A Simple *Fiqh*-and-Economics Rationale for Mutualization in Islamic Financial Intermediation

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June 2006

Abstract

Islamic finance is a prohibition-driven industry, aiming to avoid the prohibitions of *riba* and *gharar*. It is well accepted in Islamic jurisprudence that *riba* and *gharar* do not affect the legal validity of non-commutative financial contracts (e.g. gifts). Jurists have long viewed this as a potential solution to the problem of *gharar* in commercial insurance, proposing mutual insurance as a non-commutative alternative. Likewise, Al-Qarafi had shown that loans are exempted from the rules of *riba* and *gharar* because of their non-commutative (in this case charitable) nature. It is thus argued that a substantial portion of Islamic financial intermediation can and should be conducted through mutual financial institutions.

1. Introduction

The rhetoric of Islamic finance often suggests that the industry employs mutual structures. For instance, a recent article reported the following:

> Sheikh Kamel does not fancy the word customer or depositor and prefers to use the term 'partner'. "Those people who place their money in Al-Baraka bank or any other Islamic bank are considered shareholders of these banks. This means if these banks prosper so will they".[1]

The mutuality structure (wherein depositors are in fact shareholders of the bank) implied by this quote, and belied by investment-account practices in Islamic banking, would solve one of the most difficult regulatory and governance issues raised by these institutions: In these institutions, investment-account holders neither have the protection of being creditors of the Islamic financial institution, nor do they have the protection of being equity holders with representation on those institutions' boards of directors. This introduces a host of other well-documented risk factors for the institution, since it has to account for the probability that account holders withdraw their funds for fear of excessive risk taking by shareholder-appointed managers; c.f. AAOIFI (2004a, p. 215 and 2004b, p. 241). Economic advantages of the mutuality solution are discussed in El-Gamal (2006, Chapter 8). This note provides an additional religious rationale for mutualization based on traditional juristic analysis of *riba* and *gharar*.

In the area of insurance, while some scholars have accepted all forms of insurance as permissible – most notably, see Al-Zarqa (1994, pp.8-9) and Al-Misri (2001, p.6) – the official majority opinion adopted by the Fiqh Academy of the Organization of Islamic

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[1] *The Daily Star* (Monday, August 15, 2005), by Osama Habib, "Saudi businessman tackles task of polishing Islam's image"

Conference rejected that opinion in ruling 9/2. In that ruling, the Academy distinguished between two main types of insurance contracts: (1) commercial insurance with fixed premium, which they deemed forbidden based on *gharar*; and (2) "cooperative insurance (*al-ta'min al-ta`awuni*) built on the principles of voluntary contribution (*tabarru`*) and mutual cooperation (*ta`awun*)", which they deemed permissible, since *gharar* does not affect non-commutative contracts; c.f. moamalat.al-islam.com and Al-Darir (1997).

Interestingly, while the Islamic insurance industry has adopted a name suggestive of a mutual cooperative structure, *takaful* companies have generally been structured as for-profit shareholder-owned companies, or subdivisions thereof. In other words, the corporate form of those *takaful* companies is identical to that of the commercial-insurance companies whose contracts they forbade. *Takaful* companies invoke non-commutativity by stipulating that the shareholders pay policyholder claims as a form of voluntary contribution (*tabarru`*), where the operator is usually set up in the form of silent partnership (*mudaraba*), with the exception of few recent attempts at using agency (*wakala*) – while still falling short of mutual forms. In both structures, there are unresolved *fiqhi* issues about bindingness of promises in such voluntary *tabarru`*. It would appear, thus, that in the Islamic insurance (risk intermediation) industry as well as in the Islamic banking (credit intermediation) industry, mutuality can align rhetoric with reality and resolve simultaneously a number of corporate governance, religious, and financial problems. In the next section, we shall approach the problem form a risk-management view of all financial activity, including intermediation. Toward that end, we need to develop an encompassing model of *riba* (the reason for having Islamic banks) and *gharar* (the reason for having *takaful* companies).

