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Islamic Financial Institutions

Financial institutions, Islamic or otherwise, play two indispensable roles in financial systems. The first role is providing support for various financial markets. For instance, exchanges of various types are institutions that facilitate the functioning of markets, by setting rules of trading and providing clearinghouse and margin logistical support. Those services alleviate many of the information asymmetries between buyers and sellers that might lead to market failures. The second role that financial institutions perform is providing financial solutions where market failures exist despite the existence of market-supporting institutions. For instance, although any company should – in theory – be able to access debt markets by issuing bonds, commercial paper, and the like, transactions costs may be disproportionately high, and investor information may be extremely lacking. In such cases, the terms at which a small investor can borrow from the market may be prohibitive.

In contrast, a bank that retains professional staff specializing in the assessment of loan applications or business plans, for example, can provide loans to investors with limited market experience. The same argument applies even more forcefully to consumer financing, since consumers suffer the additional disadvantage of lacking a legal structure that would allow them to borrow directly from the market. Banks solve the information asymmetries that lead to market failure by capitalizing on economies of scale in processing information on creditworthiness, business plan prospects, and the like. They also rely on economies of scale to enhance their abilities to pool the savings of numerous very small savers and to diversify their investments across the enterprises of numerous very small investors. Thus, specialization together with the unique set of corporate structures and regulatory frameworks for retail and investment banks allow them to fulfill various roles in society for which financial markets fail. Of course, at later stages those financial institutions can tap financial markets to diversify their risks further (e.g., by selling mortgage- and asset-backed securities).

Moreover, the theoretical ability of financial markets to provide risk mitigation and transfer mechanisms has its efficiency limits. For instance, it is possible for me to seek the writer of a put option on my car that would specify that the writer will have to buy my car at the strike price, even if it had been damaged in an accident. With millions like me seeking such options, there should be a way to structure the writing of those (insurance) options, circumventing the market failure stemming from information asymmetries. (Am I a crook who will damage his car on purpose? Is my car worth that much? etc.) This informational problem and the associated statistical problem of utilizing sufficient diversification (to ensure that actuarial calculations provide proper pricing formulas for the insurance contract) are again solved through economies of scale. Insurance companies train clerks who specialize in assessing the eligibility of various customers and build statistical models to diversify their risks and price them properly. At a later stage the insurance companies can further mitigate risks by tapping financial markets and wholesale reinsurance companies.

A third group of institutions that we consider in this chapter are venture capital and private equity firms. Those companies specialize in acquisition and control (with various degrees of actual day-to-day management) of prospective or existing companies with financial values that may increase substantially for one reason or another. Venture capital firms typically invest in companies the bulk of whose capital takes the form of human knowledge (engineering specifications, business model, etc.), thus restricting their abilities to access capital in more conventional forms, such as secured borrowing or issuing stock.

The probability of success of the average company at an early stage of development is very small, but the profitability of investing at that stage can be substantial if the company succeeds. This high-risk/high-return profile and lack of sufficient expertise on the part of high-net-worth individuals who may be willing to invest in such companies lead to market failure. By specializing in specific areas, venture capital firms can increase the probability of picking future winners and enhance that probability further by providing advice (sometimes in the form of heavy-handed guidance) to entrepreneurs. They further mitigate risk exposure for investors by pooling the resources of a number of like-minded investors and diversifying their portfolio across a number of investment prospects. Of course, the ultimate success of a venture capitalist is realized when he can take one or more of his investments to market, typically through an initial public offering. Hence, one may think of the venture capital firm as another form of financial intermediary.

Likewise, private equity firms serve a number of investment interests of high-net-worth individuals that are not readily addressed by existing market products. The activities of such firms vary from venture-capital-style investment, to acquisitions and mergers activities typically performed in association with one or more investment bank, to structuring tailor-made fixed-income instruments. Although private equity investments may or may not eventually be taken to market, the various types of institutions involved in this industry (ranging from large investment banks to small financial boutiques and hedge funds) provide valuable financial services that would not otherwise be available because of size and informational-induced market failures.

In this chapter we shall discuss how Islamic versions of commercial banks, insurance companies, and venture capital and private equity firms have evolved over the past few decades. We shall briefly discuss the theoretical "Islamic economics" processes that gave rise to "Islamic financial institutions," the rhetoric of which continues to define that industry to this day. Then we shall discuss in some detail the classical juristic foundations of that rhetoric and continuing debates among contemporary jurists over centuries-old issues. Although Islamic financial practitioners and the contemporary jurists who support them view dissenting juristic voices as a threat to the industry's very existence, we shall argue that, in fact, a synthesis of the different contemporary juristic views (those promoting Islamic finance as it exists today, and those finding conventional finance to be superior and even more Islamic) can help Islamic finance to become more efficient, and to transcend its rent-seeking Shariʿa-arbitrage modes of operation.

8.1 Banking and Islamic Banking

Islamic finance was conceived in the 1970s as a practical implementation of contemporary thought in "Islamic economics." The latter field had begun to take shape in the 1950s, based primarily on the writings of Muhammad Iqbal and Abu Al-Aʿla Al-Maududi in the subcontinent, and Baqir Al-Sadr and Sayyid Qutb in the Arab world.[1] Timur Kuran (2004a) noted the importance for that field of the concurrent emergence of a political independence movement, with accompanying emphasis on national and religious identities. He argued convincingly that the ideology that gave rise to Islamic economics, and sustains it to this day, is socio-politically (and not scientifically or ethically) based on religion. Over the course of three decades, Islamic economics morphed into a subfield of economics as suggested by contemporary leaders of the field:

> Islamic economics . . . has the advantage of benefiting from the tools of analysis developed by conventional economics. These tools along with a consistent world-view for both microeconomics and macroeconomics, and empirical data about the extent of deviation from [normative] goal realization may help.[2]

> [Islamic economics] is the Muslim thinkers' response to the economic challenges of their times. In this endeavor they were aided by the Qur'an and the Sunna as well as by reason and experience.[3]

Therefore, although "Islamic economics" was initially conceived as an independent Islamic social science, it quickly lost that emphasis on independence and redefined its identity in terms of normative ethical and social values. However, once researchers started using conventional economic tools, their discipline was quickly subsumed by the larger field of economics:

> [Islamic economic thought] failed to escape the centripetal pull of Western economic thought, and has in many regards been caught in the intellectual web of the very system it set out to replace.[4]

Similar to the convergence of Islamic economics with mainstream economic thought, Islamic finance also quickly turned to mimicking the (interest-based) conventional finance it set out to replace. However, writings in Islamic jurisprudence, Islamic economics, and Islamic finance continued to assert that conventional interest-based banking and finance is the forbidden *riba*. Thus, popular Islamic discourse continues to refer to conventional banks as "*ribawi* banks,"[5] and to assert that the Islamic alternative is "interest free."[6]

Theoretical Structure: Two-Tier Silent Partnership

At its inception, Islamic banking was theoretically conceived based on the principle of profit and loss sharing through two-tier silent partnership (*mudaraba*) in place of the *ribawi* deposit/loan-based commercial banking.[7] Providers of funds would be viewed as principals or silent partners extending their funds to an Islamic bank, who is viewed as an entrepreneur or investment agent. The Islamic bank would thus invest the funds on the principals' behalf, in exchange for a share in profits. If the investments were not profitable, the bank/agent would lose only its effort, and the principals would bear all financial losses. In turn, the bank may invest directly or act as a principal in a second investment agency contract (silent partnership), with its customers seeking funds as limited-liability profit-sharing entrepreneur-agents.[8]

This profit-sharing form of financial intermediation, including legal stratagems or ruses (*hiyal*) to fix profits as a percentage of capital, was hardly new. Indeed, Abraham Udovitch (1981) had dubbed the practitioners of this form of finance in medieval Mediterranean trade, as "bankers without banks."[9] The basic profit-sharing principle also bears very close resemblance to the Jewish legal concept of the *heter isqa* (or *iska*, partnership clause) contract, a silent partnership profit-sharing arrangement, to avoid the Biblical prohibition of *ribit*.[10] Later refinements of the *heter isqa* allowed the profits received by the principal to become a fixed percentage of the partnership's capital, to solve the inherent moral hazard problem in silent partnerships. The fundamental argument underlying the December 2002 ruling of Al-Azhar's Islamic Research Institute revolves around the same issue of fixing the silent partner's profit percentage to solve moral hazard problems.

