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Governance and Regulatory Solutions in Mutuality

We need to discuss issues of governance, regulation, and enforcement in Islamic finance only to the extent that Islamic financial markets and institutions differ from their conventional counterparts. Wherever substantive differences do in fact exist, reduction of Islamic financial practices to conventional analogs can provide the easiest approach to regulation and governance. In this regard, we have illustrated through numerous examples in previous chapters that Islamic financial market products are substantively identical to their conventional counterparts. Thus, Islamic financial markets and market-supporting institutions require minimal effort to view all products and operations therein in light of their conventional counterparts, and thus conventional governance, regulation, and enforcement best practices may be applied directly.

For instance, many asset-based transactions can be easily converted into conventional loans for regulatory and enforcement purposes, and regulatory capital, reserve ratio, and risk management requirements may be easily applied to Islamic transactions and the institutions that implement them. The only requirement in this regard is to keep track of things like multiple trades and leases in order to report Islamic loan alternatives in the same format used by conventional banks in their reporting to central banks and other regulators.¹

Regulation and governance of Islamic mutual funds, investment banks, venture capital firms, and the like are even more direct, since their operations are virtually identical with conventional counterparts. The two sets of Islamic financial institutions for which corporate governance and corresponding regulation and enforcement standards need to be developed are in the areas of banking and insurance. We suggested in Chapter 8 an agency framework for those two sets of institutions. In this chapter we shall elaborate on this proposed agency structure, with emphasis on the need for mutualization in Islamic banking and insurance, which would allow us to reduce governance and regulatory problems to ones for

which conventional counterparts are well developed, while ensuring avoidance of forbidden *riba* and *gharar*, both formally and substantively.

9.1 Rent-Seeking Shari‘a Arbitrage and Absence of Mutuality

Historical studies of Islamic banking prior and leading to the Mit Ghamr experiment in Egypt in 1963, which was a pivotal point in the history of Islamic banking, point to the strong influence of European mutual banking institutions and cooperatives. This influence applied equally to early-1950s banking experiments in Pakistan, as well as the 1960s Malaysian Tabung Haji, which eventually gave rise to the fast-growing Malaysian Islamic banking sector. Dr. Ahmed Al-Najjar’s initiative in Mit Ghamr appears itself to have been equally influenced by the social and economic thought of the Muslim Brotherhood in Egypt and the mutual banking institutions that Dr. Al-Najjar witnessed in West Germany during his years of study there.²

The later GCC-based pioneers of Islamic banking in Dubai, Kuwait, and Saudi Arabia capitalized the first group of Islamic banks in the mid-1970s and later lamented the modes of operation adopted by those banks, which mimicked conventional banking practices. Many today criticize Islamic banks for failing to deliver economic and social development to Muslim populations that remain among the poorest and least educated in the world. Indeed, Dr. Al-Najjar, Sheikh Saleh Kamel, and most of the early pioneers of Islamic banking expressed their displeasure with the industry’s modes of operation on the assets side and predicted that foreign banks would soon be able to capture significant market share in an Islamic banking industry built on synthesizing loans and bonds from sales and leases.³

On the liabilities side, there is great disparity between the rhetoric and practice of Islamic banking. For instance, Sheikh Saleh Kamel made the suggestion in a recent interview that Islamic bank “depositors” were in fact “partners” who thrived when Islamic banks did, thus assuming a mutuality structure, which is not in fact how Islamic banks are structured today.⁴ Some mutuality initiatives in Islamic finance exist in Canada, the United States, Trinidad, and other countries in the forms of housing cooperatives and credit unions, but those are very few to alter the fundamentally Shari‘a-arbitrage profit-driven nature of the industry.⁵

Mutuality in Islamic insurance would have also been a natural development, given that jurists sought solutions to the problem of *gharar* inherent in the risk-trading business of insurance through noncommutativity of the relationship between insurer and insured in *takaful*. However, they sought this solution only by making the insurer (still a stock-holder company) pay valid claims as an act of voluntary contribution (*tabarru’*), rather than commutative trade. We have outlined the problems with this model of *tabarru’* in Chapters 6 and 8, especially given the

general nonbindingness of gift promises in classical jurisprudence. Interestingly, jurists who approved conventional insurance, as well as jurists who preferred the Islamic *takaful* alternative, were in agreement that the essence of any permissible Islamic insurance scheme lies in its fundamental characterization in terms of mutual cooperation. Thus, mutuality in Islamic insurance would have been natural. However, in insurance as in banking, financial professionals and jurists have approached the industry from the vantage point of exploiting profitable Shari'a arbitrage opportunities.

