

Islamic Bank Corporate Governance and Regulation: A Call for Mutualization

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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”.

The Daily Star (Monday, August 15, 2005), by Osama Habib,
“Saudi businessman tackles task of polishing Islam's image”

Abstract

The rhetoric of Islamic banking – exemplified in this opening quote by one of the industry’s most prominent pioneers – is derived from its historical evolution as a model of two-tier silent partnership. In fact, Islamic banks have mimicked conventional bank assets – from receivables to bonds, with credit sale and lease-backed debt instruments. In the meantime, Islamic banks have continued to rely for the bulk of their liabilities on “investment accounts”, which have a peculiar quasi-equity structure. Contrary to the opening quote, holders of those investment accounts in fact are *not* shareholders of Islamic banks. In this paper, I analyze different means of reverse engineering a debt-structure for Islamic banks’ liabilities, which would resolve the corporate governance and regulatory problems posed by the investment account structure (wherein holders of those accounts lack internal corporate protection through representation on the board of directors, and lack legal and regulatory protection as creditors and first claimants to the banks’ assets). However, adopting those measures – similar ones having been suggested in the earliest stages of industry development – likely would be rejected by industry practitioners, as they would negate the perceived unique nature of Islamic banking upon which the industry was built. I also suggest that the current mutual-fund model of investment accounts, which is favored by industry practitioners and theorists is fundamentally unsuitable for banking in the narrow sense. I propose mutuality as a solution to the corporate governance and regulatory problems currently unresolved due to the peculiar investment account structure. I show that mutual banking would be closer to the religious tenets enshrined in the prohibition of *riba*, and thus would strengthen the brand-name of Islamic banking by re-focusing it on the nature of finance and its objectives, and away from formal-legalistic contract mechanics. Moreover, mutual banking is well understood by regulators and economists, and thus the corporate governance and regulatory frameworks for mutuality-based Islamic banking may easily be adopted from western best practices.

1. Historical background

In this opening quote by Sheikh Saleh Kamel, he suggested that Islamic banks are in fact mutual banks (or credit unions or other mutually owned thrift institutions), where depositors are shareholders. In fact, had Islamic banks adopted this style of mutual banking, they may have simultaneously approached the Islamic ideal intended by the prohibition of *riba*, and allowed regulators in various countries to adopt the regulatory standards applied to such mutual financial institutions in the west. Moreover, they would have been able to create a niche market that serves an important social function – a niche wherein they would be protected from competition by large multinational banks that are the primary beneficiaries today from Islamic banking. Alas, Islamic banks did not adopt the mutuality structure suggested in the opening quote, and consequently the treatment of “investment account holders” (IAHs) has continued to raise a number of regulatory concerns for Islamic banks and their regulators worldwide.

Most Islamic economists attribute the vision of Islamic bank structure to the work of Mohammad Uzair in the mid-Twentieth Century.¹ With very few exceptions, Islamic jurists of the Nineteenth and Twentieth Centuries have equated “interest” (or its Arabic counterpart, *fa’ida*) with the forbidden *riba*.² The rise of Islamism under the influence of the Muslim Brotherhood in Arab countries and the *Jamat-i-Islami* in the South Asian subcontinent did not stop at condemnation of interest-based banking. The movement also called for replacing existing banking systems – which they characterized as an alien western intrusion into the Islamic world – with an Islamic alternative. The model envisioned by Uzair, Siddiqi and others was one of two-tier silent-partnership or *mudaraba*.

Banks operating under this principle would only guarantee fiduciary deposits, on which depositors receive no guaranteed rate of return.³ Other deposit alternatives on the liabilities side of Islamic banks would take the form of investment accounts, for which investors’ principals were not guaranteed, as they were envisioned to share in the bank’s profits and losses from various pools of investments. Those investments comprising the assets of Islamic banks were envisioned also to be silent partnerships, wherein the bank acts as principal, with each of its customers (would be borrowers of conventional banks) acting as an investment agent (*mudarib*). It is important for understanding Islamic banking today, and for developing an appropriate regulatory framework thereof, to understand how Islamic banking behavior has emerged in fact, both on the assets and liabilities sides.

¹ For instance, see Siddiqi (1983). The most widely cited publication of the initial vision of two-tier *mudaraba* was Uzair (1955).

² Most influential in this regard have been the writings of Abu al-A’la al-Mawdudi of *Jamat-i-Islami*, including Mawdudi (1986), and Sayyid Qutb of the Muslim Brotherhood, including Qutb (n.d.).

³ Although un-promised gifts were allowed, see for instance fatwa #12/1 in Abu Ghuddah and Khujah (1997b). The idea of offering un-promised gifts on guaranteed principal instruments was offered by Egyptian National bank in the form of certificates of deposit (type C, with gifts), and utilized in Malaysian Government Investment Certificates, which also guaranteed the principal, but not the rate of return.

