

A Split in The Middle East Financial System

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Abstract

In the Middle East, it has been proven that religious and cultural particularities can have a decisive impact on the economic environment. In this way, has developed Islamic financial system, a counterpart to the conventional one, that is based on the principles of Shari'ah. A niched system according to addressability but also to the degree of geographical spreading, Islamic financial system increases with higher rates than the conventional one. Although the financial market in this case is closely related to real market. Islamic and conventional systems resilience is similar. The Middle East economy seems ready to host in parallel both types, certainty that is proven by the United Arab Emirates, a state that operates with a share of nearly 20% of Islamic finance, which aims to become the regional financial hub in the future.

Key words: Conventional economics, globalization, Islamic economics, Middle East financial system, Islamic finance

J.E.L. Classification: A1, G1, P5

1. Introduction

In a world led by globalization, unifying principles seem to be a major orientation nowadays. Derived by the necessity to make things like businesses work in different countries around the world, trade is an example that worldwide economic systems can become compatible. Even though the contemporary lifestyle asks for cross-cultural skills, this can become useless when it comes about moral and religious conceptions. People need to adhere to their principles but still be part in the modern society, sharing all the same contemporary needs.

2. Uniformization and split: Islamic and conventional finance

According to 2010 edition of Longman Exams Dictionary, globalization is defined as being "the process of making something such as a business operate in a lot of different countries all around the world, or the result of this: the globalization of world trade/ The globalization of business makes cross-cultural skills mandatory". Although the main necessary tendency results to be the uniformization of systems, mainly the economic ones, in the mid-1970s, with the establishment of the first bank with different principles, the conventional financial system was joined by the Islamic counterpart, due to particular religious confessions among Muslims. Starting from the Arabian-specific geographic area, the system is systemically important: first, due to accelerated growth rates, and second due to geographic expansion. Today, the Islamic financial system encompasses banks, insurers and capital market, but also benefits from institutional support for regulation and supervision.

Banks, the securities market, mutual funds and pension funds, insurers, market infrastructures, the central bank, as well as regulators and supervisors constitute the financial system of a country, a framework for the development of economic transactions and monetary policy. The interconnection of states through commercial and financial links, but also through financial institutions, leads to the rapid spread of shocks from one state to another, which raises the need to build resilient, well organized and regulated financial systems that contribute to domestic and commercial stability. In this respect, financial stability is a prerequisite for sustainable economic development (IMF

Factsheet, 2016, p. 1).

Only by developing strong fundamentals, in the form of regulations and operational principles, a sector can develop in a market. In the last decade, Islamic finances encountered substantial development in this area, ending by having its own regulatory and supervisory systems and institutions (like the IFSB – Islamic Financial Services Board and the AAOIFI – The Accounting and Auditing Organization from Islamic Financial Institutions). “Like Conventional Banking, Islamic Banking can only thrive with the existence of an enabling Legal and Supervisory Framework” (Tumusiime-Mutebile, 2016, p. 1)

Opinions of well-informed people can be a valid argument to state that “international efforts to create the foundations for a sustainable and resilient Islamic financial system in the global financial system” are made, like Dr. Zeti, the governor of the Central Bank of Malaysia shows to be grateful for having contributed at. At the Islamic Economy Award 2014 held in Dubai, in January 2015, when he received a Lifetime Achievement Award for the global development of Islamic finance, he pointed out that this kind of financial intermediation which is well anchored to the real economy brings benefits to the overall economy and strengthens the connection between economies, “facilitating international trade and cross border investment activities” (Bank Negara Malaysia, Zeti, 2015, p. 37).

Taking into account the global spread of Islamic finances, we can argue that a niche financial system is being discussed. First, it was born in response to the needs of contemporary Muslims, people who needed to move their financial resources in a religious ethical way, integrating them into a Shari’ah-aligned movement system. Secondly, although the foundations of this financial system have been recently put in place, despite its accelerated growth rates, its share in total global financial assets is less than 1%, according to a report by the European Central Bank in 2013 (Di Mauro et al., 2013, p. 18).

On the other hand, referring to the addressability of this system, that it is essentially created for Muslims, it is found to be conceived for about 23% of the planetary population.

3. Dual banking system: approaches and performance

Discussing about the conventional banking system, although the first practices appeared in the ancient empires of Babylon, Assyria and Judea, the initial contemporary bank was the Bank of Venice, established in 1157. With the incorporation of the Bank of England by Royal Charter in 1694, started the financial regulation and the banking regulation (Scheepers, 2014, p. 38).

Regarding the banking sector as the most important part of the financial system, certain differences between the conventional and Islamic ones exists. Certain aspects can be stated in antithetical manner. The Maldives Islamic Bank summarizes some of the most important differences between Islamic and conventional banking, highlighting some key aspects: the role of the money, interest, profit and the connection between real and financial sectors. It states that conventional banking uses money like a commodity which can be sold at a higher price and also leads to inflation, while Islamic Banking regards money just as a medium of exchange and store of value; the first one uses the time to charge interest and the second one earns profit by sharing it or by charging services (they operate only on the basis of profit and loss sharing, by assuming risks with the business man – the loss is also divided, while in conventional banking the interest and the cost of financing is charged anyway) and the agreements in the case of Islamic banking are linked with the real sector, not just for disbursing funds but also for the exchange of goods and services (Maldives Islamic Bank, 2017).

