Mutuality Is No Panacea
The Mirage of “Islamic Finance”

Mahmoud A. El-Gamal
Rice University
Department of Economics

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1. Prohibitions and Arbitrage
   - Rationale for “Islamic Finance”
   - “Islamic Finance” Arbitrage

2. Substance and Form, Revisited
   - Prohibitions and Injustice
   - Mutuality Is No Panacea

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 lead to the second and/or third.

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

This would invalidate “Islamic finance” as legal arbitrage
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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 (المكان) 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
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It is obvious how commutative (exchange) contracts such as credit sales (murabağa, 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 Ḥanafi and Shafi‘i 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.
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 Rafi‘ ibn Khadij)
- 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*
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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
All formulaic rules on contracts, conditions, corporate forms, etc. can be arbitrated to effect the worst forms of inequity + arbitrage costs (through financial engineering) are now quite low

All financial jurisprudence is formulaic; mostly ignoring intention, incentive, and outcome (hence *ma’ālāt* & *sadd al-dhara’i‘* for Malikis)

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