Two Conflicting Fatawa

Over the past two centuries, there have been two conflicting juristic views of the banking industry: one unfavorable and one favorable. The unfavorable view characterized traditional banking as usury or *riba*-based, both bank deposits and financing being viewed as forbidden interest-based loans. The other view, which originated with the Ottoman Mufti Ebussoud Efendi and continues to this day in various juristic circles, views contemporary banking practice as a new financial technology, which is not intrinsically forbidden, although certain corrections of specific banking behavior may be required to ensure adherence to the percepts of Shariʿa. Recently the debate erupted once more with a high-profile *fatwa* from the prestigious Azhar Islamic Research Institute, which deemed the collection of interest on conventional bank deposits permissible (by characterizing it as a fixed profit rate in investment agency). This *fatwa* reiterated an earlier issued *fatwa* in the late 1980s by the current rector of Al-Azhar, Tantawi, who was then the Grand Mufti of Egypt. The logic of that *fatwa*, in turn, was based on the analysis of various earlier Azhar jurists of the twentieth century C.E., as quoted below.

The full text of the Azhar *fatwa* is translated below. Note that the questioner in this *fatwa* characterized conventional bank assets as "permissible investments," thus side-stepping a difficult problem of recharacterization of conventional bank assets, which are mostly loans. Instead, the question set the agenda by focusing the *fatwa*'s language on the liabilities side of banking practice, seeking in effect characterization of funds deposited at the bank in terms of investment agency, a characterization that the Rector of Al-Azhar, to whom the question was sent, had already published. The official issued *fatwa* stated the following:

Office of the Grand Imam, Rector of Al-Azhar

Investing funds with banks that prespecify profits

Dr. Hasan ʿAbbas Zaki, Chairman of the Board of Directors of the Arab Banking Corporation, sent a letter dated 22/10/2002 to H.E. the Grand Imam Dr. Muhammad Sayyid Tantawi, Rector of Al-Azhar. Its text follows:

H.E. Dr. Muhammad Sayyid Tantawi, Rector of *Al-Azhar*:

Greetings and prayers for Peace, Mercy, and blessings of God

Customers of the International Arab Banking Corporation forward their funds and savings to the Bank to use and invest them in its permissible dealings, in exchange for profit distributions that are predetermined, and the distribution times are likewise agreed upon with the customer. We respectfully ask you for the [Islamic] legal status of this dealing.

(Signature)

He has also attached a sample documentation of the dealing between an investor and the Bank. The sample reads as follows:

The International Arab Banking Corporation Bank

Date __/ __/ 2002

Mr/________________ Account number ____________

Kind Greetings

This is to inform you that your account with us, in the amount of L.E. 100,000 (only one hundred thousand Egyptian Pounds) has been renewed.
For the period 1/1/2002 until 31/12/2002:

Rate of return 10% resulting in a return of L.E. 10,000
Total of deposit + return on distribution date L.E.110,000

____

New amount, including return as of 31/12/2002 L.E.110,000

His Excellency, the Grand Imam, has forwarded the letter and its attachment for consideration by the Council of the Islamic Research Institute in its subsequent session.

The Council met on Thursday, 25 Sha‘ban, 1423 A.H., corresponding to 31 October, 2002 A.D., at which time the above-mentioned subject was presented. After the members' discussions and analysis, the Council decided to agree that investing funds in banks that prespecify profits is permissible under Islamic Law, and there is no harm therein.

Due to the special importance of this topic for the public, who wish to know the Islamic Legal ruling regarding investing their funds with banks that prespecify profits (as shown by their numerous questions in this matter), the Secretariat General of the Islamic Research Institute decided to prepare an official *fatwa*, supported by the Islamic Legal proofs and a summary of the Institute members' statements. This should give the public a clear understanding of the issue, thus giving them confidence in the opinion.

The General Secretariat presented the full *fatwa* text to the Islamic Research Institute Council during its session on Thursday, 23 Ramadan 1423, corresponding to 28 November 2002 A.D. Following the reading of the *fatwa*, and noting members' comments on its text, they approved it.

This is the text of the *fatwa*:

Those who deal with the International Arab Banking Corporation Bank – or any other bank – forward their funds and savings to the bank as an agent who invests the funds on their behalf in its permissible dealings, in exchange for a profit distribution that is predetermined, and at distribution times that are mutually agreed upon. . . .

This dealing, in this form, is permissible, without any doubt of impermissibility. This follows from the fact that no canonical text in the Qur'an or the Prophetic Sunna forbids this type of transaction within which profits or returns are prespecified, as long as the transaction is concluded with mutual consent. God, transcendent is He, said: "O people of faith, do not devour your properties among yourselves unjustly, the exception being trade conducted by mutual consent . . . " (Al-Nisa':29)

The verse means: O people with true faith, it is not permissible for you, and unseemly, that any of you devour the wealth of another in impermissible ways (e.g., theft, usurpation, or usury, and other forbidden means). In contrast, you are permitted to exchange benefits through dealings conducted by mutual consent, provided that no forbidden transaction is thus made permissible or vice versa. This applies regardless of whether the mutual consent is established verbally, in written form, or in any other form that indicates mutual agreement and acceptance.

There is no doubt that mutual agreement on prespecified profits is Legally and logically permissible, so that each party will know his rights. It is well known that banks only prespecify profits or returns based on precise studies of international and domestic markets, and economic conditions in the society. In addition, returns are customized for each specific transaction type, given its average profitability. Moreover, it is well known that prespecified profits vary from time period to another. For instance, investment certificates initially specified a return of 4%, which increased subsequently to more than 15%, now returning to near 10%. The parties that specify those changing rates of returns are required to obey the regulations issued by the relevant government agencies.

This prespecification of profits is beneficial, especially in this time, when deviations from truth and fair dealing have become rampant. Thus, prespecification of profits provides benefits both to the providers of funds, as well as to the banks that invest those funds. It is beneficial to the provider of funds since it allows him to know his rights without any uncertainty. Thus, he may arrange the affairs of his life accordingly. It is also beneficial to those who manage those banks, since the prespecification of profits gives them the incentive for working hard, as they keep all excess profits above what they promised the provider of funds. This excess profit compensation is justified by their hard work.

It may be said that banks may lose, thus wondering how they can prespecify profits for the investors. In reply, we say that if banks lose on one transaction, they win on many others, thus profits can cover losses. In addition, if losses are indeed incurred, the dispute will have to be resolved in court.

In summary, prespecification of profits to those who forward their funds to banks and similar institutions through an investment agency is Legally permissible. There is no doubt regarding the Islamic Legality of this transaction, since it belongs to the general area judged according to benefits, i.e., wherein there are no explicit texts. In addition, this type of transaction does not belong to the areas of creed and ritual acts of worship, wherein changes and other innovations are not permitted.

