Mutuality, Reciprocity, and Justice
Within the Context of A Unified Theory of *Riba* and *Gharar*

Mahmoud A. El-Gamal
Rice University

First and Incomplete Draft, January 2014.

Abstract

The essence of Islamic jurisprudence of financial transactions is to approach the ideal of justice in exchange (as argued by Ibn Rushd). The Islamic finance envisioned by Islamic economists wrongly emphasized contract forms (namely, partnership finance, ostensibly more approbated than debt finance, without a shred of supporting evidence from Islamic scripture or classical jurisprudence). This gave rise to an industry based on legal arbitrage, synthesizing conventional finance at a cost, thus replicating any injustice or inefficiency therein, and adding inefficiency through arbitrage procedures. Mutual contracts were traditionally exempted from juristic prohibitions, for example in interest-free loans, which are technically riba, mutual insurance, etc., because of their apparent charitable purpose (as argued by Al-Qarafi in his Furuq). However, mutual structures can be arbitraged just as easily (and inefficiently) as commutative ones. The regulatory substance of classical Islamic law, seeking justice, cannot be enforced through contract and corporate forms, mutual or otherwise!

1. Introduction

Finance is the field of economic transactions that transfer and/or transform credit and risk. In this regard, the great Islamic jurist, judge, and philosopher Abu al-Walid Ibn Rushd classified all transactions as follows:[1]

> Every transaction between two parties is either an exchange of two specific objects, a specific object (*`ayn*) for a fungible obligation (debt; *shay'un fi al-dhimma)*, or debt for debt. Each of these three categories may be delivered immediately (*najiz*) or deferred (*nasi'ah*), giving us three other possibilities: both sides are received immediately, one immediately and the other deferred, or both deferred. Thus, we have nine possibilities for trade (*buyu`*). Of these, both parts of the transaction being deferred is impermissible by consensus, whether the items are specific or fungible obligation, because it is the forbidden [in Hadith] "trading of debts for debts"…

[1] Ibn Rushd, A. *Bidayat Al-Mujtahid wa Nihayat Al-Muqtasid*, Beirut: Dar Al-Ma`rifa, 1997, vol. 3, pp. 175—8.

> If we consider all possible reasons for Islamic legal (*Shar`i*) 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 can be reduced to one or more of the first three…

The industry that started in the 1970s under the name "Islamic finance" has aimed to conduct the financial business of extension of credit (e.g. trade finance, consumer finance, corporate finance, public finance) and transfer of risks other than credit risk (e.g. insurance, derivatives) by avoiding these prohibitions. Regarding *riba*, Ibn Rushd continued his analysis thus:[2]

> Scholars are in agreement that *riba* may exist in two categories of transactions: (i) trade (*bay`*); and (ii) debt-related dealings (*fima taqarrara fi al-dhimma*) in trade, deferment (*salaf*), or other transactions. *Riba* in debts consists of two types: the first is universally agreed upon as forbidden, which is the forbidden *Riba al-Jahiliya*, whereby they extended credit, and then demanded increase for deferment, to which the Prophet (p) referred in his final Hajj…, and the other is discounting for prepayment (*da` wa ta`ajjal*), which is controversial…

Ibn Rushd then proceeded to classify the rulings of *riba* according to four categories, depending on whether or not inequality in the two sides of trade is allowed, and whether or not deferment is allowed. After reviewing the famous Prophetic Tradition of the six commodities (gold, silver, wheat, barley, dates, and salt) that must be traded hand-to-hand *and* in equal quantities, hence for which both inequality and/or deferment are disallowed, he reviewed the generalizations to other assets made by analogy in the different schools of jurisprudence. His acceptance of the Hanafi opinion embodied his principle of justice in exchange:[3]

> It appears in the Law (*Shar`*) that what is intended in the prohibition of *riba* is the potential (*li-makan*) for excessive injustice (*al-ghabn al-kathir*) therein. In this regard, justice in exchange is the attempt to balance the two sides of the exchange.