Other comparisons state that Islamic banking involves less debt and more equity, strong finance-assets relation and poor leverage, good cooperation investor-manager, based on transparency and information sharing, and risk diversification. The conventional finance, after the same author, is being criticized by: the big amount of the debt, “overleveraging of assets and ... excessive securitization and creation of new assets that were neither transparent nor understood” (Tlemsani and Suwaidi, 2016, p. 298).

4. Middle East selection: United Arab Emirates' banking system

While in Iran and Sudan are found only Islamic banking assets, and in Brunei and Saudi Arabia the conventional with the Islamic assets seem to operate in a perfect equilibrium, descending proportions of Islamic banking assets are found all over the globe, especially in the Gulf Cooperation Countries. Eleven countries have systemic importance in the field (meaning more than 15% Islamic banking assets, the difference being conventional banking, after IFSB), of which UAE are the tenth Holding about 8% from total global Islamic banking assets. UAE operates with dual banking system, with at a rough estimate 20-80% share in the favor of the conventional banking assets (IFSB, 2016, p. 8). The proportion of Islamic lending in the banking system at the end of 2015 was 20.6% (CBUAE¹, 2015, p. 52).

Considering that the United Arab Emirates became an important financial center in the last years, aiming to become a regional financial hub in the future, concluding remarks can be made regarding the coexistence of the two financial systems within the borders of this state. For the last years (2014, 2015), indicators best describe the situation:

Table no. 1: Conventional and Islamic finance in UAE

	Islamic		Conventional	
	2014	2015	2014	2015
No. of banks	8 fully-fledged 26 Islamic windows		45	
Assets growing rate	11%	15%	8%	5%
Assets share	17.5%	18.7%	82.5%	81.3%
Banking system lending	19.2%	20.6%	80.8%	79.4%
Banking system deposit	20%	22.6%	80%	77.4%
CAR (capital adequacy ratio)	15.8%	15.6%	18.2%	18.3%
Tier-1 capital ratio	15%	15%	16.2%	16.6%
ROA (Return on assets)	1.6%	1.5%	1.7%	1.5%
ROE (Return on equity)	13.5%	14%	13.6%	11.6%

Source: CBUAE, 2015, pp. 24, 29, 54, 55; CBUAE, 2014, pp. 1, 18 and author's calculations

Comparing the two operating banking systems, in a state which has a civil law system which incorporates in a large extent Shari'ah rulings (as a conclusion, commercial laws are compatible with Shari'ah principles), it can be noted that the last years' growth rates are bigger for Islamic assets, gaining territory in the market share. As consumer behavior, we notice that the proportions of banking system lending and deposit are kept similar with the proportion held by the two systems: around 20% for Islamic banking and 80% for conventional banking. The main difference is that the Islamic ones are growing and the conventional ones are decreasing. In terms of the capacity of absorbing unexpected losses, the conventional banks have a bigger capital buffer size (CAR) against unexpected risks. Considering ROA, the bank's profitability is similar, but regarding ROE, Islamic banks show higher profitability, CBUAE attributing this to higher leverage. The ratio of Islamic banks' core equity capital to its total risk-weighted assets (Tier-1) keeps a satisfactory level, even if lower than in the case of conventional banks.

In the period prior to the crisis, the research was generally militating for better performance in Islamic compared to conventional banking.

A research made to compare the performance of Islamic and conventional banking from the United Arab Emirates during the period 2008-2014, finds the conventional banks superior over Islamic ones in terms of profitability, credit risk management and solvency. The Islamic banks are found here less solvent, less profitable and facing higher credit risks more liquid (El Massah and Al Sayed, 2015, p. 69,80).

Another study finds Islamic banks more affected by the financial crisis in terms of capital ratio, leverage and return on average equity, while conventional banks showed to suffer more than Islamic banks in terms of return on average assets and liquidity. It states that for a four years' period (2006-2009), Islamic banks performed better than conventional banks (Parashar and Venkatesh, 2010, p. 54)

Even if the Emirates are not the state with the biggest share in Islamic finance, it "has an ambitious plan to be a global hub for Islamic finance within the next few years. The CBUAE supports this initiative by making it one of its core responsibilities in its organisational strategy" (CBUAE, 2015, p. 55). Even so, the same source states the challenges lying ahead: legal and financial infrastructure, Shari'ah governance, prudential regulation and consumer awareness.

A final remark needs to address stability. To define the concept after Central Bank of UAE, the financial system reaches financial stability when banks, other financial markets and institutions "efficiently performs its key functions", like "allocating resources, spreading risk as well as settling payment", and continues to do the same "in the event of shocks, stress situations and periods of profound structural changes" (CBUAE, 2015, not numbered). As the complexity of the financial markets is more extensive in countries with double-operating systems, the financial stability is harder to define and also to obtain.

5. Conclusions

There are certain differences between Islamic and conventional economic systems. Despite the fact that in the case of conventional economics the only governing principles are the socio-legal ones, Islamic economics are driven by the ethical or the religious principle. Based on Shari'ah, which represents the religious but also the civil code for Muslims, an entire economic system was needed to cover the economic needs of the citizens who live their lives by following the principles of the Islamic law. As a result, new foundations were created: for the banking system, financial markets and institutions.

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