Based on the preceding, investing funds with banks that prespecify profits or returns is Islamically Legal, and there is no harm therein, and God knows best,

(signed)
Rector of Al-Azhar
Dr. Muhammad Sayyid Tantawi
27 Ramadan 1423 A.H.
2 December 2002 A.D.

The penultimate paragraph of the *fatwa* hinted at the common objection to fixing profits in the Islamic silent partnership contract (*mudaraba*). As we shall see below, jurists often claim that there is a consensus that the principal's profit share must be specified as a percentage of total profits, rather than a fixed percentage of the capital. The text of the *fatwa* hints at the view that this opinion was merely an artifact of the historical thought of Islamic jurists who developed the principle and does not rely on any direct injunction in canonical Islamic texts.

As we discussed before quoting the *fatwa*, the banker posing the question must have known that the scholar to whom he addressed the question had in fact made a strong argument in favor of characterizing bank deposits in terms of investment agency with profit margins specified as a percentage of capital. In his book on bank operations, Tantawi explicitly focused on moral hazard considerations:

Nonfixity of profits [as a percentage of capital] in this time of corruption, dishonesty and greed would put the principal under the mercy of the agent investing the funds, be it a bank or otherwise.[11]

Tantawi also cited similar opinions by highly respected earlier jurists, including Muhammad ʿAbduh, ʿAbdul-Wahhab Khallaf, ʿAli Al-Khafif, and others.[12] Most notable among those quotations are the following:

When one gives his money to another for investment and payment of a known profit, this does not constitute the definitively forbidden *riba*, regardless of the prespecified profit rate. This follows from the fact that disagreeing with the juristic rule that forbids prespecification of profits does not constitute the clear type of *riba* which ruins households. This type of transaction is beneficial both to the investor and the entrepreneur. In contrast, *riba* harms one for no fault other than being in need, and benefits another for no reason except greed and hardness of heart. The two types of dealings cannot possibly have the same legal status (*hukm*).[13]

The juristic condition for validity [of *mudaraba*] that profits are not prespecified is a condition without proof (*dalil*). Just as profits may be shared between the two parties, the profits of one party may be prespecified. ... Such a condition may disagree with previous jurists' opinions, but it does not contradict any canonical text in the Qur'an and *Sunna*.[14]

In this regard, the only objection against this dealing is the juristic validity condition for *mudaraba*, which stipulates that profits must be specified as percentage shares, rather than specified amounts or percentages of capital.

I reply to this objection as follows:

First: This condition has no proof (*dalil*) from the Qur'an and *Sunna*. Silent partnerships follow the conditions stipulated by the partners. We now live in a time of great dishonesty, and if we do not specify a fixed profit for the investor, his partner will devour his wealth.

Second: If the *mudaraba* is deemed defective due to violation of one of its conditions, the entrepreneur thus becomes a hired worker, and what he takes is considered wages. Let that be as it may, for there is no difference in calling it a *mudaraba* or an *ijara*: It is a valid transaction that benefits the investor who cannot directly invest his funds, and benefits the entrepreneur who gets capital with which to work. Thus, it is a transaction that benefits both parties, without harming either party or anyone else. Forbidding this beneficial transaction would result in harm, and the Prophet forbade that by saying: "No harm is allowed."[15]

We now note again that this *fatwa* is focused on the liabilities side of banking and even then addresses the issue only from the point of view of depositors. Tantawi (2001) argued that the depositor-bank relationship should be viewed as neither one of depositor-depositary nor one of lender-borrower. Either characterization of the relationship, he admitted, would render any interest payment to be forbidden *riba*. In contrast, he argued, savers forward their funds to banks to invest on their behalf. Therefore, he argued, the relationship is one of principal-agent in an investment agency, and the juristic problem discussed above is only regarding the permissibility of fixing profits as a percentage of capital in such investment agency.

This *fatwa*, and its foundation, clearly contradicted prior *fatawa*, for example, by the Shariʿa Appellate Bench of the Supreme Court of Pakistan (on December 12, 1999, containing six hundred pages of rebuttals of arguments similar to those forwarded by various Azhari jurists over the past century).[16] The history of Pakistani rulings unequivocally declared that all forms of interest are forbidden *riba* and urged the government to purge all forms of interest from the economy. Unfortunately, although the Pakistani judgment purported to address the economic concerns (e.g., regarding moral hazard problems), it just made ideological claims and purported that moral hazard problems (characterized as dishonesty) exist in all systems and should be fought separately – thus avoiding honest argument on economic grounds. Given the continued lack of juristic appreciation for the economic viewpoints regarding information asymmetry (let alone the view that finance without "interest" generally defined is impossible), we shall instead look at the counter-*fatwa* issued by an Islamic jurisprudence council shortly after the Azhar *fatwa* was issued, explicitly focusing on juristic grounds for prohibition of interest on bank deposits.

Deposits vs. Loans: Trust and Guaranty

Although Dr. Tantawi argued that the term "deposit" in "bank deposit" is misleading, since the relationship is in fact one of investment agency, the majority of jurists chose to characterize "deposit" (or *wadi ʿa*) in terms of the premodern contract of fiduciary deposit (*idaʿ*), as discussed in classical jurisprudence texts. Within that fiduciary deposit contract, the depositary holds deposited property in a possession of trust. Once the depositary uses the funds deposited therein, however, classical jurisprudence stipulates that the depositary would have thus violated the simple safekeeping duties of fiduciary deposit and must thus guarantee the funds for the depositor.[17] Therefore, the classical juristic argument concludes, the contract can no longer be viewed as a fiduciary deposit (*idaʿ*), and they concluded that the closest contract of guaranty – and hence the one they assign to the transaction – is the loan contract (*qard*).[18]

In the conclusions of the Fourteenth Session of Majlis Majmaʿ Al-Fiqh Al-Islami in Duha, Qatar, January 11–16, 2003, the Azhar IRI's characterization of dealings with conventional banks as a legitimate investment agency was thus rejected. The following lengthy quotation from the official conclusions of the meeting summarizes the contemporary majority view on conventional banking among jurists who support an Islamic banking alternative (including Arab as well as Pakistani and other jurists). Note that – like the Pakistani rulings – the *fatwa* presumes that the alternative to *riba* (viewed as all forms of interest) is "profit and loss sharing," as in *mudaraba* and *musharaka* partnership forms, stipulated in the Islamic economics literature to be the correct Islamic modes of finance that achieve the Islamic ideal:

A. Conventional Bank functions:

Banking laws forbid banks from dealing through profit and loss-sharing investment. Banks receive loans from the public in the form of deposits, and restrict their activities – according to lawyers and economists – to lending and borrowing with interest, thus creating credit through lending deposited funds with interest.

B. Conventional Bank relationship with depositors:

Religious-law (*sharʿi*) and secular-law characterizations of the relationship between depositors and banks is one of loans, not agency. This is how general and banking laws characterize the relationship. In contrast, investment agency is a contract according to which an agent invests funds on behalf of a principal, in exchange for a fixed wage or a share in profits. In this regard, there is a consensus [of religious scholars] that the principal owns the invested funds and is therefore entitled to the profits of investment and liable for its losses, while the agent is entitled to a fixed wage if the agency stipulated that. Consequently, conventional banks are not investment agents for depositors. Banks receive funds from depositors and use them, thus guaranteeing said funds and rendering the contract a loan. In this regard, loans must be repaid at face value, with no stipulated increase.