Ibn Rushd proceeded to explain the use of monetary prices to determine justice (or lack thereof) in exchange. Shortly thereafter, he provided a section on trades that are instruments of riba (*babun fi buyu` al-dhara'i` al-ribawiya*), citing the disagreement between the majority of scholars on the one hand and the minority opinion of Al-Shafi`i, Dawud, and Abu Thawr on the other, whereby the majority forbade same item sale resale (known in Hadith and jurisprudence books as *bay` al-`ina*), but the minority argue that they cannot rule on intentions, and thus allow the

---

[2] Ibid, p. 179.
[3] Ibid, p. 184.

practice, which has been a workhorse for so-called "Islamic finance" from its earliest days in Malaysia.

Elsewhere, where the Shafi`i school of jurisprudence is not dominant, a third party is often introduced in what is called *Murabaha* finance. Thus, instead of selling the item on credit and buying it back from the same party on the spot at a lower price, a third party is introduced as a degree of separation. Thus, the "Islamic finance" provider would buy an item on the spot and then sell it to its client on credit, thus earning interest income on the difference, which is labeled as "profit." An extreme form of this instrument for *riba* is popular in the majority Hanbali GCC countries, a third step, whereby the item is sold back to the original seller on the spot, known as *tawarruq* (monetization of the non-monetary). Ibn Rushd explained the problem with such dealings:[4]

> For those who forbade [same item sale on credit then repurchase in cash], they accused the parties in such dealing of really aiming to trade a smaller sum of money for a larger deferred sum, which is the forbidden *riba*, hidden through the forgery of the contract form (*fa zawwara lidhalika hadhihi al-surah*). For example, if someone asks another to lend him ten Dinars to be repaid as twenty in a month, the latter party would say: "that is not permissible, but I can sell you this donkey for twenty payable in a month, and then buy it back for ten."

If we combine the last two quotes of Ibn Rushd, we can see the fundamental problem with so-called "Islamic finance." If *riba* was in fact forbidden because it is conducive to excessive injustice, i.e. it is difficult to know if the exchange is "fair," for example, in the implied 100% monthly interest rate in the last quotation, then adding degrees of separation cannot solve this problem. *Murabaha* finance (which is very different from the classical spot cost-plus *murabaha* trust sale permitted in classical jurisprudence), *tawarruq*, or any other contrived contract may emulate the implicit interest rate, which may be equally unjust (probably more so). Thus, commenting on the ancient forgery of *tawarruq*, Ibn Qayim commented as follows:[5]

> It is impossible for the Law of the Wisest of the wise to forbid a harmful dealing, cursing its perpetrators and warning of a war from God and his Messenger, and then to allow a contrived vehicle to reach the same effect, retaining the forbidden harm and adding to it transaction costs in contriving the forgery, ostensibly to deceive God and his Messenger. This cannot possibly be allowed in the Law. Indeed, *riba* on the ground is easier and less harmful than *riba* atop a tall ladder!…

[4] Ibid, p. 194.

[5] Ibn Qayyim Al-Jawziya, *I`lam Al-Muwaqqi`in `an Rabb Al-`Alamin*, Beirut: Dar al-Kutub al-`Ilmiyya, 1996, vol.3, p. 92.

> Tell me, by Allah, which of the harmful effects of *riba* was removed by this deception and lies?"

2. Grave Injustice Through Partnerships, Sales, Leases, etc.

Some supporters of "Islamic finance" have long suggested that profit sharing (in silent partnership, or *mudaraba*) or profit-and-loss sharing (in full partnership, or *musharaka*) is the ideal Islamic alternative to *riba*. However, the reason for the prohibition, which Ibn Rushd imputed to be the potential for extreme injustice, can be just as present there.

Consider for example a silent partnership wherein a capitalist approaches a worker with no capital. Instead of hiring the worker at the market wage, say it is $100 per day, he offers the worker to engage him as a *mudarib* (entrepreneur), while he himself will serve as *rabb al-mal* (capitalist). The capital invested for one day may be $1,000, expected to produce a profit of $200 plus or minus $10, depending on market conditions. The *mudarib* will do the same work for which he could have earned a guaranteed $100 market wage, but the capitalist insisted on "risk sharing." That may be argued to be somewhat fair if the *mudarib* is offered a 50% share of the profit, in which case, he would earn $100 plus or minus $5.