2. A Unified Economic Model of *Riba* and *Gharar*

Derivation of an economic understanding of *riba* and *gharar* is crucial for understanding Islamic finance. While rhetoric suggests that the scope of prohibitions is directly and unequivocally inferred from Islamic scripture, analyses by Rida (1986) and Al-Zarqa (1984) clearly show that the scope and nature of *riba* and *gharar*, respectively, were developed over the centuries through mostly expansive juristic analyses.

The most economically-oriented analyses of *riba* and *gharar* emphasized equity in exchange. Thus, Ibn Rushd (1997, vol. 3, p. 184) argued that "it is clear from the Law that what is targeted by the prohibition of *riba* is the excessive inequity (*ghubn fahish*) that it entails". Ibn Rushd proceeded to explain that equity in trading commodities of the same type should be determined through equality of amount, otherwise – if equity will not or cannot be ensured through equality – it should be determined by market prices.

Based on that analysis and a different Prophetic tradition in which the Prophet (p) forbade Bilal (r) from trading dates for dates – ordering him instead to sell one and use the proceeds to buy the other – El-Gamal (2000; 2006, Chapter 3) has argued that the prohibition aims to approach equity through marking to market. In credit sales (utilized in *murabaha*), leases (*ijara*), and other interest-based Islamic financial transactions, the existence of an underlying object of sale or lease allows the buyer and seller to mark the time value of the asset to market (e.g. through actual market rent), thus avoiding the fear of excessive inequity in credit extension. Thus, one can conclude that the forbidden *riba* is mainly the practice of trading unbundled credit, wherein pricing that credit may be problematic, resulting in potential excessive inequity (ibid.).

Similarly, jurists have seen the prohibition of *gharar* as one aiming to avoid inequity in exchange. Juristic definitions of the forbidden *gharar* emphasize the uncertainty aspect, c.f. Al-Zuhayli (1997, vol. 5, pp.3415-31). Perhaps the most comprehensive definition is that of the late Dr. Mustafa Al-Zarqa: "[the forbidden *bay` al-gharar*] is the sale of probable items whose existence or characteristics are uncertain, the risky nature of which makes the transaction akin to gambling". Since all contracts are incomplete and have an element of randomness in them, Al-Baji Al-Andalusi argued that "the meaning of *gharar* sale, and Allah knows best, is any sale in which *gharar* is the dominant component… However, minor *gharar* would not render a sales contract defective, since no contract can be entirely free of *gharar*" (ibid).

Thus, jurists recognized one extreme form of the prohibited *gharar* to be gambling, which is categorically forbidden by the Qur'anic verse [5:90] "O people of faith: Wine,

gambling, dedication of stones and divination with arrows are abominable works of the devil. Thus, avoid such activities that you may prosper". Al-Darir (1997) summarized the conditions required for *gharar* to render a contract invalid, and they imply an implicit tradeoff between the economic need for the contract and the amount of *gharar* therein. Thus, Ibn Taymiya, argued "it is known that this corrupting factor [i.e. *gharar*] would be overruled if it is opposed by a greater benefit", c.f. Al-Zuhayli (1997, ibid) and El-Gamal (2001; 2006, pp. 59-62) for references and detailed discussion. Thus, gambling is pure *gharar* with very little economic benefit (as verse [2:219] states about wine and gambling: "Therein is great sin and some benefit, and their sin is greater than their benefit"), and it is categorically forbidden. More generally, the prohibition of *gharar* sale (*bay` ul-gharar*) is best understood – as stated by Al-Zarqa – as being more applicable the closer we get to this extreme of gambling. Hence, one may conclude that the forbidden *gharar* sale is the unbundled sale of risk.

If we accept those two economic definitions of *riba* and *gharar*, then we recognize *riba* also as an extreme form of *gharar*: The sale or extension of unbundled credit (e.g. in an unsecured loan) is a counter purchase of credit risk (which is a negatively-priced bad, the risk of debtor default, the price of which would be one of the main components of the interest charged). Credit risk includes substantial uncertainty, because the probability of default may be difficult to estimate, and the resulting losses in case of default (esp. due to bankruptcy) can be quite substantial. One litmus test of this approach, which will also provide us with a simple unified solution for financial intermediation, is the non-commutativity solution discussed in the following section.