C. Conventional Bank interest is a form of forbidden *riba*

Banks' interest on deposits is a form of *riba* that is forbidden in Qurʾan and *Sunna*, as previous decisions and *fatawa* have concurred since the second meeting of the Islamic Research Institute in Cairo, Muharram 1385 A.H., May 1965 A.D., attended by eighty-five of the greatest Muslim scholars and representatives of thirty-five Islamic countries. The first decision of that conference stated: "Interest on any type of loan is forbidden *riba*." The same decision was affirmed by later decisions of numerous conferences, including:

... [List of conferences and Institute opinions prohibiting bank interest]

D. Prespecification of investment profits in amount, or as a percentage of the invested capital

It is generally accepted that interest-bearing loans differ from legal silent partnership (*mudaraba*). In loans, the borrower is entitled to profits and bears all losses. In contrast, *mudaraba* is a partnership in profits, and the principal bears financial losses if they occur, as per the Prophet's saying: "profits are justified for the one bearing liability for losses." ...[19]

Thus, jurists of all schools have reached a consensus over the centuries that prespecification of investment profits in any form of partnership is not allowed, be it prespecified in amount, or as a percentage of the capital. This ruling is based on the view that such prespecification guarantees the principal capital, thus violating the essence of partnerships (silent or otherwise), which is sharing in profits and losses. This consensus is well established, and no dissent has been reported. In this regard, Ibn Qudama wrote in *Al-Mughni* (vol. 3, p. 34): "All scholars whose opinions were preserved are in consensus that silent partnership (*qirad* or *mudaraba*) is invalidated if one or both partners stipulate a known amount of money as profit."

In this regard, consensus of religious scholars is a legal proof in its own right [elevated to the level of the canon].

As it declares this unanimous decision, the Council urges Muslims to earn money only through permissible means, and to avoid forbidden sources of income in obedience to God and His Messenger.[20]

This opinion contains four main arguments against the correctness and relevance of the IRI *fatwa*: (1) The *fatwa* refers to banks with permissible investments, but banks are forbidden from investing in any instruments other than interest-bearing loans and financial instruments; (2) characterizing the depositor-bank relationship as one of investment agency is incorrect, the correct characterization is one of lender-borrower; (3) there is a consensus that all forms of bank interest are forbidden *riba*; and (4) even if the relationship was to be considered one of investment agency (silent partnership), the prespecification of profits in silent partnerships must be as a percentage of total profits, not as a percentage of capital. The moral hazard argument is ignored, and the principle of return being justified by risk is highlighted. In this regard, it is noteworthy that jurists insist on the financier's bearing risk of property ownership, in essence ignoring credit, interest rate, liquidity, and operational risks to which conventional financial providers are exposed when they extend credit. Paradoxically, as we have seen in Chapter 4, those same jurists have allowed multiple innovations (e.g., through agency in *murabaha*) that practically eliminate risk of ownership and yet continue to justify return based on that cosmetic risk, rather than the true risks of extending credit, Islamically or otherwise.

The first point is clearly valid. One can easily see that by focusing on the liabilities side of banking, the IRI *fatwa*, and its predecessors, ignored the nature of bank assets, which are legally stated as interest-bearing loans and thus forbidden by the overwhelming majority of jurists as *riba*. This renders the IRI *fatwa* irrelevant for conventional banks, as long as interest on loans is deemed to be forbidden *riba*, since the overwhelming majority of conventional bank assets are receivables from loans. On the other hand, given that Islamic banks have been able to replicate debt-based assets of conventional banks, the agency argument utilized in the Azhar *fatwa* seems eminently useful, as we shall argue later in this chapter. At the very least, if jurists continue to support and create Shariʿa arbitrage opportunities, they should allow banks to reconstruct their liabilities side using the same arbitrage strategies that they have been allowed to use for reconstructing interest-paying assets (albeit in convoluted forms based on trade, leasing, etc.).

Before proceeding to the discussion of potential reconstructions of Islamic bank liabilities, we further illustrate the Shariʿa-arbitrage-inducing economic incoherence of juristic views through the analysis of two other conflicting *fatawa* on insurance. The resolution of the second set of conflicting *fatawa* will also be seen to rest on construction of a proper agency framework for the relevant financial intermediary institutions (banks as intermediaries for credit, insurance companies as intermediaries for risk, avoiding apparent prohibitions of direct trading in credit and risk – *riba* and *gharar*, respectively).

8.2 Insurance and *Takaful*

In the ninth declaration at the second session of the Fiqh Academy of the Organization of Islamic Conference, the academy ruled that conventional insurance is forbidden, with the notable dissent by the late Professor Mustafa Al-Zarqa. Professor Al-Zarqa's opinion, as published in research papers dating back to 1961, had been to permit conventional insurance of all kinds, subject to some conditions on insurance company investment vehicles to avoid *riba*. A number of recent opinions were based on his analysis, which contradicts the Fiqh Academy's. The latter series of opinions culminated in a recent *fatwa* by the Grand Mufti of Egypt, Dr. ʿAli Jumʿa, which deemed conventional insurance permissible, provided that some minor modifications are made to typical insurance contracts used therein.

Two More Conflicting Fatawa

The OIC Fiqh Academy's ruling read as follows:

> After reviewing the presentations on insurance and reinsurance by participating scholars in this session of the conference, and after researching the forms, types, principles, and objectives of insurance and reinsurance and the papers presented in that regard, and in light of the issued opinions of juristic councils and research institutes, this academy has reached the following conclusions:
>
> 1. The commercial insurance contract, with a fixed insurance premium, as practiced by commercial insurance companies, contains substantial *gharar*, which renders the contract defective. Consequently, it is [religious-]legally forbidden.
> 2. The alternative contract that respects the principles of Islamic transactions is the cooperative insurance contract, which is built on the principles of voluntary contribution and mutual cooperation. The same applies with regards to reinsurance, which should also be built on principles of mutual cooperation.
> 3. The academy calls on Islamic countries to exert effort toward establishing mutual cooperative insurance institutions, as well as ones for mutual cooperative reinsurance, so that Islamic economies may be freed from exploitation, and all other violations of the system that God has accepted for this Muslim community.[21]

Likewise, the fifth ruling of the first session of the Fiqh Academy of the Muslim League ruled – with the sole dissenting voice of Dr. Mustafa Al-Zarqa – that commercial insurance is a form of gambling, since the insured pays a premium and either receives no compensation, or a compensation far exceeding what he paid. They also debunked as inapplicable or invalid analogies all the arguments of those permitting insurance based on benefit analysis, general permissibility of transactions unless a prohibition exists, permissibility based on need, and the like. Both juristic councils proposed cooperative insurance (commonly known as *al-takaful al-taʿawuni*) as the viable and Islamically permissible alternative. However, one should not confuse what they mean by the term "cooperative insurance" with mutual insurance as known in the West. In fact, almost all existing *takaful* companies are stockholder owned. The juristic distinction that gives rise to rent-seeking Shariʿa-arbitrage opportunities is characterization of the company's obligation to pay for valid claims as a voluntary contribution (*tabarruʿ*) by the stockholders, thus excluding the contract from the rules of commutative contracts, wherein *gharar* is forbidden. Another problem that operators of *takaful* based on *tabarruʿ* face is the general rule of nonbindingness of promises to extend gifts or make voluntary contributions, which jurists advising those operators have generally maintained. In addition, *takaful* companies invest in Islamized versions of the debt instruments (mortgage-backed securities, government bonds, etc.) that constitute the bulk of conventional insurance company investments, thus avoiding charges of *riba*.