Putting aside the relative risk tolerances of the capitalist and the worker/entrepreneur for the moment, note, first, that there is nothing in the Islamic rules of *mudaraba* that prevents the capitalist from offering the worker a 25% share of profits, which is grossly unfair relative to his market wage. If the worker has no access to other work, or has incomplete information about the distribution of profit, severe exploitation is thus allowed by this ostensibly "Islamic" partnership model, whereby the worker is forced to earn half his market wage on average, with unwanted risk to boot![6] That is the very same extreme injustice (*ghubn fahish*) for which traditional *riba* in loans or trade is but one of many possible vehicles. In this regard, many jurists had traditionally considered *mudaraba* (silent partnership) to be a hire contract with unnecessary uncertainty (*ijara bi-l-gharar*).

Ironically, many of those who argued for permissibility of *mudaraba* in analogy to sharecropping (*muzara`a*) later wanted to forbid renting agricultural land for a fixed price (*karraa' al-'ard*), for the very same reasons that many contemporary jurists reject conventional finance, which is tantamount to renting money at a fixed

---

[6] Note that there is little formal difference in this regard between silent partnerships (*mudaraba*) and full partnerships (*musharaka*), as the only difference is that in the latter losses are restricted to be in proportion to invested capital, but profit shares can still be whatever the parties agree upon. In this regard, *mudaraba* is simply the extreme point where the capital contributed by one party (the entrepreneur or *mudarib*) is zero. A *mudaraba* can be easily converted into a *musharaka* by allowing the capitalist first to lend or give as a gift a tiny amount to the entrepreneur, who uses it as capital in the "partnership."

rate. In reality, classical jurists may have been looking for means of reconciling widely observed practices of sharecropping, land rent, and silent partnership. Thus, they decided in the classical period to allow silent partnership in analogy to land rent with risk sharing, and then to allow fixed land rent, despite debates about a potential Hadith (of Rafi` ibn Khadij) that forbade it.

It is in this same spirit that some contemporary Azhari scholars have tried to justify conventional banking practices as silent partnership with fixed profit specified as a percentage of capital. That would indeed violate the classical rules of *mudaraba*, but the latter themselves were originally questionable, lacking Canonical approbation, and subject to many juristic debates on appropriate analogy. The contemporary jurists who allow conventional banking argue that if the bank-client relationship can be implemented in ways that minimize *gharar* and eliminate *riba*, then it should be allowed, just as *mudaraba* and fixed land rent were allowed before.

In fact, the idea of characterizing certain types of interest based operations as silent partnerships is hardly a modern innovation, as Jews have used a silent partnership structure, known as the *heter iska*, for the longest time, to circumvent the Biblical prohibition of interest on loans, to which the Qur'an refers in its reiteration of the prohibition.[7] Likewise, Udovich has shown that the medieval Islamic use of the silent partnership (*mudaraba* in Arabic, *commenda* in Italian) also resulted in what he called "bankers without banks."[8] It is difficult to understand why the majority of contemporary jurists would formally disallow this evolution of *mudaraba*, which itself was an evolved non-canonical contract, but allow adaptations of *murabaha*, which was traditionally a spot cost-plus trust sale, to include a time factor and, therefore, implied interest.