3. The Non-Commutativity Solution

As shown by Al-Darir (1997), and adopted by the OIC Fiqh Academy, it is generally accepted that the optimal way to avoid *gharar* is to ensure that the contract is non-commutative. Interestingly, the same applies to *riba*. For instance, it is considered good character for one who borrows any property to repay more than was borrowed, provided that the increase was not stipulated in the original contract or demanded by the lender.

Indeed, the Prophet (p) himself encouraged that practice, stating that the best people are the ones who are most generous in repaying their debts (*khiyaru al-nasi ahsanuhum qada'an*, narrated by Bukhari, Muslim, and Al-Tirmidhi on the authority of Abu Hurayra). Al-Shafi`i considered such repayment above the borrowed amount reprehensible only if it becomes habitual, to the point of being conventionally expected. Based on this principle, National Bank of Egypt (*Al-Bank Al-Ahli*) has for a number of years been offering certificates of deposit (literally, investment certificates or *shahadat al-istithmar*, type C) that guarantee only the principal, and pay "gifts" that are announced ex post but not promised at a fixed rate before hand. Similarly, early Malaysian bonds known as Government Investment Certificates relied on this gift (*hiba*) principle to avoid the prohibition of *riba* if the interest rate is announced ahead of time.

The most interesting analysis of non-commutativity as a solution to the problem of *riba* applies to the case of interest-free goodly or beautiful loans (*qard hasan*). This analysis was provided by Al-Qarafi (1998, vol. 4, difference #201 – between the juristic rules of *qard* and *bay`*). In that analysis, Al-Qarafi gave the example of interest free loans to illustrate the differences between the loan contract (which is non-commutative according to his analysis, as will be shown shortly) and sale or *bay`* contracts (which are the canonical commutative financial contracts).

Note first that the famous Hadith of the six commodities has two conditions: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, [should be traded] hand to hand, and in equal amounts, and any increase is *riba*" (narrated by Muslim on the authority of Abu Sa`id Al-Khudriy). The two conditions are "hand to hand" and "in equal amount". Therefore, even though an interest-free loan satisfies the equal-amount requirement, it violates the hand-to-hand provision, and therefore would be deemed *riba* by this canonical Hadith.

However, for *qard hasan*, Al-Qarafi (1998, vol. 4, p. 3) argued in his "difference #201":

> Know that in the juristic rule of loans, three other juristic rules were violated:

[1] The rule of *riba* [is violated] if the lent property is subject to rules of *riba*, e.g. the two monies and foodstuffs; [2] the rule of *muzabana*, which is selling a known property for an unknown one of the same genus, [is violated] if the lent property is an animal or other non-fungible; and [3] the rule of selling that which you do not possess [is violated] if the lent property was fungible.

The reason for allowing the violation of those three juristic rules is charitable (*al-ma`ruf*) benefit to people. Thus, if the contract is no longer charitable (*ma kharaja `an babi al-ma`ruf*), it is forbidden, either on the basis of benefiting the lender, or on the basis of uncertainty about the traded compensations in violation of the rules of *salam* (*aw litaraddudihi bayna al-thamani, wa al-salaf*); [it is forbidden because] the prohibition is present – in violating [the aforementioned three] juristic rules – but manifest charity is not present.

(Question) A simple loan (*al-`ariya*) is also charitable like loans, and it is allowed for known term with compensation, even though it is no longer charitable. Why isn't the same applicable to the loan (*qard*), whereby it would be permissible if beneficial to the lender and thus not charitable?

(Answer) If a simple loan (*`ariya*) is compensated, then it is transformed into a lease. In this regard, it is not foreseen that *riba* and the other two violations can occur in leases. In contrast, a compensated loan (*qard*) becomes a sale (*bay`*), wherein *riba* is possible, and thus it is forbidden unless independent evidence allows it [i.e. when the rules of *salam* are satisfied].