As we have already stated, a most prominent dissenting voice from that opinion was that of Dr. Mustafa Al-Zarqa, who published two research papers that he had prepared for previous conferences in 1961 and 1976, studying the historical roots, objectives, and mechanics of commercial insurance. He insisted on the following till the end of his life:

> I have found no proof in the texts of Islamic Shariʿa, or its legal theory, that would forbid insurance itself, in any of its three forms. On the contrary, I found the proofs of Shariʿa, and its general objectives, to point jointly toward its permissibility and approbation, as a means of eliminating risk and loss.[22]

Moreover, he condemned those who have

> raised doubts in people's minds, and put the public in the dark with regards to the accurate characterization of this topic. ...
>
> Some of those who raise such doubts are driven by obstinate desire to defend earlier opinions that they had issued in haste, and find it psychologically difficult to admit their faults, and others for various other reasons, but without belief in what they say.[23]

A younger student of the same school of thought, Dr. Rafiq Yunus Al-Misri, indicated in a recent publication that he has also reached the same conclusion, that insurance is – in principle – permissible. In the process, he addressed directly the fundamental issue of Shariʿa arbitrage (forbidding some transaction, and then permitting it in slightly modified form, with unaltered substance), which we have raised repeatedly:

By permissibility of mutual cooperative insurance and commercial insurance, we mean permissibility in principle, without necessarily accepting all details. Therefore, I prefer permissibility of insurance, without *hiyal* (legal stratagems, or ruses); for there are jurists who forbid one thing, and then return to permit by various legal stratagems and means of circumvention, without worry or shame. We ask God to protect us from such practices.[24]

In a recent *fatwa* issued in September 2004 by the Grand Mufti of Egypt, Dr. ʿAli Jumʿah, the line of thinking of contemporary jurists who rejected the prohibition of insurance based on *gharar* was summarized, along with opposing views. The Mufti reached the conclusion of permissibility of all types of insurance, with minor recommended corrections, as detailed below in a full translation of the text of the *fatwa*:

Ministry of Justice
Egyptian Dar Al-Ifta'

...We have reviewed the question #1139 of 2003, presented by Mr. Tariq Saʿid ʿAli, which included: "What is the Islamic legal status ruling for life insurance?"

Answer:

Since insurance of all kinds is a recent financial practice, on which no explicit legal text ruled regarding permissibility or prohibition – as also in the case of banking operations – its practice has been subject to juristic analysis and research based on general import of legal texts, such as the verse: "Cooperate in righteousness and piety, and cooperate not in sin and transgression, and fear God, for His punishment is strict" [4:2], and the Prophetic tradition: "The example of believers in their mutual love, mercy, and compassion is like the parts of the body, if one part complains, the rest of the body responds with sleeplessness and fever" (reported by Bukhari), and many others.

There are three types of insurance:

1. Mutual insurance, in which a group of individuals or associations organize to compensate themselves if they experience realized losses.
2. Social insurance, in which the state protects workers from dangers to which they are exposed as part of their work, and this is built on the idea of cooperative mutual insurance.
3. Commercial insurance, which is carried out by joint stock companies established for that purpose.

There is near-consensus on permissibility of the first and second types of insurance based on the principles of Islamic Shariʿa, since they are based on voluntary contribution (*tabarruʿ*), and mutual cooperation toward righteousness. Moreover, they are based on the principle of social cooperation and mutual protection between Muslims, without a profit motive, and hence ignorance (*jahala*) and uncertainty (*gharar*) do not render such transactions deffective. Moreover, if collected insurance compensation exceeds the sum of paid premiums, that is not considered *riba*, since those premiums are not paid to grow with time, but rather as voluntary contributions to compensate for losses associated with various risks.

The third type of insurance, commercial insurance – including insurance of individuals – has been the subject of a sharp difference in opinions: While some jurists consider this type of financial practice forbidden based on prohibited *gharar*, gambling, and *riba*, others find it to be permissible and argue that it is built on mutual cooperation and voluntary contribution, and thus it is not a commutative financial contract.

The latter group of jurists (who allowed insurance), also cited as proof general canonical texts from Qur'an and Sunna, as well as logical analysis.

They used proof from the Qur'anic verse: "O people of faith, fulfill your contracts" [4:1], and argued that this applies to all contracts, including insurance. If this contract was forbidden, the Prophet would have clarified that during his speech in Mina, in which he said: "It is not permitted for anyone to take the property of his brother except with his consent." Thus the Prophet made transactions permissible if the one who gives money gives it with mutual consent. In this regard, insurance contracts are built upon mutual consent of the two parties, and are consequently permissible.

Logically, jurists permitted insurance in analogy to silent partnership (*mudaraba*), which is one of the general permissible types of transactions. In this characterization, the insured is considered to be providing capital in the form of insurance premiums, which are forwarded to the insurer to invest. Profits for the insured are the insurance claim payment, and profits for the insurer are the premiums, which he invests profitably. They also relied on customary practice (*ʿurf*), under which such contracts have become conventional. In this regard, it is well known that *ʿurf* is a source of legislation, in addition to benefit analysis where legal texts are silent (*masalih mursala*). Moreover, the similarities between commercial insurance and mutual and social alternatives are striking, to the point that permission of those other two types of insurance should be extended to the third.[25]

Life insurance – a type of commercial insurance – is not a type of forbidden *gharar* contracts, since it is a contract of voluntary contribution, rather than financial commutativity [which would have deemed it defective based on *gharar*]. This follows from the fact that *gharar* in such contracts does not lead to disputation between the parties, due to common usage of insurance in all aspects of economic life. In this regard, contracts that have become familiar and accepted, without leading to disputes, are not forbidden.

In fact, *gharar* is deemed to exist in this contract only by considering the contract between one individual and the company.[26] However, since insurance has become part of every economic area, and companies have customarily provided social insurance for their employees, every person now knows beforehand what he pays and what he receives – hence, one cannot characterize this practice as containing the forbidden excessive *gharar*.

Studying the documents of commercial insurance of all kinds, as issued by Al-Sharq Insurance Company and others, shows that the bulk of contract articles are simply regulations predetermined by the insurance company with consent of the customer, who thus becomes bound by those contractual regulations. Moreover, the bulk of those articles do not contradict Islamic Shariʿa. However, some other contract articles must be eliminated or amended to agree with Islamic Shariʿa, based on what was agreed by the leaders of the insurance industry in their meeting with the Mufti of the republic on March 25, 1997, which suggested the following amendments: ... [list of changes to be made in insurance contracts]

The Egyptian Dar Al-Iftaʾ thus finds that there is no Sharʿi objection to allowing any of those three types of insurance. In fact, we hope that insurance coverage will be extended further, to cover currently uninsured individuals. Monthly or annual premiums should be made affordable, and insurance should be made obligatory to get everyone accustomed to saving as well as charitable giving, on condition that their funds are returned to them together with investments that are valuable for them and their nations. Advanced nations and great societies are the ones that inculcate in their citizens the love of saving and working toward what assists them in religion and future life.

God knows best,

The Mufti of Arab Republic of Egypt
Prof. Dr. ʿAli Jumʿah

8.3 Two Sides of the Two Debates

The logic of this recent *fatwa* and the preexisting rejections of its grounds bear striking resemblance to their counterparts in the area of banking. Indeed, Dr. Jumʿa hinted at that similarity in the beginning of his *fatwa* by declaring both insurance (intermediation for risk management) and banking (intermediation for credit extension) as modern financial practices, on which the canonical texts of Islam are silent. While refusing to condemn conventional financial practice as forbidden, progressive jurists argued that they need not accept every detail of industry practice, and indeed proceeded to propose lists of modifications of conventional practice to ensure adherence to the percepts of Shariʿa. We may call their approach the minimalist or reformist approach. The basic tenet of this approach is that there is no need to reinvent conventional financial institutions. Instead, this approach dictates, we should impose the minimal necessary modifications on a functioning system to ensure "Shariʿa compliance." As a consequence, this approach would abolish Shariʿa-arbitrage opportunities and merely add consumer protection and prudential regulations as derived from Islamic canonical texts and premodern juristic derivations therefrom.

