

# A Call for Mutuality in Islamic Finance

## Corporate Form in Islamic Financial Intermediation

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# Insurance Without *Gharar* : *Takāful*

Remove The Profit Motive – Mutual Insurance

- Islamic constraint:** Prohibition of *gharar* – (trading risk for-profit)
- Consequence:** Jurists forbid conventional insurance
- Juristic solution:** Make the contract non-commutative
- Reality:** Stockholders own for-profit “*Takaful*” companies
- Fiction:** Owners provide insurance as voluntary *tabarru'*
- Economic solution:** Align rhetoric with facts – *takāful* mutuals
- Economic method:** Shift focus in risk intermediation from *contract* (*tabarru'* fiction) to *corporate form* (mutuality)



# Credit Without *Ribā* (an extreme form of *gharar*): *I'timān*

Remove The Profit Motive – Mutual Thrifts

- Islamic constraint:** Prohibition of *ribā* – (trading credit for-profit)
- Consequence:** Jurists forbid interest-based loans, deposits, bonds
- Juristic solution:** Use other contracts to synthesize interest rate
- Reality:** Profits  $\Leftarrow$  synthetic-interest income – cost of funds
- Fiction:** Contract based – bank's business is trade, leasing
- Islamic*
- Economic solution:** *Also contract based* – equity-based intermediation
- Economic method:** Shift focus in credit intermediation from *contract* (*bay'* fiction) to *corporate form* (mutuality)



# Al-Qarāfi on Loans, Sales, Leases and *Ribā*

*Anwā' u Al-Burūqī fī Anwā' i Al-Furūq* (Dār Al-Kutub Al-'Ilmiyya, Beirut, 1998, vol.4)

Difference #201 – between the Juristic Rules of *Qard* and *Bay'*

- “Know that in the juristic rule of loans, three other juristic rules were violated: The rule of *ribā* ... The reason for [allowing] those violations is the charitable (*ma'rūf*) component therein. If charity is absent, it would no longer be permitted  
“(Question:) Simple loans (*al-'āriya*) are also charitable ... but allowed for a known term with known compensation, even if no longer charitable. ... (His answer:) When simple loans are compensated, they become leases, and **it is not foreseen that *ribā* can exist in leases ... , whereas a compensated loan is a sale**”
- This logic fails if (as done currently in structured finance) leases are used to extend credit in a manner similar to loans
- Can one extend the analysis to say that the **credit component** should be **non-commutative** (minimal net interest income)?

# Centrality of Corporate Profit Motive

- Focus on contracts inadequate to regulate financial intermediaries
  - This is equally true for Shari'a and secular regulations
  - Regulators protect the system, Shari'a also protects individuals
- Profit motive + focus on contracts  $\Rightarrow$  Shari'a-arbitrage
  - Religiously: may squander objectives of Shari'a
  - Materially: Muslim customers pay more for less
- Advantages of mutual Islamic financial intermediaries:
  - Nonprofit  $\Rightarrow$  limited scope for Shari'a-arbitrage
  - Savers are in fact partners (match profit-sharing rhetoric with reality)
  - Pay higher returns to partners, charge lower rates to customers
  - Provide better "loss-ratios" to insured shareholders
  - Noncommutative *takāful* (match *takāful* rhetoric with reality)