On the assets side, Islamic banks quickly abandoned the *mudaraba* model, due to its forms of moral hazard and adverse selection problems that are unfamiliar to bankers. Islamic bank officers are mostly ex-bankers, who are proficient at credit risk analysis for their customers, but not particularly skilled in monitoring customer behavior. Consequently, to capitalize on their comparative advantage, and to minimize losses driven by customer incompetence and/or dishonesty, Islamic banks adopted debt-financing modes that were proposed by the late Dr. Sami Humud. Dr. Humud's vision was to find the closest approximation to conventional banking practice that does not violate the precepts of Islamic Law.⁴ The instruments of choice for Islamic banks thus became cost-plus credit sales (*murabaha*), and lease financing (*ijara*), where the mark-up profit component and the rent component, respectively, are commonly benchmarked to market interest rates. In recent years, sovereign governments in the Islamic world, as well as a number of corporations, have issued Islamic bond-alternatives (known by the Arabic name *sukuk*, or debt certificates) for which the primary buyers are Islamic banks. Rates of return on those *sukuk* are also benchmarked to the appropriate interest rate, and based on the issuer's credit-rating. Thus, Islamic banks have come to replicate the asset-structures of conventional banks almost perfectly, replacing loan receivables on the balance sheet with credit-sale price receivables and rents, and replacing bonds with *sukuk*.

On the liabilities side, the envisioned model of silent-partnership has been more difficult to abandon. Some economists and jurists mounted early resistance to replacing banks – which are fundamentally financial intermediaries, restricted by prudential regulators to intermediation practices – with what are essentially investment companies or collective investment schemes.⁵ In fact, one can easily envision how Islamic bank financial intermediation could have taken place in parallel to conventional banking practice, with principal plus interest being guaranteed for depositors: Since Islamic banks guarantee for themselves principal plus interest from borrowers (in the form of credit buyers, lessees and issuers of *sukuk*), the only issue in passing similar fixed interest instruments through to its creditors would be replacing the bank debtors' credit risk with the bank's own. However, this would require combining the bank's agency for its depositors – investing in fixed return securities, credit sales, and leases – with guaranty of the bank's debtors and issuers of debt securities. Unfortunately, while some earlier jurists had allowed the combination of agency and guaranty (*wakala* and *kafala*), Islamic finance jurists forbade such combinations.⁶

2. Problematic investment account structure

Thus, Islamic banks have not been allowed to act directly – through agency and guaranty – as financial intermediaries that insulate their investment account holders from the credit risk associated with the bank's own debtors. Saeed sympathized with arguments by Sami Humud, Baqir al-Sadr and others, who aimed to find alternatives within the *mudaraba*

⁴ Dr. Humud's main publication was Humud (1976).

⁵ For instance, Saeed (1999, pp. 102-3) cites arguments by Rafiq Yunus al-Misri and Mahmoud Abu el-Saud against the use of *mudaraba* or *qirad* in banking.

⁶ See for instance, fatwa 13/1 in Abu Ghuddah and Khujah (1997a, p.219), and fatwa 11/3 in Abu Ghuddah and Khujah (1997b, p.167).

context to allow the Islamic bank to guarantee investment account holders' principal. He justified that position based on the view, reported by ibn Rushd in *Bidayat al-Mujtahid wa Nihayat al-Muqtasid* that an entrepreneur (*mudarib*) who forwards an investor's funds to another entrepreneur thus guarantees the invested principal for that original investor. However, he notes correctly that most Islamic economists and bankers feared that this approach would remove any substantive distinction between Islamic and conventional banking. In particular, he argued that the Hanafi view that depositors can be entitled to a return based on provision of money, rather than liability for risk, "could shatter the foundations of *riba* theory as it is accepted in Islamic banking".⁷ Besides, he points out correctly, Islamic banks benefited from the provision that investment account holders (as investors) bear the financial risk. Thus, the Accounting and Auditing Standards, and the Shari'a Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) stipulated the following:

One of the basic characteristics that distinguish Islamic banks from conventional banks is that the contractual relationship of Islamic banks with investment account holders does not specify that holders of these account [sic] are entitled to a predetermined return in the form of a percentage of their investment as this is strictly prohibited by *Shari'a*. Rather, the contractual relationship is based on the *mudaraba* contract which stipulates that profit realized from investing the *mudaraba* fund is shared between investment account holders – as *rab-al-mal* – and the Islamic bank – as a *mudarib*.⁸

The basis for considering the *mudarib* as a trustee with respect to the *mudaraba* funds is that the *mudarib* is using another person's money with his consent and the *mudarib* and the owner of the funds share the benefits from the use of the funds. In principle, a trustee should not be held liable for losses sustained by the funds. Rather, the risks of such losses must be borne by the *Mudaraba* funds.⁹

Needless to say, this structure greatly exacerbates the moral hazard problem between depositors and banks, which is the primary focus of regulators' efforts to protect depositors from excessive risk taking by bank managers. That fundamental moral hazard problem is further increased by the fact that – contrary to Sheikh Saleh Kamel's assertion in the opening quote – the interests of bank-owners or shareholders of the bank on the one hand, and investment account holders on the other, are actually in conflict, at least in the short term. Islamic Bank managers answer primarily to the shareholders, rather than the investment account holders, and they choose how to allocate various profits and losses from the bank's investments between the two groups. This prompted the issuance

⁷ Saeed (1999, pp.104-5).

⁸ AAOIFI (2004a, p. 215).