Returning to our example of extreme injustice in silent partnership, the hire contract at a fixed wage can be marked to market to determine the worker's fair share. This is an explanation provided in El-Gamal (2006) for the prohibition of the *riba* of increase (*riba al-fadl*, to which Ibn Rushd points in the quoted passage above as *riba* in trade), which has no time component. The primary Canonical prohibition of *riba al-fadl* is in the tradition of Bilal (r), wherein the Prophet (p) forbade him from trading low quality dates for a smaller quantity of high quality dates, deeming it *riba*, and ordering him instead to sell the low quality dates and use the proceeds to buy the high quality ones.[9] By searching for the highest bid for his dates, and then searching for the lowest ask for the higher quality dates, thus marking relative

---

[7] See Reisman, Y. *The Laws of Ribis.* New York: Mesorah Publications, 1995 for details on the *heter iska*. In 1960, The Appellate Division of the New York Supreme Court ruled in Barclay Commerce Corp. v. Finkelstein (1960) that the way this contract was used was functionally equivalent to an interest-bearing loan.

[8] Udovitch, A. 'Bankers without banks: commerce, banking and society in the Islamic world of the Middle Ages', Princeton Near East Papers, No. 30, 1981.

[9] El-Gamal, M. *Islamic Finance: Law, Economics, and Practice*, NY: Cambridge University Press, 2006, pp. 53—4.

prices to market, Bilal would have ensured that the ratio in trading the two types of dates reflected market prices, and hence was fair.

We can now look at the reverse implication of this logic, which would resonate with the quote from Ibn Qayim above regarding the use of expensive ruses to result in a worse *riba* (atop a tall ladder, as he put it, symbolizing the added costs of asset and trading party degrees of separation, which are ultimately borne by the debtor, thus amplifying the evils of *riba*). A financial provider that markets some of its financial products as "Islamic," using *murabaha* (cost-plus sale), *tawarruq* (a three party stratagem to monetize any asset), *ijara* (lease), or under any other guise, has a cost of funds measured by interest rate r, and provides finance to the client at rate $i > r$.

It does not matter from the point of view of justice in exchange how the contract is formulated. Indeed, this is a fundamental rule in Islamic jurisprudence, enshrined in the third article of the Ottoman *Majallat al-Ahkam Al-`Adliyah*, that "what matters in contracts is their substance, and not their verbal terms and structures" (*al-`ibratu fi al-`uqudi bi-l-ma`ani, wa laysat bi-l-'alfadhi wa la al-mabani*).[10] If the market interest rate for similar clients with similar credit histories, collateral, etc., were significantly lower than i, this contract will still contain excessive injustice (in the form of unjustified increase, which invokes the literal meaning of forbidden *riba*), even if the interest is labeled profit in trade, or anything else. That is why Rafic Yunus Al-Masri has argued that it is better to call the markup in so-called "Islamic finance" interest, because secular regulators have put in place mechanisms that limit the charging of exorbitant interest.[11]

Ultimately, the over-arching rule for which all other rules on contracts were devised is the primary command for justice. Muhammad Asad translated the canonical Qur'anic verse [16:90] thus: "Behold: God enjoins justice, and the doing of good, and generosity towards one's fellow men, and he forbids all that is shameful and all that runs counter to reason, as well as all envy, and He exhorts you repeatedly so that you might bear all this in mind." As Rosen (2000) points out, correctly quoting many Islamic sources, the word for justice, *`adl*, at once means straightness and balance, which mandates reciprocity, and balance through equity in exchange,[12] echoing our earlier quote from Ibn Rushd.

3. A Unified Theory of *Riba* and *Gharar*

Multiple suggestions have already been provided that the canonical prohibitions of *riba* and *gharar* stem from the same Legal objective of avoiding injustice in

---

[10] An entire section was dedicated to this rule, which served as the section title, in ibn Qayyim al-Jawziyyah, *A`lam al-Muwaqqi`in `an Rabb al-`Alamin*, Beirut, Dar al-Kutub al-`Ilmiyyah, 1996, vol.3, pp.78-80.

[11] Al-Masri, R. Y. "Are All Forms of Interest Prohibited," *Islamic Economics*, Vol. 17(1), 2004, pp. 37—41.

[12] Rosen, L. *The Justice of Islam*, NY: Oxford University Press, 2000, pp. 155—8.

exchange. Moreover, it is clear that with minimal recharacterization of a financial dealing, we can move back and forth between *gharar* and *riba*. For example, many of the arguments that deem conventional modern banking permissible Islamically, such as the ones listed in Tantawi (2001),[13] and analyzed in El-Gamal (2006), have characterized the relationship between depositors and the bank as that of silent partnership, whereby the bank invests the funds on behalf of its depositors (who are not really depositors in the fiduciary sense of *mudi`in*), and guaranteed a profit rate.

