, the religion of Muslims, is a complete way of life that has a set of goals and values encompassing all aspects of human life including social, economic and political issues. It is not a religion in the limited sense of the word, interested only in man's salvation in the life to come, rather it is a religion that organizes life completely. The body of Islamic Law is known as "*Shari'a*", and the exact literal translation of "*Shari'a*" is "a clear path to be followed and observed".

The *Shari'a* is not a codified law. It is an abstract form of law capable of adaptation, development and further interpretation. The *Shari'a* does not prescribe general principles of law, instead, it purports to deal with and cover specific cases or transactions and sets out rules that govern them.

The *Shari'a* developed through four major Islamic juristic schools (*Hanafi*, *Maliki*, *Shafi* and *Hanbali*) and is derived from two primary sources, the *Quran* (the transcription of God's message to the Prophet Mohammed) and *Sunna* (the living tradition of the Prophet Mohammed), in addition to two dependent sources, namely *ijma* (consensus) and *ijtihad /qiyas* (individual reasoning by analogy).

The recent surge of religious consciousness amongst Muslims has provided the drive towards implementing and adopting Islamic principles in financial transactions. In an attempt to purify assets in the eyes of Islam, Muslims are seeking a greater balance between their lives in the modern technological world and their religious faith and beliefs.

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions, is the prohibition of all sources of unjustified enrichment and the prohibition of dealing in transactions that contain excessive risk or speculation. Accordingly, Islamic scholars have deduced from the *Shari'a* three principles that form the benchmark of Islamic economics and which distinguish Islamic finance from its conventional counterpart. These are briefly as follows:

- **The Prohibition of Interest (*Riba*)**

The prohibition of usury or interest (*Riba*) is clearly the most significant principle of Islamic Finance. *Riba* translates literally from Arabic as "an increase, growth or accretion". In Islam, lending money should not generate unjustified income. As a *Shari'a* term, it refers to the premium that must be paid by the borrower to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity, which today is commonly referred to as interest.

Riba represents, in the Islamic economic system, a prominent source of unjustified advantage. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since *Shari'a* does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value.

The UAE Federal Law No. 5 of 1985 Concerning Civil Transactions (the 'Civil Code'), which was issued with the aim of achieving maximum compliance with the *Shari'a*, recognizes this principle, and states in Article 714:

"If the contract of loan provides for a benefit in excess of the essence of the contract otherwise than a guarantee of the rights of the lender, such provision shall be void but the contract shall be valid."

- **Profit and Loss Sharing (*PLS*)**

PLS financing is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that Muslims do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the PLS-financier's share in profit is his effort and the risk he carries, since his profit would have been impossible without the investment. Similarly, if the investment has made a loss, his money would be lost.

- **Gharrar**

Any transaction that involves *Gharrar* (i.e. uncertainty and speculation) is prohibited. Parties to a contract must have actual knowledge of the "subject matter" of the contract and its implications. An example of an agreement tainted with *Gharrar* is an agreement to sell goods which have been already lost.

3. FINANCING TECHNIQUES

Thus far, Islamic scholars have approved certain basic types of contracts as being compliant with the principles of Islamic finance, and which may be used by Islamic banks to attract funds and to provide financing in a truly Islamic way. Before going into the peculiarity of each and every type of contract, there are, in general, four conditions required to effect a valid contract:

- 1) a price that is agreed mutually and not under duress;
- 2) between parties that are sane and have the legal capacity to understand the implications of their actions;
- 3) at the time of contracting, the subject matter of the contract should be in existence and able to be delivered without uncertainty or deception;
- 4) the contract should not be based upon a consideration (for the purposes of this brochure, this is translated as counter-value) that is itself prohibited under the *Shari'a* (e.g. alcohol, pork products, etc.)

In accordance with these conditions, the UAE Civil Code in Article 129 states:

“The necessary elements for the making of a contract are:-

- (a) that the two parties to the contract should agree upon the essential elements;*
- (b) the subject matter of the contract must be something which is possible and defined or capable of being defined and permissible to be dealt in; and*
- (c) there must be a lawful purpose for the obligation arising out of the contract.*

The major Islamic contracts are as follows:

- **Mudaraba (Trust Financing)**

Mudaraba is a form of partnership in which one partner provides the capital required for funding a project (*Rab-ul-amal*), while the other party (known as a *Mudarib*), manages the investment using his expertise. Although similar to a partnership, it does not require a company to be created, so long as the profits can be determined separately. Profits arising from the investment are distributed according to a fixed, pre-determined ratio. The loss in a *Mudaraba* contract is carried by the capital-provider unless it was due to the negligence, misconduct or violation of the conditions pre-agreed upon by the *Mudarib*.

