

SHARIAH COMPLIANT FINANCIAL INTERMEDIATION: LEGAL AND ETHICAL ISSUES

By:

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Presentation Outlines

- **What is Shariah Compliant Financial Intermediation**
- **Legal and Ethical Issues in Financial Intermediation**

Intro: What is Financial Intermediation

- Financial intermediation is the process of moving funds from surplus units to deficit units
- Suppliers and users of funds can be governmental bodies, private institutions and individuals.
- In Malaysia, the market where suppliers and users of funds meet is divided into:
 - Financial market (Regulator: BNM)
 - Capital market (Regulator: Securities Commission)

Intro: Financial Intermediaries

- Two forms of financial intermediaries
 - The institutions: investment banks, banks, insurers, unit trust managers, takaful operators, fund managers
 - The individuals: private bankers, remisiers, retail or personal financial executives, unit trust consultants, takaful agents, financial planners.

Intro: Essence of Financial Intermediation

POOL OF SAVINGS	
FINANCIAL MARKET Regulator – Bank Negara Institution Intermediary: <ul style="list-style-type: none">•Bank•Insurer•Islamic bank•Takaful operator	CAPITAL MARKET Regulator – Securities Commission Institution Intermediary: <ul style="list-style-type: none">•Investment bank•Unit Trust Manager•Stock broker•Fund Manager

Figure 1 – The pool of savings divided by the type of market, its regulator and type of institutional intermediaries

Shariah Compliant Financial Intermediation

- Shariah compliant financial intermediation is a financial intermediation process that is aligned to Shariah and it has 4 broad aspects.
- All aspects must conform to Shariah, in particular to the Islamic commercial rules and also to Islamic ethics (*akhlak*).

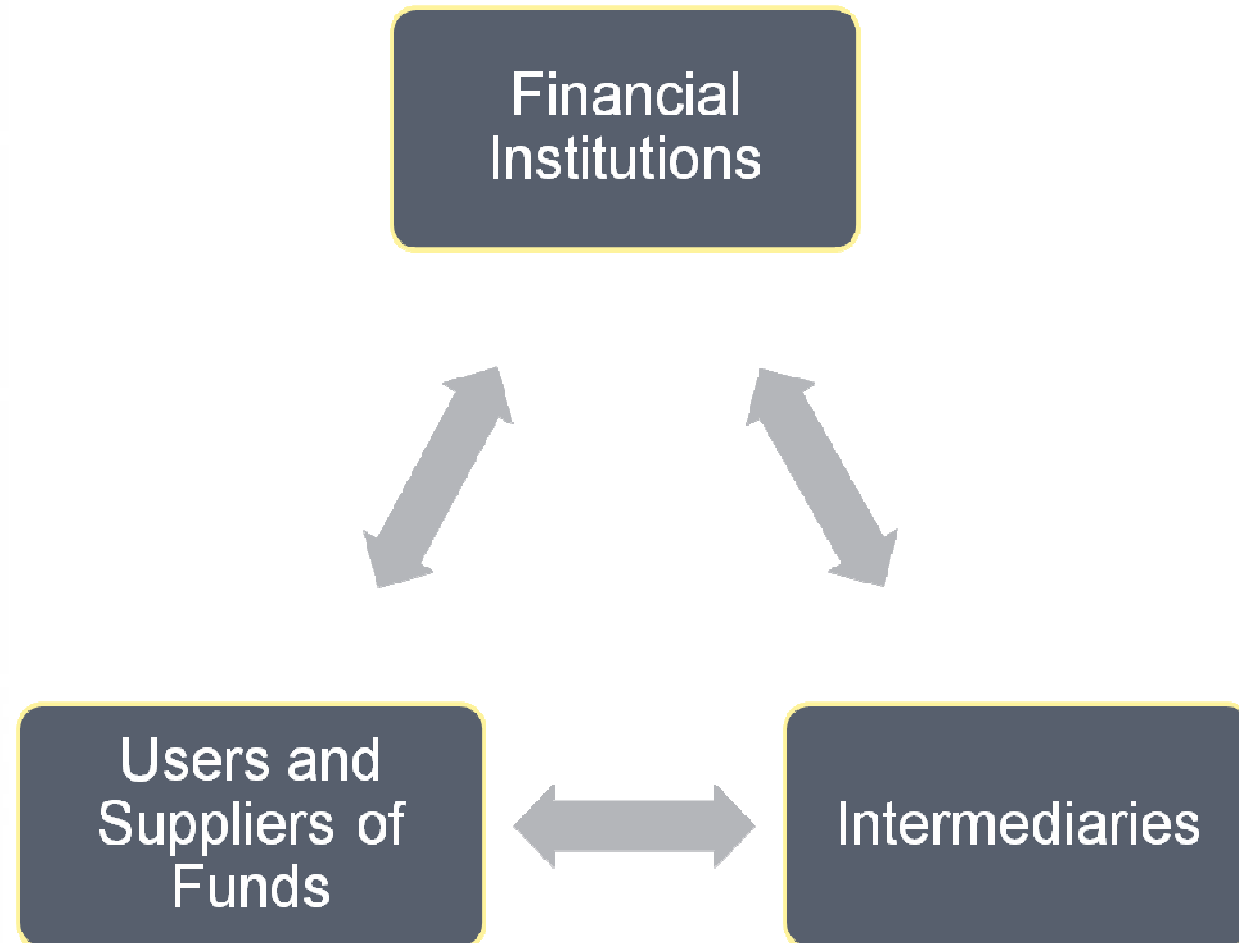
Shariah Compliant Financial Intermediation

- The 4 aspects of Shariah compliant financial intermediary can be divided into two parts: 1) product and 2) advice.
- A Shariah compliant product alone is not enough to ensure that a Shariah compliant financial intermediary process has occurred. The advice that goes along with the product must also be Shariah compliant.
- Financial advisory need to also based on the concept of mutual consent.