Separately from the analysis on two recent opposing *fatwas* described in El-Gamal (2006, pp. 139—47), one permitting conventional bank operations and the other offering a rebuttal to justify forbidding it, the late jurist Mustafa Al-Zarqa quoted the analysis in the Ottoman *Majallat al-Ahkam al-`Adliya* on a partnership wherein one of the parties stipulates that his share of the profit is fixed in amount or as a percentage of invested capital (rather than as a share of profits), then the partnership is deemed defective because of *gharar*. Al-Zarqa explained this ruling by pointing out that the partnership may make only the amount of profit guaranteed for that one party, or more, or less, and thus, the defect in this contract falls under the rules of *gharar*, and he classified it accordingly in the corresponding section.[14]

It was on this basis, as cited in Tantawi (2001), that a number of contemporary Azhari scholars, including, most notably Abdul-Wahhab Khallaf, have characterized the depositor's dealing with a bank as, in fact, a silent partnership. Khallaf then proceeded to argue that deeming a silent partnership as defective if the profit rate is prespecified as a percentage of capital (rather than realized profits) has no valid basis in the Islamic Canon, and that even if it did, one can always give this transaction a new name, see El-Gamal (2006, pp. 142—3, for multiple quotations and analyses). The counter-argument by Majlis Majma` Al-Fiqh Al-Islami did not deny the characterization of silent partnership, but merely claimed that there was a consensus among scholars that prespecification of profit in a silent partnership invalidates the contract, which "consensus" is belied by the quotes provided in Tantawi's analysis. More importantly, as Al-Zarqa has pointed out, the invalidation of the contract thus specified as an investment, rather than a deposit or loan, is classified under *gharar*, not *riba*, thus inviting us to think of the two contract defects that lead to prohibition within a unified theory of justice in exchange.

This is rather simple to do based on modern financial economics, which can explain financial contracts and institution design as vehicles for managing information asymmetry and risk. From this standpoint, the classical "Islamic Economics" and jurisprudential analysis of interest-bearing loans that stipulated the prohibition of *riba* in the form of interest-bearing loans in terms of "return without risk" or "an increase in one side of the exchange without a commensurate reward" can only be characterized as nonsensical. The juristic rule that "return should follow

[13] Tantawi, M. *Mu'amalat Al-Bunuk wa Ahkamuha Al-Shar'iyya.* Cairo: Nahdat Misr, 2001.

[14] Al-Zarqa, M. *Al-Madkhal Al-Fiqhi Al-*`Am, Damascus: Dar Al-Qalam, Vol. 3, p. 745.

risk" (*al-ghunmu bi-l-ghurmi*) and its basis in the Hadith "*al-kharaju bi-l-daman*" do not in any way imply that a loan is free of risk. Credit risk is a very real risk, and a major component in the pricing of loans in conventional as well as Islamic finance, which may be reduced through collateral, pawning or *rahn*, third-party guaranty, and the like. However, the latter also present risks, of destruction of the asset held as collateral, counterparty risk of bankruptcy of the guarantor, etc. The same applies to insurance and derivative contracts, which transform one type of risk into another, even as they aim merely to transfer some risks.