In contrast, opponents of conventional financial practice draw analogies to canonical texts, including classical unanimity over the conditions of some classical contracts such as investment agency (*mudaraba*) – consensus being raised to canonical levels in classical legal theory. Thus, while the first approach advocates using the methods and spirit of classical juristic analysis, the second advocates adherence to the specific pronouncements of premodern jurists. Consequently, adherents to the latter view feel that the Islamic financial system needs (at least in form) to be reconstructed from premodern contracts that have been approved by classical jurists: *murabaha*, *ijara*, *mudaraba*, for example, as reviewed in the previous chapters. Of course, we have seen that the contemporary Islamic banking practices, say, of *murabaha*, as approved by the jurists serving on those Fiqh Academies, bear little resemblance to the classical namesake contracts, and much resemblance to conventional banking practice. Nevertheless, jurists who adhere to this point of view, many of whom are actively involved in supporting Islamic finance in various capacities, continue to see Islamic finance as an alternative to conventional finance, rather than a minor modification thereof.

Shari'a Arbitrage vs. Islamic Prudential Regulation

As we have argued, the latter set of jurists, especially those actively involved in developing new products in Islamic finance, are very practical in their approach. They recognize that the functions performed by conventional financial institutions (financial intermediation, amelioration of risk, etc.) are necessary for the functioning of any economy. Hence, while they aim to work from the ground up, as it were, starting from the vantage point of approved contracts in classical jurisprudence, they recognize that the bankers and lawyers with whom they work closely approach the industry from the opposite direction: How can we "Islamize" any given set of financial services or products?

In the final analysis, the two sets of jurists share the same tools (analysis of canonical texts and classical jurisprudence) to reach the same ends (approximation of conventional financial practice in a Shari'a-compliant manner). This coincidence of means and ends is belied by the rhetoric of jurists on both sides of the debate, which often turns vitriolic. The minimalist-approach juristic views are sometimes characterized – quite unfairly – as in opposition to Islamic finance, whereas jurists who support Islamic finance are sometimes characterized – equally unfairly – as cynical in their attack on conventional practices that they actively try to emulate.

In fact, too much effort is wasted on such debates. An objective examination of the two camps would reveal that they have each at times used some aspects of the other camp's approach. For instance, jurists who support Islamic finance have adopted the minimalist approach to stock screening for Islamic mutual funds and other investment vehicles – starting from the existing universe of equity instruments, and devising a set of screens that would not reduce the universe too dramatically. Conversely, most of the minimalist-approach jurists have not (at least not yet) approved various types of derivative securities trading, reasoning – quite correctly, absent appropriate regulatory safeguards – that such trading in risk can be akin to gambling. In the future it is most likely that trading in such derivative securities will be permitted under certain regulatory restrictions, which will be variously proposed by the two sets of jurists approaching the problem from the two opposite extremes.

In part, it has been the objective of this book to reconcile the two views by recognizing classical prohibitions in Islamic jurisprudence as prudential regulatory mechanisms. If we accept this view, then we would recognize that we have a choice whether to start from contracts that are known to have embodied those mechanisms in premodern times (e.g., nominate contracts such as *murabaha* or *ijara*) or to start from conventional practice and impose restrictions that embody the substance of those classical mechanisms. The resulting choice of one approach or the other should be dictated by economic considerations: Which is the path of least resistance for the issue at hand? We shall elaborate on this point in Chapter 10. For now, we turn to the issues of Islamic financial practice in financial intermediation (banking) and risk intermediation (insurance). In this context we shall show that the two contrasting views of jurists supporting the opposing *fatawa* on both issues can be reconciled. The magic solution appears to be viewing financial institutions in terms of general agency contracts, as opposed to specific investment agency (*mudaraba*) contracts, for which too many conditions were stipulated in classical jurisprudence.

8.4 Generic Agency Characterization of Financial Institutions

The proposed use of agency contracts (*wakala*) as an organizing principle for Islamic financial institutions is not new. In the insurance industry, the model of agency has gained popularity in recent years, after having been contemplated (though not yet fully and successfully implemented) in Saudi Arabia by Bank Al-Jazira in their *takaful* (cooperative insurance) model. While maintaining the two main characteristics of other *takaful* companies (stock ownership and characterization of payment of insurance claims on the basis of binding voluntary contribution – *tabarru*ʿ – by the *takaful* provider), they charachterized the *takaful* provider as an agent (*wakil*) rather than entrepreneur in silent partnership (*mudarib*). Recognizing difficulties with the voluntary contribution or gift model (wherein bindingness of promises is questionable, as we have seen in Chapter 6), discussions of mutualization have also been ongoing, and there is some likelihood that the *takaful* industry will eventually move to mutual corporate structures.

Agency and Takaful as Mutual Insurance

In the framework of insurance, jurists of the two opposing camps disagreed over the *gharar* issue: Those who based the ruling on the analysis of each individual contract between the insured and the insurer viewed it as a commutative financial contract with *gharar* (premiums are paid, but the insured does not know how much he will get in return). Some other jurists (e.g., in the *fatwa* translated above) argued that – viewed collectively – this is in fact a financial practice built on mutual cooperation rather than commutativity. This argument is unconvincing for conventional stockholder-owned insurance companies. However, it is a legally accurate characterization for conventional mutually owned ones. Another argument, utilized by Professors Mustafa Al-Zarqa, Nejatullah Siddiqi, and others, invokes the law of large numbers to argue that the insurer knows with great accuracy how much it will pay on average (even though it does not know exactly which claims will be filed, etc.). The insured party, on the other hand, is the primary beneficiary from the contract and knows precisely how much he will have to pay in premiums, and how much he will collect in case of damages. Hence, the argument concludes, *gharar* on the insured party's side is not the forbidden kind that can lead to disputation.

The latter argument is convincing, but relies on the reader's judgment regarding the potential for disputation. Therefore, it appears better to eliminate the concern about *gharar* and commutativity of the contract by making *takaful* companies mutually owned. In this context, management of the company will be easily characterized as an agent that collects fixed fees for its agency activities, and the mutual owners of the *takaful* company will be seen quite accurately as a group of individuals engaged in cooperative insurance. In fact, the mutual structure of insurance companies serves other (more direct economic) interests: Managers of a stockholder-owned insurance company answer to the stockholders, and hence aim to maximize profits, which translates into seeking loss ratios that are not advantageous to the insured. In contrast, shareholders of mutual insurance companies are themselves the insured parties, and hence managers will aim to provide them with better insurance value for their premiums. There is indeed a well-documented empirical regularity of mutual insurance companies providing better loss ratios for the insured parties. We shall elaborate further on the call for mutualization and agency in Islamic finance in our analysis of corporate governance and regulation of Islamic financial institutions in Chapter 9.

Of course, there remains the issue of *riba*, which is also cited for the prohibition of conventional insurance. In most countries conventional insurance companies, whether stock or mutually owned, are required to invest in high-quality fixed-income securities such as government bonds and mortgage-backed securities. To the extent that conventional bonds and asset-backed securities are deemed forbidden by jurists supportive of Islamic finance, signing policies with conventional mutual insurance companies may evade *gharar* but would violate the stricter prohibition of *riba*. Consequently, *takaful* companies (or Islamized insurance companies) invest the premiums they collect in Islamic securities. Given the quick growth in issuances of "Islamic" bonds and asset-backed-securities, and given that such securities pay a similar return to their conventional counterparts, this restriction to investing in Islamic securities presents an increasingly diminishing obstacle to providing insurance without violation of Shariʿa percepts.

