Mutuality Is No Panacea

The Mirage of "Islamic Finance"

Mahmoud A. El-Gamal

Rice University
Department of Economics

April 26, 2014

Outline

Riba and *Gharar*

- Ibn Rushd (*Bidayat Al-Mujtahid*, vol. 3, p. 176):

  > *If we consider all possible reasons for Islamic legal (Sharʿi) prohibition of any of these transactions, we find only four: the first is prohibition of the specific item, the second is riba, the third is gharar, and the fourth is any condition in contract that lead to (تؤول إلى) the second and/or third*

- The fourth prohibition invokes (Ibn Rushd’s) Maliki principle of *sadd al-dharāʾiʿ* (blocking means or stratagems)

- This would invalidate “Islamic finance” as legal arbitrage

Outline

Simple Arbitrage I: *Murabaha*, *Sukuk*, etc.

- The bulk of Islamic finance replicates formal debt (loan or bond) and interest through two degrees of separation:
  - An object of trade or lease, intended for actual ownership or not
  - A third trading party, real or SPV
- In reality, the object of sale is credit:
  - True *murabaha* in this case would mandate disclosing the financial intermediary's cost of funds and net-interest margin
- Otherwise, the potential for exploitation through *riba* and *gharar* is the same, Ibn Rushd (ibid, 184):

  > *It appears in the Law that what is intended in the prohibition of riba is the potential for (لمكان) excessive injustice therein: Justice in exchange is the attempt to balance the two sides of the exchange.*

- Or worse (Ibn Qayim on "more expensive *riba*" in *tawarruq*)

Simple Arbitrage II: Pseudo-Takaful

- It is well known that the rules of *riba* and *gharar* are suspended in charitable and cooperative non-commutative (i.e. non-exchange) contracts
  - For example, Al-Qarafi argued in *Al-Furuq* that interest-free loans are technically *riba* (they fail the "hand-to-hand" provision in the Hadith of the six commodities), but allowed as charitable exceptions
- Pseudo-*Takaful*:
  - Separate-shareholder-owned corporation collects premiums, pays claims based on principle of voluntary contribution (*tabarru*') or agency (*wakalah*)
  - Full mutuality would require that shareholders be the policyholders, sharing profits pro rata

Outline

Riba, *Gharar*, and Injustice

- It is obvious how commutative (exchange) contracts such as credit sales (*murabaḥa*, *tawarruq*, etc.) and leases can be used unjustly, with an excessively high implied interest rate
    - This was the ancient loan-shark trick
- Partnership finance, ostensibly the Islamic ideal, as per twentieth century "Islamic Economics," can also be a vehicle for injustice:
    - The line between commutative contracts and partnership is thin:
        - *Muḍaraba* (silent partnership) had no foundation in Qur'an or valid Ḥadīth, most Ḥanafī and Shafiʿī scholars saw it as "hire with uncertain work and wage," permitted as exception against analogy
    - Profit share of *muḍārib* (entrepreneur) can be set excessively below their market wage ⇒ unlawful devouring of others' rights
    - Full partnership *mushāraka* with a 1 cent gift as *muḍarib*'s share in capital, and profit rates can again be set so that profit share is excessively below market wage

Riba As An Extreme Form of *Gharar*

- Most scholars forbade fixing the capitalist's (*rabb al-māl*) profit as percentage of capital (i.e. interest) based on *gharar*
    - There is no unified theory of contract: fixed land rent was allowed (controversy regarding Ḥadīth of Rafiʿ ibn Khadīj)
    - Many contemporary scholars argued that not all bank interest is *riba*
- Hadith of Bilal (dates for dates): barter price ratio may not be fair
- The ancient problem with interest, to build on Ibn Rushd's analysis, is that we could not ascertain if the charged interest rate was fair
    - Secured lending, credit scores, bankruptcy laws, etc., would change the rulings – limiting the extent of *gharar*, and, therefore, suspending categorization as forbidden *riba*

RICE

Outline

Inequity Potential In Mutual Financial Institutions

- Mutuality in credit through balanced reciprocity (e.g. RoSCA), in risk through balanced contingent reciprocity
  - Ameliorates agency problem by aligning shareholder's interests with depositors or policy holders' interests
  - However, agency problem is not entirely eliminated: S&L debacle (book value accounting), demutualization during market booms, excessive manager privileges, etc.
- Some mutuals (e.g. credit unions) are more democratic (one shareholder one vote), while others (e.g. mutual savings banks; one share one vote) can suffer from asymmetric information and control by large shareholders
- Juristic (formulaic) overriding of the rules of *riba* and *gharar* in non-commutative contracts does not take such asymmetries into account ⇒ yet another legal arbitrage opportunity

Conclusion

All formulaic rules on contracts, conditions, corporate forms, etc. can be arbitraged to effect the worst forms of inequity
+ arbitrage costs (through financial engineering) are now quite low

All financial jurisprudence is formulaic; mosty ignoring intention, incentive, and outcome (hence *maʾālāt & sadd al-dharaʾiʿ* for Malikis)

Thus, jurisprudence-based, banker-driven, "Islamic finance" is a mirage.