As I have argued in the previous section, there is no more guarantee in profit sharing (or profit and loss sharing) partnerships that the stipulated profit shares reflect the fair value of the work to be done, let alone the risks of default, fraud, theft, negligence, etc., all of which are implicitly priced in the contract. What justice demands is the use of all credible information on the risks in debt, equity, derivative, insurance, or other contracts, in order properly to price these risks. In most cases, one party will have more information about certain risks (e.g. of own likelihood of default, fraud, etc.) than the other. In modern finance, the role of financial institutions is to specialize in the collection of information and assessment of the appropriate market price for each risk tranche, in order to avoid lemon-problem-style market failures.[15]

Interestingly, Abdul-Wahhab Khallaf had also argued for fixing the profit shares as a percentage of capital based on bad characters of people in the modern world, which may be translated in economic terms to severe adverse selection and moral hazard problems. Interestingly, when Islamic banks began in the 1970s, they aimed to apply the 1950s "Islamic economics" theory of profit sharing finance. They quickly discovered that with high cost of monitoring, many "entrepreneurs" can easily misrepresent the profitability of their investments. This "lemon problem" prompted the industry quickly to switch to debt-based trade finance models using *murabaha* and later devices, and using conventional banking technology to determine credit risk, try to ameliorate it with collateral, and price it by benchmarking to conventional interest rates.

---

[15] Briefly put, if there are, say, two types of potential borrowers or insurance buyers; one type is high risk and the other low risk. If, respectively, the lender or insurer cannot distinguish the two types, he will charge an interest rate or insurance premium that is somewhere between the level appropriate for the good and bad types. The good types recognize this interest rate or insurance premium as too high for their type, so they leave the market. This leaves only the bad types (adverse selection), for whom the financial product is underpriced, and therefore the financial provider chooses not to offer the product at all. This is called market failure. The name "lemon problem" comes from the analogy to used car purchase, where the buyer cannot tell if the car offered for sale is "a lemon" (i.e. defective and in perpetual need of repair), c.f. Akerlof, G. "The Market for Lemons: Quality Uncertainty and the Market Mechanism," *the Quarterly Journal of Economics* 84(3), 1970, pp. 488-500.

Of course, credit markets in the ancient world suffered more severe consequences of information asymmetry, rife both with adverse selection (bad credit risk borrowers being more likely to seek loans) as well as moral hazard (after a borrower received the funds, he may be tempted to take risks not intended by the lender). These risks were exacerbated in the Islamic contract of loan, in the sense of *qard*, because the latter transferred ownership of the funds to the borrower, and, therefore, there was no way to limit the adverse selection and moral hazard risks. This necessarily resulted in high interest rates that did not reflect the fair market price of credit, especially to the creditworthy customers. The resulting exploitation of some needy debtors who were charged excessive interest, as well as low levels of credit extension to good entrepreneurs, reasonably prompted jurists to exclude the loan contract altogether from finance, keeping it only within the domain of charitable transactions (*qard hasan*).

Because of the market failure in debt markets, especially with no way in the ancient *qard* contract to specify how the borrower may or may not use the funds (a problem that is no longer shared in today's bank lending best practices), partnerships were a reasonable alternative wherein a capitalist (*rabb al-mal*) can restrict the activities of the entrepreneur (*mudarib*), whether or not monitoring was possible, thus managing the adverse effects of information asymmetry to the extent possible. However, with scholars finding loopholes in the juristic rules, it was always possible to conduct financial transactions at unfair prices, whether through sales, leases, partnerships, or any other approbated contract form. As El-Gamal (2008) has argued, the costs of such stratagems were relatively high in ancient times, restricting their use to cases of actual need. However, with the advent of financial engineering, it has been possible to synthesize all contracts, regardless of fair or unfair pricing, at relatively low costs, and thus the regulatory content of Shari`a has been squandered.[16]

4. What Mutualization Can and Cannot Do

El-Gamal (2007) has argued that mutual organizations can provide a simple juristic solution to problems of *riba* and *gharar*.[17] Citing the argument of Al-Qarafi in his *Furuq* that even interest-free monetary loans (*qard hasan*) would have been invalidated based on the rules of *riba*, which mandate hand-to-hand as well as equal exchange, were it not for the charitable (*ma`ruf*) component therein. Jurists have long used the non-commutative nature of mutual contracts to justify *takaful* as insurance alternatives. Likewise, mutual credit associations, especially in structures

[16] El-Gamal, M. "Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering," *Wisconsin International Law Journal* 25(4), 2008.
[17] El-Gamal, M. "A Simple *Fiqh*-and-Economics Rationale for Mutualization in Islamic Financial Intermediation", in N. Ali (ed.), *Integrating Islamic Finance into the Mainstream: Regulation, Standardization, and Transparency*, Cambridge: Islamic Fiance Project, Islamic Legal Studies Program, Harvard University, 2007.

without interest, such as classical rotating savings and credit associations (RoSCAs), are thus easily approbated by religious scholars of all schools, and widely accepted by Muslim subjects, including those that are skeptical of “Islamic finance” products based on *murabaha* and other stratagems.