Prohibitions as Means of Risk Mitigation

More generally, mutuality in banking and insurance would provide natural solutions to the problems of *riba* and *gharar* associated with intermediation of credit and risk, respectively. In this regard, we have argued in previous chapters that the prohibitions of *riba* and *gharar*, and associated conditions imposed by classical jurists on contracts that allow transfer of credit and risk without violating those prohibitions, are in essence forms of prudential regulation and risk management. Although secular regulators have put in place regulatory requirements that limit systemic risks posed by joint-stock financial companies, mutuality appears to fill a needed regulatory gap for protecting individuals from their own tendencies to undertake excessive risk that may prove personally ruinous. Interestingly, the rise of mutual savings banks and mutual insurance companies appears to have occurred in the West precisely to meet the demands of farmers and other risk-averse groups, who built such institutions to gain access to credit and risk mitigation without necessarily having their financial interests governed by profit motives.⁶ It is this similarity of motives and substance that made mutuality a natural idea in the early days of Islamic banking, and in the early literature on Islamic insurance.

Later in this chapter we shall summarize theoretical results and empirical evidence indicating that mutual financial institutions tend to provide their owners with lower risk and return profiles, and to offer their customers (who are often shareholders as well) better service, compared to joint-stock banking and insurance companies. In other words, mutual financial institutions provide the same financial (credit and risk) intermediation services and products, which are necessary for economic well-being, but do so in a manner that does not increase risks unnecessarily. This lower risk profile also makes mutual financial institutions more resilient, especially during periods of financial panic, such as during the Great Depression of the early twentieth century. It is interesting in this regard to note that the prohibitions of *riba* and *gharar* are precisely restrictions on means of trading in risk (the extension of credit exposes the creditor to potential borrower default or bankruptcy, and leverage increases the borrower's own risk thereof). Thus, the spirit of Islamic jurisprudence allows transfer of credit and risk only if bun-

dled within a financial transaction such as sales, leases, and partnerships.⁷ Such bundling regulates the riskiness of financial transactions, thus allowing for necessary risk taking to encourage investment and economic growth, while minimizing individual and systemic risks of bankruptcy and wild fluctuations in economic values.

Rent-Seeking Shari'a Arbitrage Encourages Risk Taking

The lack of mutuality in Islamic banking and insurance is not surprising when we consider the motivation behind their growth in the past two decades, as discussed in the previous chapters: abnormal profit or rent seeking. The bulk of growth in Islamic finance has come from multinational financial conglomerates and conventional banks that were attracted to Islamic finance by lucrative profit opportunities. As we have argued in earlier chapters, the very nature of Shari'a arbitrage – which increases transaction costs – has justified charging higher fees or interest rates for Islamic financial services and products, while competitive pressures have simultaneously limited new entry to the industry mainly to the more efficient multinational rent-seeking financial providers.

In this regard, it is useful to note that demutualization in conventional banking and insurance during the past two decades was driven by the same profit/rent-seeking incentive of Shari'a arbitrageurs. As Gron and Lucas (1997) have argued, demutualization was driven by the stock market boom of the 1980s and 1990s, which strengthened the incentive to seek additional capital from equity markets, as it promised mutual owners fast riches. In this regard, it is generally accepted that demutualization of credit unions and other mutual financial institutions mainly enriched managers and large stockholders, in many instances at the expense of smaller shareholders.

Of course, seeking higher returns – through demutualization or avoidance of mutuality in the first place – can be achieved only through increased risk exposure. To the extent that shareholders in mutual banks and mutual insurance companies selected that ownership structure to avoid excessive risk, yielding to the temptation to pursue investments with higher risks and higher returns appears to contradict the initial incentive to shun risk, at least for the part of their portfolio held with mutuals. In the area of Islamic finance, one could argue that the unique power of religious injunctions (especially against *riba* and *gharar*) is that they protect individuals from temporary greed-driven heightening of their appetites for risk. Alas, by shunning mutuality and adopting some of the most transparent forms of Shari'a arbitrage, the regulatory substance of the Shari'a has been squandered, while adherence to its forms has continued tragically in the shallowest way.

Potential for Mutuality in Islamic Banking

Replacement of conventional bank savings accounts with investment accounts based on profit and loss sharing continues to be the main distinctive feature of Islamic banks, to which much of the work of AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions, in Bahrain) and IFSB (Islamic Financial Services Board) is devoted. Of particular concern in this context is the fact that Islamic bank managers answer to shareholders, whose risk preferences (associated with equity investment) are typically quite different from those of investment account depositors (conventionally associated with debt investments that seek low risk and low return). The problem is exacerbated by investment account holders' lack of control over bank decisions, which exposes them to substantial moral hazard compared to bank shareholders. Investment account holders are also disadvantaged relative to conventional depositors who are deemed creditors of the bank, and thus have first claims to its assets in case of bankruptcy.

A natural solution to this problem is for Islamic banks to adopt a mutual corporate structure. Of course, as we shall argue below, the mutual corporate form does not eliminate moral hazard entirely, since shareholder/depositors are typically too small individually to control bank operation. Indeed, the literature on mutual banks often identifies each shareholder's ability to withdraw his deposit from the bank as the only means of punishing its managers – a prospect called “displaced commercial risk” in the literature on Islamic banking. However, by eliminating the separate group of profit-oriented shareholders from the formula, or putting them on par with investment account holders in the corporate structure, managers' incentive for excessive risk taking is largely eliminated, resulting in lower risk taking that reflects depositors' preferences.