⁹ AAOIFI (2004b, P.241).

of an AAOIFI standard on reporting the basis and procedure for profit allocation:

The accounting treatments of the equity or profits of investment account holders differ greatly from one Islamic bank to another. This has prompted AAOIFI, as a first step, to promulgate Financial Accounting Standard No. 5: Disclosure of Bases for Profit Allocation Between Owners' Equity and Investment Account Holders in order to provide users of the financial statements of Islamic banks with information on the bases which Islamic banks adopted in allocation profit [sic] between owners' equity and investment account holders.¹⁰

Thus, AAOIFI has restricted its role in protecting investment account holders to maximizing transparency and uniformity of reporting standards. The only recourse for investment account holders, assuming that the Islamic bank does not engage in negligence or fraudulent activities, is to withdraw their funds from that bank. This gives rise to what AAOIFI research and later analysts called “displaced commercial risk”. That threat of fund withdrawal drives Islamic Banks to use their loan-loss reserve accounts to smooth rates of return paid to investment account holders, ensuring their competitiveness against rates paid by other Islamic and conventional financial service providers. This complex set of competing incentives has made the issue of corporate governance of Islamic banks one of the most difficult.

As of the writing of this article, the publication of a consultation paper on the subject in early 2006 was promised by the Islamic Financial Services Board. All indications at this time point to maintaining the “mutual fund” model, whereby investment account holders continue to lack the protection of board-representation as equity holders, or the protection of principal-guarantee as depositors. Under the mutual fund model, all that is required of Islamic banks – as *de facto* collective investment schemes, even if not labeled as such – is to provide consistent and transparent distribution rules for profits and losses between the competing interest groups (equity-holding owners and quasi-equity investment account holders). In the remainder of this article, I shall argue that this solution is vastly inferior to the solution in mutuality that is implicitly assumed in Sheikh Saleh Kamel's reference to investment account holders as “partners” who would prosper when the Islamic bank prospers – i.e. whose incentives are aligned with those of shareholders and the managers they appoint and oversee.

3. Possibility of debt-structured Islamic deposits

Before proceeding to discuss the specific financial areas wherein Islamic banking may be required, and how it should be structured, one should point out that Islamic bank liabilities can easily be made to mimic conventional bank liabilities, in a manner similar to Islamic banks' use of synthetic debt assets. However, the bulk of thought on Islamic bank regulation and corporate governance has maintained the assumption that investment

¹⁰ AAOIFI (2004a, p. 215).

or savings accounts offered to Islamic bank customers must be based on *mudaraba* or profit and loss sharing. This maintained assumption is patently false.

Clearly, since jurists have allowed Islamic banks to synthesize debt-finance instruments on their asset-side through sales and leases, the same can be done on the liabilities side. An Islamic bank obviously owns physical assets, which can be sold to depositors and leased back (perhaps through a Special Purpose Vehicle – SPV), thus guaranteeing those depositors’ principal plus interest in the form of rent. An Islamic bank can also engage with customers in commodity sale contracts based on [reverse] *murabaha* or *salam*, where depositors provide the immediate “price” and collect the higher deferred price (in *murabaha*) or spot resale price (in *salam*), in the same manner that Islamic banks and *sukuk*-buyers collect interest synthesized from price differentials in multiple sales. In the case of rent-based debt instruments, liquidity (withdrawal rights) can be provided for depositors through a unilaterally binding option to re-sell the property to the bank. For sale-based debt instruments, Islamic banks can provide resale facilities similar to the ones developed by the Bahrain Monetary Agency to facilitate Islamic banks’ liquidity management with its *sukuk al-salam*.

In other words, miniature variations on the debt instruments that allow banks and *sukuk* buyers to collect a guaranteed principal plus interest (characterized as price differential, profit or rent, depending on the contract) may be utilized equally successfully to synthesize Islamic bank deposit structures. Moreover, Islamic deposit contracts may use the same legal covenants used in structuring *sukuk*, which allow those instruments to pay a rate of return that is benchmarked to LIBOR, and based solely on the credit rating of the issuer. In this regard, the fundamental non-tradability of bank deposits (discussed in the following section) makes it possible extensively to use cheaper sale-based structures for Islamic bank savings deposits, which would be practically mirror-images of those banks’ assets.

This approach has the added advantage of aligning the structures of Islamic bank assets and liabilities, which helps Islamic banks in their management of liquidity, credit and interest rate risks. Indeed, this author had argued in an earlier paper that “Islamic bonds”, which can be used in open market operations, should be optimally structured through sale and lease-based contracts, to mimic Islamic banks’ other assets, thus making involvement in open market operations a natural component of asset and liability management.¹¹ In fact, the current structures of *sukuk* have precisely mimicked the structures of other Islamic bank assets along the “reverse financial engineering” approach suggested in that paper. The same can be accomplished with equal ease for Islamic bank liabilities.

Of course, this approach would have some drawbacks, including the two issues raised by Abdullah Saeed: that passing some of the risk of loss to depositors is financially advantageous for Islamic banks, and allows them to have a distinguishing feature from

¹¹ See El-Gamal (1999). This paper was originally presented at a seminar on “Design and Regulation of Islamic Financial Instruments”, organized and hosted by Central Bank of Kuwait in Kuwait City on October 25-26, 1997.

their conventional counterparts.¹² However, there are more substantive economic issues that suggest altering the structure of Islamic banks along the mutuality dimension suggested in Sheikh Saleh Kamel's opening quote. In the following two sections, I shall argue that given the recent advances in securitization and structured finance, the bulk of financial activities need not be intermediated through any type of bank, Islamic or otherwise. For the remaining areas where banking continues to play an important role, I shall argue that the spirit of Islamic law strongly suggests favoring a mutuality structure, rather than the current commercial structure utilized by Islamic banks.