Adding interest to a credit union operation would be more controversial, because technically, the partner/borrower would be paying interest to the collective group, which may be excluded from *riba* rulings as some have claimed that there is no *riba* between a father and his son, a husband and his wife, or the state and its subjects. However, this would be controversial, and brings us back to the preferred characterization of financing in terms of silent partnership with prespecified profit, along the lines detailed in Tantawi (2001). However, in this case, mutuality may be of limited interest, as I shall discuss below. No contract form or organizational form can guarantee justice in exchange! In our ongoing research, my coauthors and I have focused on interest-free RoSCAs for the poor who are shunned even by microfinance institutions and NGOs. Although, technically, the first recipient of the RoSCA benefits the most, order is usually driven by need, and social norms dictate that one should always agree to participate in a RoSCA when asked by someone in their social network, and therefore, there is a strong sense of balanced reciprocity.

El-Gamal, El-Komi, Karlan, and Osman (2013) have found theoretical as well as empirical experimental evidence that a variation on the RoSCA known in Egypt as *gam`iya*, which adds guaranty against default for participants, generates higher takeup rates and higher repayment rates than Grameen-style microfinance offerings.[18] In the meantime, the World Council of Credit Unions had reported successful introduction of credit unions in Afghanistan that found some success as early as 2007, avoiding injunctions against conventional financial models in part by employing the mutual ownership argument.[19] Of course, in the area of insurance alternatives, the mutual insurance idea of *takaful* has been invoked for much longer, even if the implementations have been by stockholder-owned companies that paid claims to policyholders through an agency (*wakalah*) or voluntary contribution (*tabarru`*) structures.

There are unmistakable advantages to mutual financial structures in the reduction of unfairness in exchange. This primarily stems from the corporate structure of mutuals, where depositors and shareholders in the case of credit unions, or policyholders and shareholders in the case of mutual insurance companies, are one and the same, reducing the moral hazard problem for management that answers to one set of stakeholders (shareholders) at the expense of others. Thus,

---

[18] El-Gamal, M., M. El-Komi, D. Karlan, and A. Osman. “Bank-Insured RoSCA for Microfinance: Experimental Evidence in Poor Egyptian Villages,” Rice University, Baker Institute for Public Policy working paper, Sept. 2011; revised, December 2013.
[19] WOCCU, “Supporting Credit Union Development in Afghanistan: An Overview of Issues Important to The Development of Shari`a Compliant Cooperative Finance.” World Council of Credit Unions Research Monograph, Madison, WI, July 2007.

mutual may be expected (and are often found empirically) to take less risk and make financial products more affordable for their clients. However, there are also well known disadvantages to mutual structures, which were evident even to P.J. Proudhon, who was a nineteenth century anarchist, adversarial contemporary of Karl Marx, opponent of capital earning interest, and advocate for mutual banking who established his own "bank of the people" and wrote about it.[20] Even he recognized that mutual financial institutions cannot possibly meet all the financial needs of society.

One of the primary limitations of mutual financial institutions is their inability to attract large amounts of capital for quick growth, because the only way to get new shareholders is to get new members or policyholders. This may not be a defect if all financial sector firms used the same model, but in a competitive environment, non-mutual financial institutions can grow faster and capture market share from mutuals. Indeed, the profit motive can be so enticing during stock market euphoria that mutual financial institutions would demutualize, literally "selling out" to their shareholder owned competitors and receiving shares therein. Moreover, because mutual financial institutions may face less competition, they may not be as efficient in cutting costs as their stockholder-owned counterparts.