In a *Mudaraba*, the management of the investment is the sole responsibility of the *Mudarib*, and all assets acquired by him are the sole possession of *Rab-ul-amal*. However, the *Mudaraba* contract eventually permits the *Mudarib* to buy out the *Rab-ul-amal's* investment and become the sole owner of the investment.

Mudaraba may be concluded between the Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee (please note this has a different meaning to the English law concept of trustee) of their funds, and its business-owner clients. In the latter case, the bank pays its depositors all profits received out of the investment, after deducting its intermediary fees. It may also be conducted between the bank's depositors as providers of funds and the Islamic Bank as a *Mudarib*.

Mudaraba can either be restricted or unrestricted. Where unrestricted, depositors authorize the bank to invest their funds at its discretion. In the restricted *Mudaraba*, the depositors specify to the bank the type of investment in which their funds should be invested.

The UAE Civil Code includes a chapter under the title of “*Mudaraba*”, Article (693) thereof states:

“A Mudaraba is a contract whereby the person owning property puts in the capital, and the Mudarib puts in effort or work, with a view to making a profit.”

- **Mosharaka (Partnership Financing)**

Mosharaka is often perceived as an old-fashioned financing technique confined in its application to small-scale investments. Although it is substantially similar to the *Mudaraba* contract (see above), it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment.

Profits are shared between partners on a pre-agreed ratio, but losses will be shared in the exact proportion to the capital invested by each party. This gives an incentive to invest wisely and take an active interest in the invest-

ment. Moreover, in *Mosharaka*, all partners are entitled to participate in the management of the investment, but are not necessarily required to do so. This explains why the profit-sharing ratio is left to be mutually agreed upon and may be different from the actual investment in the total capital.

In a typical *Mosharaka* between a bank and a customer (i.e., partner), at the time of distribution of profits, the customer pays the bank its share in the profits and also a pre-determined portion of his own profits, which then reduces the bank's shareholding in the investment. Eventually, the customer becomes the complete and sole owner of the investment.

The UAE Civil Code recognizes *Mosharaka* in a general way and states in Article 654 thereof:

"A company is a contract whereby two or more persons are bound each to participate in a financial project by providing a share of property or work for the exploitation of that project and the division of any profit or loss which may arise thereout."

- **Morabaha (Cost-plus Financing)**

Morabaha is the most popular form of Islamic financing techniques. Within a *Morabaha* contract, the bank agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then resells the assets or goods to its client with a mark-up profit. The client purchases the goods either against immediate payment or for a deferred payment.

This financing technique is sometimes considered to be akin to conventional, interest-based finance. However, in theory, the mark-up profit is quite different in many respects. The mark-up is for the services the bank provides, namely, seeking out, locating and purchasing the required goods at the best price. Furthermore, the mark-up is not related to time since, if the client fails to pay a deferred payment on time, the mark-up does not increase due to delay and remains as pre-agreed. Most importantly, the Bank owns the goods between the two sales and hence assumes both the title and the risk of the purchased goods, pending their resale to the client. This risk involves all risks normally contained in trading activities, in addition to the risk of not necessarily making the mark-up profit, or if the client does not purchase the goods from the bank and whether he has a justifiable excuse for refusing to do so. However, the Organisation of the Islamic Conference ("OIC") has declared that a customer's promise to purchase the goods in a *Morabaha* is an ethically binding promise. Accordingly, the OIC Academy has held that the customer is bound to compensate the bank for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods.

The purchase of goods under the *Morabaha* contract may be funded by the Islamic Bank either from its own funds, or from the funds of its depositors. In the latter case, the bank acts as its depositors' agent, retaining its fees from the mark-up profits. In such circumstances, the depositors will own the purchased goods during the period pending its resale, and therefore assume its risk.

Article 506 of the UAE Civil Code covers *Morabaha* Sales:

1. *A sale may be by way of resale with a profit, a loss, or at cost price if the capital value of the thing sold is known at the time of the contract, and the amount of the profit or loss is specified.*
2. *If it appears that the seller has exaggerated in declaring the amount of the capital value, the purchaser may reduce (the amount) by the amount of the excess.*
3. *If the capital value of the thing sold is not known when the contract is made, the purchaser may rescind the contract when he learns of it, and the same shall apply if the seller conceals a matter affecting the thing sold or the capital value, and he shall lose his right to elect if the goods are sold or consumed or pass out of his ownership after delivery."*

- **Ijara (Leasing)**

Ijara is defined as sale of *Manfa'a* (i.e., sale of right to utilise the goods for a specific period). The *Ijara* contract is very similar to the conventional lease. Under Islam leasing began as a trading activity and then much later became a mode of finance. *Ijara* is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. The jargon accorded to the financier, that is the bank, is "lessor", and to the client, "lessee".