The charitable nature of interest-free loans is well established, as documented in the footnote of Al-Qarafi (ibid) on the authority of Anas: The Prophet (p) said that lending a property (without interest) is better than giving it away in charity (reported by Bayhaqi).

From an economic viewpoint, note most interestingly that Al-Qarafi has implicitly confirmed our characterization of *riba* as an extreme form of *gharar* (for which he has listed the juristic rules of *muzabana* [2] and selling what one does not possess [3] – two of the categories of *gharar* – as being present even in excusable interest-free loans). In this regard, when the lent property was not directly subject to the rules of *riba* as stipulated in the Hadith of the six commodities (two monies, gold and silver, and four foodstuffs), he implicitly forbade interest on the basis of commutativity implied by benefit to the lender, and violation of the rules of *gharar* because of uncertainty about the deferred compensation (which is only allowed in the special case of satisfying the conditions of *salam* because of evidence from the Prophetic traditions that allow it).

Note also that Al-Qarafi has identified the non-commutative (in this case charitable) nature of interest-free loans as the reason for overlooking the prohibition based on *riba* and/or *gharar*. Finally, note that his analysis of the difference between compensated-simple-loans (*`ariya*) as leases and compensated-loans (*qard*) as sales is no longer valid in today's economic environment. Indeed, the Office of the Comptroller of the Currency analyzed a U.S. lease-based model of home financing as follows: "Today, banks structure leases so that they are equivalent to lending secured by private property... a lease that has the economic attributes of a loan is within the business of banking... Here it is clear that UBK's net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender...".[2] Advances in structured finance have allowed many companies to take debts and interest payments thereof off their balance sheets, re-characterizing interest payments as part of the rent. If we are to avoid turning Islamic jurisprudence perpetually into an instrument of rent-seeking legal arbitrage, those types of rents must be treated the same way other means of extending credit should.

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[2] See http://www.occ.treas.gov/interp/dec97/int806.pdf.

One way to accomplish this goal is to look not at "interest" per se, but rather at the issue of "benefiting the lender". If the latter is interpreted as "profiting from the act of extending credit", then the provision would be ensuring that the financial intermediary is not for profit. Indeed, jurists in the past have not objected to Islamic banks extending interest-free or goodly loans (*qard hasan*), and collecting fees that cover their clerical expenses, without profiting from the extension of such loans. Likewise, one can think of the finance charges paid to non-profit financial mutuals as means of covering the cost of extending credit or risk reduction. To the extent that not-for-profit financial institutions also tend to be mutually owned (e.g. mutual savings banks, credit unions, mutual insurance companies, financial cooperatives, etc.), the combination of mutuality and lack of profit motive appears to provide an ideal economic solution for financial intermediation. For further discussion of the role of mutuality to avoid rent-seeking legal arbitrage in Islamic finance, see El-Gamal (2006, Chapter 9).

4. Concluding Remarks

A claim that mutuality in financial intermediation – which is very well established in the West – can provide a one-size-fits-all solution to all the problems addressed and caused by Islamic financial intermediation would be admittedly an overly simplistic and grandiose claim. However, there is ample evidence in traditional juristic analyses of *gharar* and *riba* to conclude that both prohibitions can be ameliorated through non-commutativity in financial intermediation, which lies at the heart of the non-profit and community-oriented philosophies of mutual financial intermediaries. Contemporary jurists have focused on this idea of non-commutativity in cooperative insurance, but have not in fact insisted on its mutuality implementation in *takaful* companies, and have not yet addressed the usefulness of the same non-commutativity principles in credit intermediation. The analysis by Al-Qarafi discussed in this note appears to provide an opening for further *fiqh*-and-economics research on the benefits of mutualization in Islamic financial intermediation of credit and risk, and any additional Islamic prudential regulatory requirements that may be developed for this framework.

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