The primary advantage of mutual financial institutions is their ability to cater to those who are shunned by profit-seeking stockholder-owned financial institutions. This is the case, for example, for the poor customers targeted by credit union structures that leverage community social capital and networks to provide credit at reasonable costs. Information asymmetries make catering to the same poor customers very costly to conventional banks, because the activities of a loan officer cost approximately the same whether they administer a $10 loan or a $1,000,000 loan, making the interest rates on microloans exceptionally high. For insurance purposes, these information asymmetries can result in market failures, which may be solved by risk-sharing mutual insurance schemes that emerge in traditional societies, although the principle of *ex ante* reciprocity is difficult to accept in some such contexts.[21]

5. Concluding Remarks: Mutuality Is No Panacea

It is important to avoid turning mutuality into another "Islamic economics and finance" gimmick, ostensibly avoiding the forbidden *riba* and *gharar* formally by using non-commutative contracts wherein these rules do not apply. Mutual financial structures, despite their aforementioned merits, are also potentially subject to abuse and excessive risk taking, as is well known from the Savings and Loans crisis in the United States during the 1980s and 1990s. Therefore, to ensure proper

[20] Dana, C.A. *Proudhon and His "Bank of the People*." Chicago: Charles H. Kerr Publishing Company, 1984.
[21] For example, see Platteau, J.P. "Mutual Insurance as An Illusive Concept in Traditional Rural Communities," *The Journal of Development Studies* 33(6), 1997.

management and fair pricing, regulation of these institutions is required in most advanced economies, even if they receive some preferential treatment, such as tax exemptions, because they serve segments of society that otherwise may not have access to affordable financial services. Moreover, they are subject to the same "truth in lending" and similar consumer protection measures imposed on conventional banks, in order to ensure fair pricing of their financial products.

The rhetoric of Islamic finance, with its focus on profit sharing, has often invoked ideas of mutual finance, for example, when depositors in Islamic banks are treated as "investment account holders," even though they do not in fact own the banks, and are thus exposed to severe moral hazard risk, or Islamic insurance products marketed as *takaful*, even though the policyholders don't own the company's assets or receive dividends. It is tempting to conclude that migration to mutual corporate structures would solve the problems of "Islamic finance," but that would be yet another form of focusing on form rather than substance. Without proper regulatory frameworks and their vigilant enforcement, mutual financial institutions can be just as exploitative and can engage in equally unfair dealings as any others, just as injustice in exchange can be equally effected through loans, sales, leases, or partnerships.

Conversely, as many contemporary jurists and economists have argued, advances in information technology, and the ability to collect data and diversify investment portfolios can allow insurance companies and banks to build actuarial tables and credit scores on the one hand, and to exploit the law of large numbers on the other, as to eliminate many of the bad effects of asymmetric information that were addressed through the prohibitions of *riba* in *gharar* in their traditional forms. Thus, as detailed in El-Gamal (2006, Chapter 8), many prominent contemporary scholars have allowed conventional banking, conventional insurance, or both. Of course, we know that these institutions have been engaged in many un-Islamic practices, including predatory subprime lending practices leading up to the most recent financial crisis. However, this is a regulatory problem that cannot be addressed through juristic rulings on contracts or corporate forms. "Islamic banks" offering "Islamic mortgages" are, by definition, culprits in the financial crisis from which we are still trying to recover.

Ultimately, state authorities and regulators are the ones responsible for implementing the essence of Islamic jurisprudence by instituting policies for consumer, institutional, and systemic protection through proper risk management regulation, monitoring, and enforcement. This cannot be reduced to formulaic lists of allowed and disallowed contracts, or favored and discouraged corporate forms. No such lists based on any juristic analysis would ever be sufficient to ensure that the practices by these institutions using these contract forms cannot be predatory or systemically dangerous (which would make them "un-Islamic"). So called "Islamic finance," with its emphasis on contracts and institutional structures is thus not only incoherent, but also potentially abusive of its pseudo-religious marketing name.