During a pre-determined period, the ownership of the asset remains in the hands of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented. Likewise, the lessor assumes the risk of ownership, and in practice seeks to mitigate such risk by insuring the asset in its own name. Under an *Ijara* contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed

interval. This is to ensure that the rental remains in line with prevailing market leasing rates and the residual value of the leased asset.

Article 742 of the UAE Civil Code defines the *Ijara* as -

“A hire shall be the conferring by the lessor on the lessee of the right of use intended for the thing hired for a specified period in consideration of an ascertained rent.”

Under this contract, the client does not have the option to purchase the asset during or at the end of the lease term since this is considered under the *Shari'a* to be tainted with uncertainty. Yet, this may be reached under another contract, very similar to *Ijara* (known as an *Ijara wa Iktina* (*Hire-purchase*)) except that there is, at the outset, a commitment from the client to buy the asset at the end of the rental period at an agreed price with the rental fees previously paid constituting part of the price.

- **Salam (Advance Purchase)**

Salam is defined as forward purchase of specified goods for full forward payment. This contract is regularly used for financing agricultural production.

Article 568 of the UAE Civil Code defining *Salam* states:

“A forward sale is for property, the delivery of which is deferred, against a price payable immediately.”

Article 569 of the UAE Civil Code states its requirements:

“The following conditions must be satisfied for a forward sale to be valid:

- 1. The property must be such as can be specified by description and quantity, and it must normally be available at the time of delivery; and*
- 2. The contract must contain particulars of the nature, type, description and amount of the goods, and the time at which they are to be delivered.*

- **Istisna'a (Commissioned Manufacture)**

Istisna'a is a new concept in modern Islamic finance that offers a number of future structuring possibilities for trading and financing. In this contract, one party buys the goods and the other party undertakes to manufacture the goods, according to agreed specifications.

Islamic financial practice holds that the contract is binding on both parties at the outset. Islamic banks frequently use *Istisna'a* to finance construction and manufacturing projects.

There is no specific article in UAE law that expressly refers to and deals with *Istisna'a*, however, the official commentary to the UAE Civil Code stipulates that the *Shari'a* principles of *Istisna'a* are to apply in the case of construction contracts (*Muqawala*) as defined in Article (872) thereof, that states:

“A muqawala is a contract whereby one of the parties thereto undertakes to make a thing or to perform work in consideration which the other undertakes to provide”.

- **Quard-Hasan (Interest-free Loan)**

The *quard-hasan* mechanism effectively amounts to an interest-free loan either to corporate customers in financial distress, (which later might be converted into an equity stake in the enterprise), or to individual clients for welfare purposes.

In making the loan available, the bank may take security for the loan (e.g. mortgage over the customer's premises) and some may charge a nominal fee. The service charges are not for profit; they are the actual costs recovered under one important condition, (to prevent the charges from becoming equivalent to interest), that the charge cannot be made proportional to the amount or to the term of the loan.

- **Takaful (Mutual Insurance)**

The model of *takaful* offers clear guidelines for the establishment of Islamic banking insurance that substitutes its conventional counterpart. The modern conventional system of insurance is contrary to the *Shari'a* because of its exploitative, interest-based nature.

Takaful aims to provide security and protection to its participants in a way that is seen to be socially responsible and fair. It refers to the pool of payments by a group of participants of an agreed sum into a common fund

that will be managed in accordance with the *Shari'a*, particularly the *Mudaraba* contract. In case of the occurrence of the insured event, the participant benefits through claiming compensation from the fund. In the absence of the claim, the participants share the surplus of the invested funds.

Conventional insurance companies manage the funds of its clients on their behalf. Similarly in *takaful*, the Islamic Bank is a trustee (not to be confused with the legal concept of trustee under English law) managing the funds of the participants for a fee. Thus, each participant retains title over its share of the funds, and under certain conditions may withdraw its share.

However, in practice, it is seen that the pure Islamic nature is detracted from concept of *takaful*. The reason behind this is that the *takaful* funds are currently reinsured on a conventional basis due to the lack of a developed Islamic reinsurance market.