4. Debt and equity in Islamic banking

In this section, we investigate the need for Islamic "banks" (as differentiated from other financial institutions), and the specific financial areas wherein Islamic banks can play a useful role. The answers to those questions revolve around the general nature of banks and the financial services and products that banks provide. Consequently, we begin by briefly reviewing the informational asymmetry, specialization and scale economy justifications for financial intermediation in general, and banking in particular. We shall then focus on the financial areas wherein conventional banks continue to play an important role. For those specific areas, we shall finally turn to the role that a distinctive Islamic banking sector can play, and the corporate structure that can allow them to fulfill their religious mission.

Banks as financial intermediaries exist generally to solve a number of market failures due to information asymmetry, economies of scale and liquidity mismatches. Providers of funds may find it prohibitively expensive to collect information on investors seeking funds, thus adverse selection and moral hazard problems prevent those investors from acquiring funds directly through financial markets. Banks solve this market failure due to information asymmetry by specializing in rating the credit worthiness of various investors. The cost of hiring and retaining skilled loan officers can be significantly reduced due to economies of scale. Banks also help to convert the funds of savers who demand high degrees of liquidity into longer-term investments with entrepreneurs who need the funds for extended periods of time. Of course, while banks solve the adverse selection and moral hazard problems between savers and investors, they create multiple other moral hazard problems. There is a moral hazard problem between the bank and the entities that it helps finance, another moral hazard problem between banks and the providers of funds, and a third potential moral hazard problem between banks and any deposit insurance scheme that might be put in place. The liquidity transformation function of banking interacts with those information asymmetries to magnify the risk of bank failure.

On both sides of financial intermediation, banks can use either equity or debt instruments. In the early literature on Islamic economics and finance, Islamic banks were envisioned to use equity or quasi-equity instruments on both asset and liability sides. In that regard, they would have become the polar opposite of commercial banking practice (wherein debt instruments dominate both the asset and liability sides) in most countries that do not

¹² Saeed (1999, pp.104-5).

allow German-style universal banking. In general, it has been well known that debt contracts are superior in dealing with information asymmetries of the type discussed above, especially when monitoring is costly.¹³ It is not surprising, therefore, that Islamic bankers have discovered at an early stage that the moral hazard problem made equity investment on the assets side of Islamic banking prohibitively risky. Thus, Islamic banks have switched the bulk of their assets to debt-instruments as discussed above. On the other hand, Islamic banks chose a peculiar structure on the liabilities side: with some equity holders and some quasi-equity holders. Before turning to that particular structure, we should consider the two natural mixed combinations of debt and equity on the assets and liabilities sides.

The first would be using debt instruments on the liabilities side, guaranteeing principal and interest for depositors, while investing the funds using equity contracts. This appears to be the model underlying the [in]famous *fatwa* issued by Al-Azhar's *Majma` al-Buhuth al-Islamiyyah* (Islamic Research Institute), wherein the characterization of interest on deposits was justified as fixed profit rates on funds forwarded to banks to "invest in permissible ventures".¹⁴ This closely approximates the model of universal banking, wherein savers deposit their funds with the bank on a debt-basis, usually with an added deposit insurance scheme, while banks can take equity positions in various companies. Under this structure, Boyd, Chang and Smith (1998) have shown that moral hazard problems between the bank and the deposit insurance company is increased substantially, especially when banks can benefit from diversion of funds ostensibly being invested (a very real threat in the developing Islamic world where similar abuses exist even within a debt-based bank asset structure). Thus, the model implicitly envisioned by Al-Azhar's *fatwa* – with equity-based bank investments being funded by guaranteed bank deposits – seems to be a very poor candidate for further examination.

Thus, to recap, we have eliminated three of the four possible combinations of debt and equity structures on the asset and liability sides:

1. Debt-assets and debt-liabilities is the classical commercial banking model, which can be replicated as I have argued in the previous section, by mimicking Islamic bank asset-structures on the liabilities side. This structure has the advantage that all corporate governance and regulatory issues will be handled in the same manner as for conventional banking. However, as Saeed (1999) has argued convincingly, adopting this structure may undercut the very rationale for existence of Islamic banks.
2. Equity assets and equity liabilities give rise to a very meaningful and successful model of mutual funds, private equity and venture capital, which have gained substantial market shares worldwide. However, this is not a model of banking, as Islamic banks discovered quickly from practice. This class of models plays an important financial intermediation role, through aggregation of savings on

¹³ See, for instance Townsend (1979), and Hart and Moore (1991). Similar analysis for Islamic finance was conducted by Humayun Dar and John Preseley (2000), who suggested that equity financing is only optimal for sufficiently small scale operations, wherein the cost of monitoring is minimal.

¹⁴ For a detailed analysis of this *fatwa*, including suggestions of its incoherence since bank assets in Egypt are restricted to interest-bearing loans, see El-Gamal (2003).

the liabilities side, and diversification of investments, with various levels of risk, on the assets side. It must thus play an important part in any financial system, Islamic or otherwise. However, it does not provide the appropriate solution for information asymmetries that require financial intermediation in the form of banking, wherein loan officers can specialize in credit risk analysis, and utilize economies of scale to reduce moral hazard and adverse selection problems economically.

