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FINANCIAL INTERMEDIATION

Introduction:

An efficient financial system is a system that facilitates financial intermediation through financial markets and institutions. Financial intermediaries channel resources from capital surplus units to capital deficit units. They take part in asset transformation by matching demand and supply, as well as brokerage and risk transformation. They conduct orderly payments, transfers and settlements.

Despite the changes that have taken place in the financial intermediation sector, the basic function of intermediation remained the same.

In the period related to the advent of Islam, "Sarrafs" used to fulfill the functions of banks in terms of lending, intermediation and other financial services. They also used to secure one another in periods of liquidity shortages which were then called "ibda".

Intermediation contracts can be classified in three main groups. The first deals with partnership of capital and entrepreneurship such as Musharakah and Mudarabah. Such intermediation instruments used to be practiced not only by early Muslims, but also by Jews and Christians.

For example, the Caliph Omar used to invest the orphan funds with merchants and traders.

Another example is the prophet Mohamed (pbuh) who used to be a Mudarib with the capital of his wife Khadija.

The second group includes contracts of security for the sake of providing trust and protection.

The third group facilitates guarantees between economic agents. They provide stability and mitigate risk in the financial system.

Intermediation contracts are meant to facilitate an efficient execution of transactional and financial contracts. They include Mudarabah, Musharakah, Kifalah, Amanah, Takaful, Wikalah, and Jo'alah.

Contracts of Partnership:

Musharakah (partnership):It is a versatile contract combining many variations. It includes investment and management. It is a contract whereby two or more people combine their capital or / and labor to share profits and losses generated. It can be in the form of Mudarabah (partnership of capital and labor) whereby partners share profits on a pre-determined basis, where losses are borne by the capital provider (Rab al-mal) except in cases of misconduct where the Mudarib is liable for loss.

In Musharakah profits per partner are predetermined as proportions and no fixed amount is determined. Losses should be borne proportionate to each partner's share in the capital.

A new form of partnership called consecutive partnership has been created by Islamic banks. Such a partnership considers depositors as partners during the financial year and entitles them to proceeds of that period.

Another form is diminishing Musharakah used to provide housing mortgages whereby ownership of the asset remains in the possession of both partners proportionate to their shares. The client purchases shares through every monthly payment, and the share of the financier diminishes gradually. At the end, the client acquires the financier's shares completely.

Mudarabah: it is a contract whereby a capital provider gets into partnership with an entrepreneur (offering expertise and entrepreneurial skills) to share profits. Such an instrument combines the most important factors of production: capital, labor and entrepreneurship.

The capital owner (Rab al-mal) entrusts the entrepreneur (Mudarib) his capital to invest it. The profits generated are shared according to a pre-determined rate. The losses, on the other hand, are to be borne by the capital provider only, and the Mudarib loses his effort and time. However, the Mudarib can be liable of loss in case of misconduct or negligence.

There are two kinds of Mudarabah according to the limitations of the contract:

- The restricted Mudarabah: is a contract whereby the capital provider restricts the Mudarabah investment with a certain period of time or certain activities
- The unrestricted Mudarabah: is a contract whereby the Mudarib has no restrictions. In modern times, Islamic banks are being the entrepreneurs (Mudarib) investing the depositors' funds in financial markets according to their expertise.

The Mudarib is an agent entrusted the capital for investment. Therefore, the capital provider is not entitled to control or take part in decision making in the investment activities.

The Mudarib can engage multiple tiers as partners (capital providers) to expand the partnership. He can as well engage other entrepreneurs as Mudarib to invest according to their expertise. Such a structure is a basis of work for Islamic banks.

To minimize risks, Islamic banks should be very diligent in selecting the Mudarib with reference to his historical background and reputation. The Mudarib himself has to be diligent in terms of investment opportunities selection.

Contracts of Trust:

Wikala (representation): means to designate a second party to act on one's behalf. It gives a power of attorney to a financial intermediary to perform certain tasks.

Both Mudarabah and wikalah contracts are principal-agent contracts. However, the Wakil (agent) has only the powers to act as indicated by the principal's instructions.

Wadiah(Deposits): is safe-keeping of one's property with someone else without any intention of profit. The assets delivered are a trust in the hands of the person keeping them. However, if the trustee is not given any fees for safe-keeping the asset, and if losses occur without being due to negligence, the trustee is not liable for the loss. On the other hand, if fees have been charged for safe-keeping, then the trustee is liable to compensate in case of loss. The trustee may use the asset upon approval of the owner and return it on demand.

Amanah (Trust): is entrusting someone with the custody or safe-keeping of someone else's property. Unlike Wadiah, where the trustee is allowed to use the asset, Amanah is purely for safe-keeping. If the trustee is found guilty of negligence, he is liable for the loss.

Ariyah(Gratuitous lending):is a contract where the borrower of an asset enjoys the benefits of such an asset for free. He is responsible for maintaining the asset and returning it to the lender on demand.

Jo'alah (Service fee): is offering a service for a predetermined fee in accordance with the terms of the contract. The scope of such an instrument is wide and can include professional services, consultancy, asset management and fund placements.

Contracts of Security:

Rahn (Pledge): is taking an asset as collateral for repayment of a debt. It is taken as security against a loan so as to recover the liability in case of nonpayment. It has many features as follows:

- Only assets that can be sold are put in pledge.
- An asset may be pledged to two or more creditors if its value permits.
- In case of nonpayment, the asset can be sold to recover the debt.

Kifalah (Suretyship): is a contract whereby a third party is involved as surety for the payment of a debt in case it is not honored by the debtor. It is like a pledge given to the creditor. However, discharging the kafil from liability does not necessarily discharge the debtor.

Hawalah (Transfer of Debt): means transfer of debt from one debtor to another whereby the first debtor is released from any liability.

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