Islamic finance is constantly developing mechanisms to enter into the primary market. The most common Islamic financial mechanisms are as follows:

- **Mudaraba Funds**

Many investors get together to become shareholders in large financial projects through the mechanism of the *Mudaraba*. The Islamic Bank's role in these funds is to act as the *Mudarib* and to use these funds to finance a large project. This *Mudaraba* fund can be utilised by the bank in conducting its business using any of the Islamic contracts, such as, *Murabaha*, *Ijara'a*, *Salam* or *Istisna'a*.

- **Companies with Common Shares**

On a worldwide basis, investment securities are generated by companies that issue their shares as stocks. The Organisation of Islamic Conference (OIC) has approved the purchasing of shares of such companies, provided that these companies are not formed for anti Islamic purposes, such as pork trade, liquor production etc. In order for this to work, the western legal principles of the limited liability of shareholders and the artificial personality of companies have been accepted.

Purchasing stocks in Companies with Common Shares is similar to purchasing shares (that may or may not be listed in financial markets) of Public Joint Stock Companies as stated in the UAE Commercial Companies Law. Article 64 of the Commercial Companies Law defines Public Joint Stock Companies as:

"Any company whose capital is divided into negotiable shares of equal value shall be considered a public joint-stock company and a partner therein shall be liable only to the extent of his capital share."

- **Muqarada Bonds**

This is similar to a revenue bond. An existing company (a *Mudarib*) issues *Muqarada* bonds to investors (who are *Rab-Al-Amal*) to generate the finance required for a new project. This new project must be separate from the issuing company's general activities. Once the profits of this separate project are distributed, they are apportioned according to the percentages agreed upon between the *Mudarib* and the *Rab-Al-Amal*. The holders of such *Muqarada* bonds may later become shareholders in the issuing company, depending on the terms of the issuance of the *Muqarada* bonds.

Islamic Banks provide a comprehensive range of core banking services similar to those offered by their conventional counterparts. These are briefly as follows:

- **Current Accounts**

Islamic Banks accept deposits into current accounts from customers looking for safe custody of their funds, together with convenience and use. The bank may levy a charge for providing such a service on a non-interest basis. These deposits are not subject to any conditions on drawing or depositing. The bank may use such deposits at its own risk and responsibility in respect of profit or loss.

- **Savings Accounts**

Savings accounts are much similar to current accounts. Yet, customers may be restricted in the frequency in which they can withdraw their funds or may be required to give a notice period to the bank prior to doing so. The bank, at its discretion, may reward its customers with a profit-share generated from their deposits at the end of its financial year.

- **Investment Accounts**

Islamic Banks open investment accounts into which they accept deposits from customers seeking investment opportunities for their funds using the *Mudaraba* contract. Deposits are held for a specified period. The profits generated by the bank from the investment of the funds are shared between both the bank and the customer, according to a pre-determined ratio. In the event of a loss, the customer will bear it all, unless it was attributed to any fault by the bank.

- **Trade Finance**

To provide this service, the Islamic Bank uses either the conventional letter of credit or the *Morabaha* contract. In practice, Islamic Banks tend to open a letter of credit only for customers who have an equivalent credit balance with the bank and in return for a charge.

The Islamic Bank is likely to use the *Morabaha* contract for trade financing where the customer does not have an adequate credit with the bank. As mentioned, under a *Morabaha* contract, the bank earns its return from the mark-up profit.

- **Project Finance**

The financing of a project by an Islamic Bank is generally provided through the use of the *Mudaraba* contract (in the manner described earlier).

- **Assets Finance**

Islamic Banks finance assets acquisition by using the *Ijara* contract, and the *Ijara wa iktina* for longer-term assets.

- **Overdraft**

Islamic Banks are unlikely to give an overdraft facility to its customers since it will not charge interest for such a service. Instead, the bank may give a *Quard-Hasan* (interest-free loan) to customers in case of hardship to enable them meet certain obligations.

The United Arab Emirates Central bank was formed in 1980 and replaced the Currency Board which was set up in 1973. The establishment of the Central Bank was to bring about control and discipline to the banking sector in the U.A.E. and to provide greater control of national and foreign banks operating within the State in addition to regulating various financial institutions.