3. Equity assets and debt liabilities give rise to a universal banking system, which some of the jurists at Al-Azhar appear to find plausible. However, this model does not seem to be appropriate for reducing moral hazard and adverse selection problems on the investor side, especially in developing Islamic countries where those information problems have been extreme even when debt instruments are used to extend bank credit.

This leaves us with the fourth potential combination of debt and equity structures on the assets and liability sides, which simultaneously resembles the model envisioned in Sheikh Saleh Kamel's opening remarks, as well as the structures of thrift institutions such as mutual savings banks, credit unions, etc. Under this model, Islamic banks would – as they do currently – build the bulk of their assets in the form of debt-based instruments, through *murabaha*, *ijara*, and various *sukuk* structures. The finance (loan) officers at those Islamic banks would – as they do currently – utilize the same criteria used by their conventional bank counterparts (prospective debtors' earnings before interest, taxes and depreciation, credit risk scores, etc.). In the meantime, the liabilities side of the bank will consist mainly of shares (after excluding various owed debts, e.g. for leased bank buildings, etc.), whereby shareholders and investment account holders will be put on par. As we shall see in the following section, while this does not eliminate information asymmetry problems, it does eliminate the substantial short-term conflict of interest that currently exists between Islamic bank shareholders and investment account holders, which is addressed by the AAOIFI standard quotes in previous sections. In other words, this would reduce the corporate governance and regulatory issues for Islamic banks to their well-studied counterparts for mutual thrift institutions such as mutual savings banks, credit unions, etc.

5. Mutual banking: secular considerations of corporate governance and regulation

While there are a number of different secular models of corporate governance in the world, the Anglo-American model is the one of greatest relevance for Islamic finance, since most countries with fast growing Islamic financial sectors (excluding Iran and Sudan) were previously under various types of British control, and continue to have strong links with English and U.S. banks and law firms. In this regard, it is important to note that the bulk of academic and practical advances in corporate governance in the Anglo-American world have the objective of aligning manager interests with those of shareholders. This is accomplished through a variety of mechanisms ranging from shareholder representation on the board of directors to external market discipline and

manager compensation schemes.¹⁵

As Allen and Gale (2000) have argued persuasively, the emphasis in theory and practice of corporate governance on making managers pursue exclusively the interests of shareholders is too restrictive. However, the focus in countries where other stakeholders of the firm are considered in corporate governance is often restricted to firm employees (especially in the traditional Japanese context). Within the context of the banking firm, the interests of depositors are not included within the scope of corporate governance, since depositors are considered creditors and first claimants on the banks' assets. Thus, the interests of depositors in the commercial banking setup are guarded by regulators, including deposit insurance corporations, who impose restrictions such as reserve ratios and capital adequacy, to reduce the probability of bank failure, and potential depositor losses in case of such failure.

If Islamic banks adopt either of the two debt-based deposit structures discussed in the previous section, corporate governance and regulatory recommendations would be no different from their best-practice counterparts in the Anglo-American system. Boards of directors and external market discipline will ensure that managers pursue the best interests of shareholders, while capital adequacy and other risk management regulatory requirements protect the interests of depositors. However, as we have noted previously, this solution is likely to appeal only to customers who are currently satisfied with conventional banking, and thus may undercut the very rationale for having Islamic banking.

The mutual fund solution, with equity Islamic-bank investments and quasi-equity investment account shares has its own conventional corporate governance and regulatory requirements in the Anglo-American financial system. For such collective investment scheme, transparency and information dissemination are paramount for protecting the rights of investors. Of particular interest for Islamic countries with under-developed regulatory structures are the conflict of interest driven abuses of universal banking prior to the Glass-Steagall Act in the U.S., and more recent conflicts of interest caused by conflation of securities research and marketing, partially addressed by the Sarbanes Oxley Act of 2002.¹⁶ Due to the general low degree of investor sophistication in the Islamic world, and the higher riskiness of mutual-funds, even under the best regulatory oversight imaginable, it seems compelling that the mutual-fund model should best be kept as a tool of collective investment, separate from banking. Unfortunately, all indications to-date suggest that the Islamic Financial Services Board (IFSB) will continue pursuing this model for Islamic banking – focusing its corporate governance recommendations on transparency of investment vehicles and profit distribution rules.

Meanwhile, the solution to the fundamental corporate governance problems of Islamic banks as they exist today – which revolve around the status of investment account

¹⁵ This literature arose as a response to the realization that managers may pursue their own interests, rather than those of shareholders, following the publication of Berle and Means (1932). For major advances in this field, see Schleifer and Vishny (1997).