Agency in Banking

As we have seen in previous chapters, Islamic banks have managed to replicate the asset structures of conventional banks quite accurately. However, jurists supporting Islamic finance continue to require Islamic banks to act on the liabilities side in a mutual-fund-like manner. Interestingly, that *mudaraba* structure is in fact one of agency: The bank acts as an entrepreneur, investing the depositors' funds on their behalf. However, in this traditional *mudaraba* structure, classical jurists were indeed in agreement that the entrepreneur or agent may not guarantee a percentage profit/interest rate to the provider of funds. Arguments by Azhar scholars past and present notwithstanding, the above-cited argument that a new type of *mudaraba* should be developed defeats the purpose of using classical nominate contracts, which is to provide continuity and ensure embodiment of the prudential standards imposed by classical jurists.

It is a fact that Islamic banks invest almost exclusively in interest-bearing debt instruments (such as arise from *murabaha* and *ijara* financing, as well as *tawarruq* in recent years). In such investments the only material risks to which Islamic banks are exposed are the same ones to which conventional banks are: credit risks (debtors may default), interest rate risk (the opportunity cost of funds might rise), liquidity risk (too many depositors may demand their funds at the same time), and operational risks (including internal and external fraud, accounting errors leading to penalty payments, etc.). Islamic finance practitioners point to an additional source of risk, called "displaced commercial risk," stemming from the moral hazard problem caused by lack of guarantee of principal to depositors seeking a return on their funds (if depositors suffer a loss relative to conventional bank depositors, they may withdraw their funds from the Islamic bank). We shall discuss this risk in greater detail within the context of corporate governance of Islamic banks in Chapter 9. It would be ideal for Islamic banks to remove that additional source of risk, by providing their investment account depositors a structure similar to familiar conventional deposits.

Note that a simple structure such as closed-end *murabaha* funds as well as open-end *ijara* funds are quite feasible and utilized in various contexts, as we have shown in previous chapters. However, such structures lack the guarantee of the offering financial institutions. To the extent that conventional banks also bolster their own guarantees with access to central banks that act as lenders of last resort, as well as various deposit insurance schemes, such funds fail to mimic the level of safety given to conventional bank depositors.

The clue to making Islamic bank investment deposits similar to conventional bank deposits is to maintain the agency characterization of the bank's role, without resorting to the specific "investment-agency" (*mudaraba*) characterization that ignores the debt-instrument nature of bank investments. In fact, hints at the appropriate agency structure can be already seen in the Bahrain Monetary Agency *salam-sukuk* structure reviewed in the Chapter 6. We have seen that the government in that structure acts as an agent that guarantees a fixed-percentage return to the *sukuk* holders. In fact, we have seen that the same is true for *ijara-sukuk* structures, including the Qatar Global *Sukuk* structure reviewed in Chapter 6. All such *sukuk* structures guarantee a fixed-percentage return to *sukuk* holders, thus fetching the same credit rating and interest rate as conventional bonds issued by the same governments.

On the other hand, juristic analyses of such *sukuk* structures have not been readily accessible, and the structures themselves are too cumbersome for seamless replication of conventional banking practice for Islamic banks that invest in permissible instruments. We have already discussed in previous chapters the economic substance of restrictions imposed on Islamic bank assets, and the potential for squandering said substance. We have also highlighted the fact that the Azhar *fatwa*'s implicit claim that conventional banks' investments are permissible is inaccurate according to its own declared scope of *riba*, and their characterization of bank activities as investment agency (*mudaraba*) is juristically troublesome. Instead, our objective is to find a pure agency model for passing through the debt structure of Islamic bank assets, together with the bank's own guarantee, bolstered by deposit insurance and central bank backing.

Toward that end, we shall consider a particularly interesting pair of *fatawa* regarding Islamic banks acting as agents, without themselves offering financing to the customers viewed as principals. Our objective in analyzing those *fatawa* is the following: Instead of viewing Islamic banks traditionally as investment agents for depositors and then as investors through financing various customers (the double-tier *mudaraba* model envisioned in the fifties and surviving to this day), consider the depositors themselves as investors who finance the various activities of bank customers, the bank itself acting merely as an intermediary agent and guarantor of the financed parties. It is in this regard that the following *fatawa* can be instrumental to setting the appropriate precedents.

The two *fatawa* appear at the end of Ahmad and Abu Ghuddah (1998, *fatawa* 16-13 and 16-14, pp. 365–72). We now provide translations of the most important segments:

16-13 Collection of Certificate Receivables

Question (1):

Please indicate the Shar'i opinion regarding the following operations, which are considered customary banking operations on behalf of bank customers. This class of bank services is different from bank investments, since it does not involve any financing for the customer, with or without deferment. Banks perform such operations using their back offices, seeking – when needed – the assistance of other (corresponding) domestic or foreign banks. This type of cooperation between banks takes place based on prior agreements, wherein each party agrees to perform the banking operations for which the other asks, based on pre-specified conditions and compensations. One of the financial services that banks perform on behalf of their customers, based on instructions issued by those customers, is collection of the values of IOUs, checks, and other certificates that stipulate payment of certain amounts. The steps taken for those financial activities are as follows:

First, the customer gives Faisal Islamic Bank of Egypt one or more certificates (*sukuk*) as described previously, which certificates stipulate that the customer is entitled to a sum of money owed to them by one or more other individuals.

Second, the customer asks the bank to collect the amount owed to him by the debtors, as specified in the certificates, and the amount of money thus collected from the debtor is put at the customer's disposal, either to receive in cash, or to be deposited in a current account at the bank, under his name.

Third, it is customary in such practices that the customer asks the bank to take all necessary legal steps against the debtor if the latter is delinquent, so that the customer may benefit from the legal papers thus produced if he needs to resort to court in order to collect his right from the delinquent debtor.

Fourth, the bank performs the same function regardless of whether the certificates are forwarded to the bank directly by the customer, or through other corresponding domestic or foreign banks, since the bank also relies on other banks in collecting the funds of its own customers, especially if the debtors reside in a different country, wherein the bank has no branches or agents.

Answer:

Agency from the Shar'i point of view is assigning another in place of oneself to perform a known and permissible action that he can perform during his lifetime. Consequently, every action that the individual may perform himself, he may assign to another as an agent in his place. Consequently, the above-mentioned operations, wherein the bank is assigned by its customers to collect the values of debt certificates (*sukuk*) owed by others, are valid agency operations, in which the debtor's consent is not required. It is permissible for Faisal Islamic Bank of Egypt to conduct such operations, provided that the certificates are not documentations of debts based on forbidden activities such as gambling, trading in forbidden goods, etc. In this regard, it does not much matter whether the bank collects the values of certificates itself, or through appointing another bank as its agent, which usually happens when the bank has no branch or agent in the city wherein the debtor resides. If the debtor resides abroad, the corresponding foreign banks may collect the value from the debtor, and then perform a currency exchange to determine the amount in domestic currency, to be paid to Faisal Islamic Bank of Egypt. ... It is noteworthy that Faisal Islamic Bank of Egypt does not, in the course of such operations, perform any financing or pay any amount to the customer prior to collecting them from the debtor, or receiving notification from a corresponding bank that it had collected the amount and put it under the disposal of Faisal Islamic Bank of Egypt.[27]

The nature of receivables that banks can collect on behalf of their corporate customers was more explicitly discussed in the next *fatwa*:

16-14 Collection of installment payments of deferred sale prices

Question:

Deferred price sales constitute a large portion of the balance sheets of companies that sell used cars. Collection of the installment payments for those sales is difficult for such companies, but easy for banks. In this regard, some automobile companies have suggested that we collect the installments that their customers owe them, by deducting those installments from the customers' current accounts, after the latter arrange for automatic deposits of their salaries at Kuwait Finance House. Please tell us if it is permissible to perform the following operations:

First: Opening a current account for the customer wishing to purchase a car (if he does not already have one).