4 Broad Aspects of Shariah Compliant Financial Intermediation

- 1) The objectives of all parties must support the *Maqasid as-Shariah*.
- 2) The relationship between the financial institution and the suppliers and users of funds must comply with Islamic commercial rules.
- 3) The relationship between the financial institution and the individual intermediaries.
- 4) The relationship between the individual intermediaries and the supplier and users of the funds.

Relationship between Parties in Financial Intermediation



1)

FI VS Suppliers/ Users of Funds

- Islamic legal relationship between **suppliers of funds** and FIs
- For mudharabah accounts, FI carry no liabilities if capital losses.
- Non-Mudharabah account holders amount to qard or lending relationship.

1)

FI VS Suppliers/ Users of Funds

- Islamic legal relationship between **users of funds** and FIs
 - Recent judgment on BBA property financing product widely is highly controversial. Civil court had declared the BBA as NOT a *bona fide* Islamic financial product.
 - Other violations of Islamic commercial rules found. Eg. Documentation had been found faulty. The legal documents failed to capture the Islamic commercial rules that govern the properly-labeled products.

2)

FI VS Intermediaries

- Shariah compliant between the financial institution and the individual intermediaries mainly concerns with fair dealings between an agent and his principal, or between an employee and his employer.
- The usual Islamic contracts to establish the relationship in this respect are the *wakalah* and the *ijarah al-a'mal*.
- If the individual intermediaries are agent i.e. non-employee with commission and other incentives remuneration scheme, a proper reward based *jua'la* (fee-based) contract should be used in addition to a general *wakalah* contract.

3)

Intermediaries VS Suppliers and Users of Funds

- Conventional financial market intermediaries are not allowed to accept deposits for investment (except for investment banks).
- Islamic bank can accept deposit for investment and as savings from the fund suppliers, the basic difference between investment and savings must be conveyed to the depositor clearly
 - What does non-mudharabah or mudharabah contracts mean to the depositors, such as the liability of the rabbul mal and other definitions
 - The risk-return profile of each type of deposits

3)

Intermediaries VS Suppliers and Users of Funds (Cont'd)

- To resolve the communication issues between individual intermediaries and their clients is the adoption of financial planning approach in their marketing of Islamic financial products.
- A financial planning approach is a comprehensive way in analyzing the financial needs of a person as oppose to a product selling approach that is based on the salesperson's persuasive propositions.

3)

Intermediaries VS Suppliers and Users of Funds (Cont'd)

- Industry players have introduced training programs that cater specifically to Islamic finance.
 - Islamic Financial Planner (IFP) certification program offered jointly by Financial Planning Association of Malaysia (FPAM) and Islamic Banking and Finance Institute Malaysia (IBFIM)
 - Shariah RFP program being developed by the Malaysian Financial Planning Council (MFPC)
 - The Islamic financial advisors being produced by these training programs are bound by the Islamic ethics.

3)

Intermediaries VS Suppliers and Users of Funds (Cont'd)

- Effects of Shariah non-compliant in financial advisory between the individual intermediary and the supplier and users of funds.
- One real effect when Islamic ethics are not adhered is that it can cause credibility crisis i.e. loss of confidence. This has yet to happen in the Islamic financial system but it happened to the conventional counterparts during the financial crisis.

Financial Advisory: Bad Stories

- Singaporean investors who were exposed to Mini-bond and Pinnacle notes financial products by defunct Lehman Brothers and Morgan Stanley of the US called for the Monetary Authority of Singapore (MAS) to intervene.
- MAS banned 10 FIs from selling structured notes after they improperly sold SGD508 million of the notes.
- Summary of the Settlement Outcomes from MAS.
- Findings and Action from MAS's investigation: ABN Amro

Financial Advisory: Bad Stories

- The regulators in Singapore and Hong Kong are treating the cases differently.
- It was reported that a lawyer for one of the banks said “to go for 100 percent compensation will be a long fought battle and probably unlikely to beat the current offer.” But in Singapore, 6,241 cases with amount invested of SGD374 million have been decided.
- 23% received full settlement, 40% partially and 37% did not get any compensation.

Shariah Compliant Financial Advisory: Mutual Consent & Ethics

- Mutual consent between the parties is the most important aspect in trade as well as in dealings in financial products.
- In Shariah compliant financial intermediary, the losses must be free from any negligence and the investors must be well informed of the risks they face in the investment scheme.
- The duty to ensure a financial intermediary process that is Shariah compliant lies upon the financial institutions and their individual agents or employees.
- Proper advice is very much at the heart of financial planning.
 - Eg. Rule 202 of FPAM Code of Ethics says that a financial planner shall act in the interest of the client.

What is Shariah-compliant advice?

It is all sorts of proper advice that lead to the mutual consent of the contracting parties.

If the advice is less than proper or does not lead to the parties being well informed of the situation, then the mutual consent of the user and supplier of funds is not achieved.

Being well informed means that the clients of the intermediary are aware of the consequences of their actions; and vice-versa.

Shariah-compliant advice: Risk Profiling

Risk profiling of the client is needed because the risk profile of the investment products must be matched to that of the client

Both risk profiles i.e. client and product must be fully understood by the financial adviser

Complications arise when they are mismatched

The complications are manifested in the aftermath of the Lehman Brothers collapse