¹⁶ See, for instance, Pari (1996), and Micaela and Womack (1999).

holders, and the protection of their interests – can be easily found in the opening quote of Sheikh Saleh Kamel: The rhetoric of Islamic banking suggests that investment account holders are in fact shareholders, whose interests are aligned with the Islamic banks' owners. The solution is to align the corporate structure of Islamic banks with that rhetoric, through a process of mutualization which puts those investment account holders on par with shareholders, and affords them the same corporate governance protections, through internal representation on the board of directors and external market discipline. In fact, it is interesting to note that early Islamic banking experiments in Pakistan, Malaysia and Egypt were inspired by European mutual forms of banking, and many utilized mutual forms to varying degrees.¹⁷

The phenomenal growth of Islamic finance at the hands of large multinational banks, such as HSBC, Citi, etc. will no doubt continue in various areas of investment banking and fund management. Needless to say, those activities do not fall within the scope of banking proper, where assets are financed primarily by deposits. Those non-banking segments of Islamic finance can continue to grow – as they have to-date – within the same corporate governance and regulatory frameworks for conventional financial markets and institutions. In the meantime, mutualization can help to bring Islamic banking proper (focusing on the depositary function of banks) within the familiar governance and regulatory framework of thrift institutions. In the remainder of this section, we shall review the performance of thrift institutions in comparison to commercial banks.¹⁸

In mutually owned banks, shareholders and depositors are one and the same, which resolves the fundamental corporate governance problem in Islamic banking. However, since mutual bank shares are non-tradable, one of the main mechanisms of corporate governance through external market discipline – linking managers' compensation to stock prices – is missing. Of course, tying manager compensation to internal accounting entries (profits, volume of transactions, risk adjusted rates of return, etc.) is possible, but it lacks the external discipline and objectivity commonly associated with capital market pricing of stocks. This concern is somewhat ameliorated by the likely high concentration of shareholdings by current owners of Islamic banks, who will continue to have a strong incentive for internal monitoring of bank manager performance and risk taking.¹⁹

In fact, the very lack of linkage of mutual bank managers' compensations to profitability appears to align their interests with those of the mutual bank shareholders, who generally do not buy mutual bank shares seeking a high-risk high-return profile. This is in contrast to investors in commercial banks, whose stocks may in fact be bought as part of the riskier components of their shareholders' portfolios. Consequently, mutual bank managers recognize that their potential gains from taking higher risk are bounded, while their potential losses are substantial, since they may lose their jobs.²⁰

¹⁷ See Warde (2000, p.73), and Saeed (1999, pp. 119-128).

¹⁸ For discussions of the uniqueness of deposit-based banking, see Wood (1970) and Hodgman (1961).

¹⁹ Allen and Gale (2000, pp. 95-110) and references therein.

²⁰ Fama (1980), Fama and Jensen (1983a, 1983b).

As long as managers of mutuals avoid excessively risky investment opportunities, managers of mutual banks tend to keep their positions for long periods of time, receiving higher compensations in non-pecuniary forms, including more leisure, better office furniture and business automobiles, etc.²¹ The advantage of longer and more comfortable job tenure increases the mutual bank manager's incentive to shun risks, thus providing shareholder-depositors with the types of low-risk, low-return investments that they desire. Research has shown that mutual banks have in fact chosen less risky investment portfolios, thus providing excellent low risk investment opportunities to uninformed depositor-shareholders who have no resources for monitoring bank manager performance.²² In addition, empirical research has shown that mutual banks are no less efficient in their operations than their stockholder owned counterparts, even though there is no theoretical reason to think that mutual bank managers would be interested in cost minimization.²³

Thus there appears to be no secular reason to question the economic merits of mutualization. Indeed, there is evidence that mutual banking institutions have played a very important role in the development of the U.S. financial system during the Nineteenth Century, when they were every bit as competitive as stockholder owned banks.²⁴ Many, if not most, mutuals are also structured as non-profit organizations, which ensures that customers who obtain financing from such mutual organizations have access to credit at lower rates than those generally offered by profit-oriented banks. In the following section, I shall argue that this non-profit approach to credit-extension may bring financial practice closer to the Islamic ideal enshrined in the prohibition of *riba*. Indeed, it is not surprising that early credit unions and mutual savings banks in Europe and North America was closely associated with churches and other religious institutions that sought to avoid usury by providing credit at affordable rates to community members, and to avoid profiting from the extension of such credit.

6. Religious considerations of *riba* and profiting from extension of credit

In his main work on comparative jurisprudence, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, the jurist, judge, philosopher and physician ibn Rushd (Averroës) provided what has perhaps remained – to this day – the best Islamic juristic analysis of the reason for forbidding *riba*. Ibn Rushd sought an argument to justify his agreement with the Hanafi view, which broadened the scope of the prohibition of *riba* from the six commodities mentioned in the Prophetic tradition (gold, silver, wheat, barley, salt and dates) to all fungibles measured by weight or volume. His own Maliki school of jurisprudence had limited the application of rules of *riba* only to monies (gold and silver) and storable foodstuffs (by inference from the other four commodities). In contrast, the Hanafi school had viewed gold and silver as examples of fungibles measured by weight, and the listed four foodstuffs as examples of fungibles measured by volume. The Shafi'i and Hanbali schools accepted the narrower Maliki scope of *riba*, with slight

²¹ O'Hara (1981).

²² Rasmusen (1988).

²³ Altunbas, Evans and Molyneux (2001).