- **Laws Governing Banks and Financial Institutions and their Operation in the U.A.E.**

The most relevant Laws, Decrees, Resolutions and Decisions in the field of Banking, Finance and related areas in the U.A.E. are the following:

1. Federal Law No. 10 of 1980 concerning the Central Bank, The Monetary System and Organization of Banking.
2. Federal Law No. 8 of 1984 concerning Commercial Companies.
3. Federal Law No. 6 of 1985 concerning Islamic Banks and Financial Institutions.
4. Federal Law No. 5 of the 1985 concerning Civil Transactions.
5. Federal Law No. 18 of 1993 concerning Commercial Transactions.
6. Central Bank Resolution No.123/7/92 regarding Regulation of Money Changing Business in the U.A.E.
7. Central Bank Resolution No.164/8/94 regarding Regulation of Financial Investment Companies and Banks, Financial and Investment Consultancy Institutions and Companies.
8. Central Bank Resolution No.126/5/95 regarding Financial and Monetary Brokers.
9. Central Bank Resolution No.57/3/96 regarding Representative Offices.
10. Central Bank Resolution No.58/3/96 regarding Finance Companies.
11. Central Bank Regulation No. 24 for the Year 2000 concerning Procedures for Anti-money Laundering.

- **The Role of the Central Bank**

Article 5 of Law No. 10 of 1980 ("1980 Law") provides that the Central Bank shall direct monetary, credit and banking policy and supervise its implementation in accordance with the State's general policy and in such ways as to help support the national economy and the stability of the currency. In order to attain those objectives, the Central Bank is required to:

1. exercise the privilege of currency issue in accordance with the provisions of the 1980 Law;
2. endeavour to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies;
3. direct credit policy in such ways as to help achieve a steady growth of the national economy;
4. organize and promote banking and supervise the effectiveness of the banking system according to the provisions of the 1980 Law;
5. undertake the functions of the bank of the U.A.E Government within the limits prescribed by the 1980 Law;
6. advise the U.A.E Government on financial and monetary issues;
7. maintain the U.A.E. Government's reserves of gold and foreign currencies; and
8. act as the bank for banks operating in the State.

The Central Bank has been granted substantial powers to enable it to carry out the above objectives particularly the organization, promotion and supervision of the banking and financial system in the State.

- **Islamic Banks, Financial Institutions and Investment Companies**

Article 1 of Federal Law No. 6 of 1985 concerning Islamic Banks, Financial Institutions and Investment Companies defines Islamic banks, financial institutions and investment companies as

"those companies whose Articles and Memorandum of Association include an obligation to apply the Islamic Sharia Law and that their operations would be conducted pursuant to Islamic Sharia Law".

Article 2 of the Law No. 6 of 1985 provides that such institutions are subject to the provisions of the 1980 Law in addition to Law No. 8 of 1984 relating to Commercial Companies.

Such banks and institutions are required to adopt the form of a public joint-stock company and must, prior to commencing their operations, obtain a licence from the Central Bank.

An Islamic Bank is entitled to commence all or any banking, commercial, financial or investment operations. In addition, it is also entitled to carry out any of the services and/or operations referred to in the 1980 Law. It may also establish companies or finance projects provided that such projects are undertaken pursuant to *Shari'a* principles.

An Islamic Financial or Investment Company is entitled to grant loans, provide credit facilities or finance projects. It may also invest in movable property in addition to its ability to accept deposits from the public to invest such monies in accordance with Islamic *Shari'a* principles.

Such Islamic Banks and financial institutions (including licensed branches and offices of foreign Islamic banks and financial institutions and investment companies) are exempt by virtue of Article 4 of Law No. 6 of 1985, from certain of the prohibitions imposed on commercial banks relating to:

- (i) carrying on for its own account commercial or industrial activities or acquire, own or trade in goods;
- (ii) acquire immovable property for its own account; and
- (iii) having interest rates to be paid by banks on deposits and the rate of interest and commission to be collected from customers.

The Articles and Memorandum of Association of such companies must provide for the establishment of a *Shari'a* committee of not less than 3 persons who will ensure the adherence by such companies to *Shari'a* principles in their operations and contracts. The appointment of the relevant *Shari'a* committee within each of these companies is subject to the approval of a Supervisory *Shari'a* committee within the Ministry of Islamic Affairs.

7. CONCLUSION

Since Islam is the religion of the United Arab Emirates as stated in the UAE Constitution, the UAE is ideally placed to play a leading role in Islamic finance. In addition, implementing Islamic financial mechanisms are well suited to the legal system as it is always better to be an owner rather than a security holder in any transaction.

Further, the UAE Civil Code has a very strong *Shari'a* foundation which supports the proper regulation of Islamic financial mechanisms. Finally, the judges in the UAE come from an Islamic background familiar with Islamic concepts and contracts. This fact will eventually lead to the speedy conclusion of matters as cases will not be required to be referred to experts as frequently as in the past. Accordingly, judgments will become more predictable leading to more certainty in Islamic banking transactions.

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