Second: Directly depositing his salary, together with a certification from Kuwait Finance House that his salary is forwarded to us.

Third: Receiving monthly bills for each buyer, specifying the dates for collection, so that we may deduct the same amount out of his account.

Fourth: Deducting the values of installments at the appropriate dates, and providing the automobile merchant company with notifications that the installments were deposited in its account with us.

Fifth: Notifying the automobile merchant companies with the names of customers whose accounts were not debited for the installments, and the reasons for that.

Sixth: Calculating a commission (e.g., 100 monthly) to be collected from the auto merchant. Note that we are not bound to transfer the installments if the customer asks us not to, and the customer is not forced to deposit his salary directly with us.

Answer:

First: I needed to ask about the issue of installment sales, whether they contain interest payments, and whether the contract between the car merchant company and the customer stipulates conditions of increasing the payments for late payment, or reduction for prepayment. This question was answered stating that the customer signed obligations for monthly payments, and no interest is collected in the case of late payment. Moreover, the answer said, the cash price of the car is listed, and expenses for deferment are specified. In response, it was stated that this is not permissible, but rather a single deferred price should be mentioned in the contract, and copies of the contract and bills were requested for study.

Second: Explanation of the steps was requested, and answered as follows – an account is opened for the customer who purchased a car, and then monthly installments were deducted from his account, and Kuwait Finance House takes a commission in exchange for performing this service to the creditor Toyota, which the creditor deducts from the profits he made from his dealing with the customer.[28]

What is most interesting in the second *fatwa* is that most of the probing questions pertained to the mechanics of *murabaha* transactions. However, the collection itself and the mechanics of automatic deductions from the customer's account and crediting of the car dealer's account were not subjects of contention. Assuming that the contract was in fact structured by Kuwait Finance House (as a legal agent) on behalf of the Toyota dealership, there would be no issues about the legality of price specification and other issues. In fact, Kuwait Finance House could also have acted as the dealership's agent in finding appropriate customers with current accounts (to which salaries are automatically deposited or otherwise). The *murabaha* contract would still be between the Toyota dealership and the customer, with Kuwait Finance House fulfilling multiple agency roles. If Kuwait Finance House further certifies to the Toyota dealership that it has sufficient funds in the customer's account to make the payments, then it could in essence guarantee payment of the monthly installments.

The above-mentioned procedure would fully complete the financial intermediation task of Kuwait Finance House on behalf of its corporate customer (the Toyota dealership). However, the same principle could be carried over to funds in a pool of investment accounts (restricted or unrestricted). The Islamic bank need not engage in *murabahas* and *ijaras* directly as the financier. Instead, the Islamic bank can stipulate that it merely facilitates the *murabaha*, *ijara*, or even *tawarruq* transactions as an agent of the investment depositors, who are themselves the financiers. Thus, the investment account holders would become like closed-end *murabaha* or *ijara* fund owners, with capital and interest payments guaranteed by the financed parties. Hence, their only exposure is to credit risk arising from the possibility of defaults of their debtors.

Now, since the bank is merely an agent for both parties (depositors as financiers, and customers as debtors to those financiers), it can provide third-party guaranty for the debtor-customers' liabilities. One might think that a problem may arise based on the distinction between agent possession of trust and guarantor possession of guaranty. However, the combination of agency (*wakala*) and third-party guaranty (*kafala*) is not problematic in principle. For instance, it has been discussed by contemporary jurists in the context of letters of credit for importers (who possibly have import expenses deposited with the bank as their agent), wherein the bank may be purely a guarantor, purely an agent, or any combination thereof. The important provision in this case is to ensure that the guarantor may not collect fees for offering guaranty, although it is allowed to collect enough fees to cover clerical costs associated with it. As for agency, the collection of agency fees is accepted unequivocally.[29] Unfortunately, contemporary jurists who are active in Islamic finance have rejected this combination of agency and guaranty.[30]

One can hope that Islamic bank jurists will reconsider this prohibition of the combination of guaranty and agency. However, if they do not, then costlier Shariʿa arbitrage may still be utilized to generate debt instruments as Islamic banks' liabilities. Instead of treating depositors as investors who share in profits and losses, Islamic banks can provide reverse *murabaha*, *ijara*, or *tawarruq* facilities to depositors – much like governments that issue *sukuk* guarantee principal plus interest to their bondholders. Although this increases the transaction costs relative to the simple conjoining of agency and guaranty, it would allow Islamic banks fully to mimic the liabilities of conventional banks, much as they have mimicked their assets. This would complete the replication of conventional bank financial intermediation, while restricting the set of investment vehicles in which an Islamic bank can intermediate to those approved by the appropriate Shariʿa boards (e.g., *murabaha*, *ijara*). For regulators, such Islamic banks will look essentially the same as conventional ones, hence removing impediments to licensing them in various countries, since no alternative regulatory framework will be required. In the next chapter we shall argue for an alternative agency model of mutuality, wherein depositors would in fact be shareholders of the Islamic bank.

Agency in Asset Management

In areas of private equity, venture capital, and fund management, managers of high-net-worth individuals' wealth act predominantly as agents for those individuals, any established trusts or foundations, and others. Of course, this exposes investors to a host of adverse selection and moral hazard problems: If agents invest other people's money, and collect a management fee that increases with returns above a certain threshold (as they often do), they will be tempted to take too much risk. Those agency problems are commonly reduced by requiring fund managers to invest a substantial portion of their own net worth in the same portfolios as their principals. Needless to say, this is the same consideration behind capital adequacy requirements for banks, which also ensure that banks do not take excessive risks with other people's money (in this case, depositors).

Of course, the capital adequacy requirements for banks are significantly stronger than for managers of funds for high-net-worth individuals, precisely because of the differential between risk appetites of small depositors of banks versus wealthy individuals who allocate only small portions of their wealth to various high-risk areas. As we have seen in Chapter 7, Islamic fund management for high-net-worth individuals from the GCC region was one of the easiest areas to develop in Islamic finance, because of parallels between the Islamic and conventional structures of agency contracts therein.

Some of the ideas presented in this chapter can assist in bringing the same agency approach to retail banking practices, without need for a different Islamic banking regulatory framework. This ability to reconstruct Islamic banking as a proper subset of conventional banking practices within the existing regulatory framework would, in turn, reduce the apprehension toward that industry in countries where it has not yet witnessed significant growth, while avoiding currently unforeseen risks that a mutual-fund-style Islamic banking industry may pose to financial sectors where it has been operating. In the following chapter, we shall propose an alternative corporate structure for Islamic banks and insurance companies, based on mutuality. The mutuality approach will address a number of heretofore unresolved problems in Islamic finance, without adding Shariʿa-arbitrage transactions costs (e.g., in replicating conventional bank liabilities as discussed above), and maintaining regulatory familiarity – since mutual financial institutions have existed in the West for nearly two centuries, and regulatory best practices therein have become well understood. In the meantime, the agency framework for Islamic fund management companies of various types need not be altered, since the Islamic and conventional models in those areas are virtually identical.