²⁴ See Hansmann (1996).

modifications. Ironically, this restriction has allowed for *fatwas* that permitted essentially *ribawi* loans, provided that the commodity that is used is not gold or silver. For instance, jurists in pre-modern time excluded copper coins (*fulus*) from the rules of currency exchange and *riba*, and Al-Rajhi's Shari`a advisory board ruled in its *fatwa* #101 that platinum is excluded from those rules (reasoning that only gold and silver constituted "universal monies").²⁵

To justify his adoption of the more general Hanafi rule, ibn Rushd reasoned as follows:

It is thus apparent from the Law that what is targeted by the prohibition of *riba* is the excessive inequity (*ghubn fashish*) that it entails. In this regard, equity in transactions is achieved through equality. Since the attainment of such equality in trading different products is difficult, property values are determined in monetary terms (with the *dirham* and the *dinar*). For non-fungibles (properties not measured by weight and volume), justice can be determined by means of proportionality. What I mean is this: the ratio of one item's value to its kind should be equal to the ratio of the other item's value to its kind. For example, if a person sells a horse in exchange for clothes, justice is attained by making the ratio of the price of the horse to other horses the same as the ratio of the value of the clothes to other clothes. Thus, if the [monetary] value of the horse is fifty, the value of the clothes [for which it is exchanged] should be fifty. [If each piece of clothing has a monetary value of five], then the horse should be exchanged for 10 pieces of clothing.²⁶

Ibn Rushd thus made the argument implicitly that equity is attained through equating the ratio of benefits to the ratio of prices. Written five centuries prior to the invention of differential calculus, ibn Rushd could not be expected to state the Pareto-efficiency criterion that the ratio of prices should be equated to the ratio of marginal utilities. However, the argument and the context suggest that he had something very similar in mind: *Riba* was forbidden to ensure equity in exchange, and an easy criterion for equity in trading fungibles of the same genus is equality – hence the Canonical examples given, wherein equity is established through equality in same-genus trading:

As for [fungible] goods measured by volume or weight, they are relatively homogenous, and thus have similar benefits [utilities]. Since, it is not necessary for a person owning one type of those goods to exchange it for the exact same type, justice in this case is achieved by equating volume or weight since the benefits [utilities] are very similar.²⁷

In a previous article, I combined this analysis with a well-known Prophetic tradition, wherein exchanging high quality for low quality dates in different quantities was forbidden, in preference for selling one and using the proceeds to buy the other. In other

²⁵ <http://fatawa.al-islam.com> (in Arabic, search for "Platin").

²⁶ Ibn Rushd (1997, vol.3, p.184).

²⁷ *ibid.*

words, if equity is known to be impossible through equality, then we should refer to market values, to ensure the Pareto efficiency condition of equality of the ratio of prices to the ratio of [marginal] utilities. In turn, the latter is ensured through competitive markets, where the seller will seek the highest possible price he can get for his goods, and the buyer will seek the lowest possible price, thus marking trading ratios to market.²⁸

In this paper, we are mainly concerned with institutions that facilitate credit extension, which is the primary business of Islamic and conventional banks alike. Although Islamic banks may conduct their credit operations through multiple trades or leases, it is clear in most cases that the objective is to extend credit and earn a return thereof, rather than trading in homes, automobiles, and other properties the purchase of which they finance. In this regard, Islamic banks rely on the fact that credit sales in Islamic jurisprudence are allowed at prices that exceed the cash prices of the same properties.²⁹ Likewise, time value can be recognized in a lease setting by charging the customer “rent” in place of interest. What we need at this point is to link ibn Rushd’s view of prohibition of *riba* (to ensure equity in exchange) to the practice of Islamic banking as it exists today. Then, we can proceed to consider the advantages of a model of mutuality in avoiding *riba*.

We begin by considering loan-based finance, since this is the classical commercial banking model that Islamic banks aim simultaneously to emulate and to replace. It is important in this regard to recognize that classical Islamic jurists viewed loans as contracts of exchange. Hanafi jurists viewed a loan as exchange of the lent amount in exchange for an equal amount in the future, and jurists of the other major Sunni schools viewed it as exchange of the lent amount in exchange for an established liability to deliver an equal amount in the future.³⁰

Thus, when lending fungibles, the rules of *riba* ensure equity in exchange – as explained by ibn Rushd – through equality of amounts. Any added benefit to the lender is thus tantamount to a surcharge for the very act of extending credit, which can lead to excessive injustice, as lenders exploit people’s need for credit.³¹ Islamic banks manage to avoid the formalistic prohibition in a money-for-money transaction by turning it into a money-for-property transaction (in cost-plus credit-sale or *murabaha*-financing) or

²⁸ See El-Gamal (2000) for extension of the “mark to market” setting, as well as discussion of dynamic inconsistencies leading to uncontrollable debt cycles.

²⁹ See Al-Misri (1997, pp.39-48), for multiple quotations from all major schools of jurisprudence establishing that “time has a share in the price”.

³⁰ The vast majority of jurists from all schools also reasoned that ownership of the lent property is transferred to the lessor (upon receipt for the majority of Hanafis, Shafi’is and Hanbalis, and upon conclusion of the contract for the Malikis), c.f. Al-Zuhayli (El-Gamal, Tr., 2003, vol.1, pp. 373-4).

