Chapter 42

Shari’ah-Based Financial Intermediation

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ABSTRACT

Financial intermediation is the core of the banking business, as its role is to mediate between the owners of surplus funds and those in need of finance, sharing the generated profit with the funds’ owners. However, financial intermediation does involve some economic risks in terms of concentration of debt in financial institutions and the possibility of the inability of financed clients to repay their debts. When this happens, financial crises are inevitable, as it occurred in 2008. Islamic finance does not differ in this regard from its traditional counterparts, because the concentration of debts also holds on the concept of Islamic institutional finance, and the possibility of collective default is possible as well. The study treats the issue of financial intermediation and its risks from Maqasidi aspect using home finance as a point of comparison between conventional home finance with Islamic home finance in terms of their economic effects. The study eventually proposes a model for home financing that is free of these cautions.

INTRODUCTION

Regardless of its particular identity, banking is essentially performed on two levels: the first level is mediation between the owners and users of funds, i.e. depositors and investors (borrowers in conventional terms). The second level is between buyers (borrowers) and sellers, with the bank paying the price to sellers on behalf of buyers. The bank achieves this latter mediation through the former mediation. Hence, banking plays an important function in the present age in terms of providing a source of liquidity for individuals and institutions. It has enabled large amounts of liquidity to be available for financial intermediaries to carry out the second level of financial intermediation between buyers and sellers, by facilitating the clients’ access to expensive goods, such as homes and cars, which they can pay for in instalments over many years.
If in markets, sellers sell their goods to people directly on a deferred basis there would be no need for financial intermediation. However, the existence of financial intermediation has led to the disappearance of long-term sale contracts, especially for certain expensive items, such as homes and cars. If financial intermediaries did not exist there would be long-term sale contracts, such as for homes, but this would require large real estate companies that can afford to accept payment over several years, which is rare amongst companies.

Moreover, banks have developed a system to ensure the debts arising from their financing are reimbursed, including overseeing the transfer of their clients’ monthly salaries, establishing follow-up and collection departments that follow up with clients who are falling behind on their payments, and taking guarantees from the clients when they apply for financing. It may not be easy for real estate or car agencies to collect such guarantees.

In addition, the banks need to utilize the funds that are in their possession to generate a return from which they can earn a profit, cover their expenses, and distribute profit to depositors to attract more deposits. For this reason, banks offer to mediate between buyers and sellers, and mortgage finance became the most appropriate service to employ the vast cash reserves from deposits. From the client’s perspective, home financing meets a general need requiring large amounts of money over a long period. From the bank’s perspective, mortgage finance is most suitable for banks to employ their vast finances in order to earn a stable return on their savings deposits from individuals and institutions. It is also one of the safest financing options given that the underlying property provides a guarantee and usually increases in value over time, unlike commodities, such as cars or machinery.

Hence, real estate financing has enabled many individuals to own their homes and has ensured that the banks receive stable returns in order to pay stable investment returns to their depositors. It is also an indirect way of allowing individuals to invest, because an individual may be able to pay the price of a home in cash, but prefers to buy it on finance in order to keep money and invest it in projects that earn a return and may be productive and beneficial for the economy.

BACKGROUND

Financial intermediation can be defined as the process of transferring funds from a sector with surplus towards a deficit sector by a financial intermediary. Financial intermediation help solve several market imperfections. Khaldi and Hamdouni (2011) stated that several theories have been developed to explain how financial intermediaries reduce/solve these market imperfections. They are the theories of asset transformation, transaction costs reduction, liquidity insurance and informational economies of scale and delegated monitoring. In an attempt to achieve their intermediary objectives and overcoming several imperfections, banks have various bank management tools such as liquidity management, information management and risk management, which provide them with a comparative advantage (Kamil, 2018). Financial intermediation leads to the concentration of debt in financial institutions, which could be detrimental to the entire economy. Islamic finance has been gaining momentum over the past few decades with the enrollment of several financial instrument by Islamic banks such as mortgage financing. Islamic house financing is viewed as an alternative to the conventional mortgage financing which has the element of Riba engulfed and embedded in it. Islamic financial institutions use several modes of Home financing such as Diminishing Ijarah, Murabahah, and Diminishing Musharakah. The latter is the most amiable method of Islamic home financing, but it is not devoid of drawbacks. Hijazi and Hanif (2010)