³¹ Interestingly, in his famous fatwa in Detroit permitting the use of home mortgage financing in America, Dr. Yusuf Al-Qaradawi reasoned that the beneficiary in this case is the borrower, who gets to live in a better house, and to build home-equity. Since Muslims in a non-Muslim land are not required to establish social aspects of the religion, according to the opinion of Abu-Hanifa that was accepted by Al-Qaradawi in this fatwa, they are only required to adhere to personal aspects of the religion. In this regard, the rules of *riba* would make sense as a social custom, e.g. providing a form of implicit social insurance, as argued by Glaeser and Scheinkman (1998). Otherwise, i.e. in the absence of this social function of the prohibition, Al-Qaradawi seemed to reason, as long as the Muslim was not a victim to extreme inequity, the prohibition does not play any useful role.

money-for-usufruct transaction (in lease or *ijara*-financing). Of course, the very substance of forbidden *riba* (including its most inequitable usurious forms) can easily be realized in those types of transactions. For instance, one can charge a needy person implicit 200% overnight interest by selling him an amount of aluminum worth \$10 in exchange for a monetary debt equal to \$30, payable the next day. Technically, this would be viewed as a legitimate sale, since there are no legal ceilings on profits in sales. However, the net result is usury of the worst form, which is ironically easy to prevent in loans under current usury laws, that impose interest rate ceilings.³² In other words, using sales and leases does not ensure avoidance of the substance of usury, which is inequity in exchange – in the case of finance, charging a debtor more or less than the equitable interest rate.³³

Of course, one cannot make a general claim that all for-profit financial intermediaries would engage in usurious lending if they could, although the cited Business Week and Wall Street Journal articles in April 2005 suggest that that line may be easily crossed in pursuit of profits.³⁴ More generally, though, a profit-oriented financial intermediary is more likely to charge its borrowers the highest interest rates it can, and to pay its depositors the lowest interest rates that it can, subject only to regulations and market pressure stemming from competition. Needless to say, the level of competition in Islamic finance continues to lag behind its counterpart in conventional banking. Thus, for-profit Islamic financial intermediaries have a distinct incentive to charge higher interest rates to its debtors, and to pay lower profit rates to its investment account holders, subject only to the limited commercial risk of losing customers on either side of the balance sheet to conventional or Islamic competitors. The incentive structure in those institutions is such that managers would serve the interests of shareholders (i.e. maximize profits) at the expense of customers on both sides of the balance sheet, subject only to market pressures. Indeed, the lack of competition among mortgage providers was cited in Hagerty and Hallinan (2005) as one of the primary culprits in excessive sub-prime mortgage lending to blacks at exorbitant interest rates. When debtors of Islamic financial intermediaries are charged higher interest rates (in the form of profit or rent), and when depositor-like investment account holders receive lower interest rates (in the form of profit shares) than they would otherwise, the shareholders of those intermediaries are thus profiting from the very act of extending financial intermediation (including credit) to a captive market. Lack of competition exacerbates this problem, thus resulting in the types of inequity for which the rules of *riba* were established – according to the analysis of ibn Rushd.

7. Concluding Remarks

Interestingly, the mutual banking movement in Europe and North America was initiated by religious-minded groups who also feared that commercial banks did not face sufficient

³² This argument was articulated in Al-Misri (2004).

³³ Of course, western legal and regulatory systems have built-in provisions against predatory lending, especially to minority groups. However, there are difficulties in quantifying the appropriate interest rate to charge debtors with very high levels of credit risk, c.f. Hibbard (2005). See also Hagerty and Hallinan (2005).

³⁴ Ibid.

competition, and hence charged them exorbitant interest rates.³⁵ The mutuality structure has been shown to solve some of the secular corporate governance issues raised in the previous section. In this regard, Allen and Gale (2000) listed a number of industries in which mutual corporate forms compete successfully with stock-ownership corporate forms, despite the absence of external market discipline that plays such an important role in the corporate governance theoretical literature. Moreover, this success appears to take place despite mutuals often having unchanging boards of directors – implying that the internal discipline focus in the mainstream corporate governance literature is also misplaced. Instead, mutuals appear to adopt a model akin to the traditional Japanese managers' focus on serving the interests of all stakeholders. In conventional banks, the debt-equity structure of depositors and shareholders, respectively, creates a conflict of interests between those two sets of stakeholders.

Regulators mainly focus on protecting the interests of depositors through reserve ratios, capital adequacy requirements, etc., while managers focus on serving the interests of shareholders, who are the only remaining stakeholders, subject to regulatory constraints. Since the majority of Islamic bank managers built their careers originally in conventional banking, they naturally bring this frame of mind to their Islamic financial institutions. Consequently, it is highly unlikely that those managers would serve the interests of the others stakeholders: mainly the investment account holders and the bank-debtors (who receive credit through *murabaha* and *ijara*). This results in a regulatory dilemma for protection of the rights of those two groups, in the absence of loan-based structures of deposits and financing (where reserve ratios and capital adequacy protect the depositors, and usury and predatory lending rules protect borrowers). Thus, while Islamic bankers aim to avoid *riba* in form, their mode of operation may encourage the substance of *riba*, as argued earlier in this section. Mutuality – especially in its credit union form – appears to address simultaneously religious as well as secular regulatory and corporate governance concerns.

³⁵ See, e.g. MacPherson (1999), for a history of the global credit union movement. See also El-Gamal (2005) on the role of mutuality in combating rent-seeking Shari'a arbitrage behavior in Islamic finance.

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