In later sections I shall argue that mutuality in Islamic banking can in fact bring to the industry large numbers of depositor/investors as well as managers who are committed to Islamic ideals of social and economic development, as opposed to profit- and fee-oriented Shari'a arbitrageurs. A by-product of identification of Islamic banking with mutualization would be to give indigenous Islamic banks a much-needed comparative advantage vis-à-vis international financial behemoths that have been able to attract the most respected Shari'a advisors and law firms, thus capturing fast-increasing market shares in today's Islamic finance industry that is built on rent-seeking Shari'a arbitrage. Unfortunately the Islamic banking industry originally envisioned replacing conventional banks with a mutual-fund model of two-tier *mudaraba*, as discussed in Chapter 8, which created a curious liability structure with full equity shareholders and quasi-equity investment account holders with little protection against moral hazard.

Debt and Equity Structures for Assets and Liabilities

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 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.⁸ 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 four possible combinations of debt and equity on the assets and liabilities sides.

The first combination, corresponding to conventional commercial bank structure, matches debt-instrument assets with debt-instrument liabilities. In Chapter 8 we have argued that Islamic banks may indeed replicate the liabilities structure of conventional banks, for example, either by using combinations of agency and guaranty or by synthesizing debt liabilities through reverse *murabahas*. This structure has the advantage that all corporate governance and regulatory issues will be handled in the same manner used for conventional banking. However, as Saeed (1999) has argued convincingly, adopting this structure may undercut the very rationale for the existence of Islamic banks and hence would be an unlikely candidate for Islamic banking in the near future.

At the other extreme, we have a model of equity-instrument assets and equity-instrument liabilities (two-tier *mudaraba*), which was envisioned historically as the Islamic alternative to conventional banking. Of course, this equity-based structure is a very meaningful and successful model for mutual funds, private equity, and venture capital, which have gained substantial market shares worldwide. This class of models plays an important financial intermediation role, through aggregation of savings on 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, this structure is not an appropriate model of banking, as Islamic banks discovered quickly from practice. In this regard, the pure equity structure does not provide the appropriate solution for information asymmetries that re-

quire 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.⁹ Indeed, the great amplification of moral hazard under that structure is illustrated by the discussion of *mudaraba* conditions in Islamic banking in AAOIFI standards:

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*.¹⁰

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.¹¹

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.¹²

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 chapter, the publication of a consultation paper on the subject was promised by the Islamic Financial Services Board for early 2006. 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). This solution appears vastly inferior to the solution in mutuality, which aligns the incentives of shareholders and depositors.

A third alternative would be to use 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 *fatwa* issued by Al-Azhar’s Islamic Research Institute (discussed in Chapter 8), wherein the payment of interest on deposits was justified as fixed-profit rates on funds forwarded to banks to “invest in permissible ventures.” 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.

This leaves us with the fourth potential combination of debt and equity structures on the asset and liability sides, which is the mutuality structure of thrift institutions such as mutual savings banks and credit unions. 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 – rely on 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), whereby shareholders and investment account holders will be put on par. Of course, this does not eliminate information asymmetry problems. However, it does eliminate the substantial short-term conflict of interest that currently exists between Islamic bank shareholders and investment account holders, which has been a main feature of Islamic banking literature. 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 and credit unions. Moreover, regulating Islamic finance from a religious

point of view should also focus on corporate forms of Islamic financial institutions. In this regard the focus on contract forms only may be sufficient for regulation of Islamic financial markets, but analysis of corporate forms and incentives must play an important role in regulation of financial institutions.

Need for Mutuality in Takaful

As we have argued earlier, the absence of mutuality is even more surprising in the Islamic insurance industry, known generally by its Arabic name *takaful* (mutual guaranty). It is interesting that even companies that use the term *takaful ta'awuni* (cooperative mutual guaranty or insurance) have not adopted mutuality structures. This is particularly astonishing given the classical ruling 9/2 of the Fiqh Academy of the Organization of Islamic Conference (OIC), which distinguished commercial insurance from what it called “cooperative insurance . . . built on the principles of voluntary contribution (*tabarru'*) and mutual cooperation.” In fact, as we have seen in Chapter 8, contemporary jurists have enumerated three types of insurance, which they called mutual insurance, social insurance, and commercial insurance. The first form was envisioned along the lines of Western mutual insurance companies (where policyholders are themselves the stockholders), the second form encompasses state-sponsored pension and health insurance plans, and the third is the familiar type conducted by profit-oriented joint-stock companies. As we have seen in Chapter 8, Dr. Mustafa Al-Zarqa, Dr. 'Ali Jum'a, and other scholars have also recognized that the mutual insurance version was the least controversial, and unanimously accepted, alternative.

Unfortunately the contemporary Islamic insurance industry has adopted a superficial mutuality notion in its name (*takaful*), but not in substance. Thus, most Islamic insurance providers are structured with stockholder rather than policyholder ownership. Insurance claims are paid by shareholders through the *takaful* provider on the basis of *tabarru'* (voluntary contribution, as opposed to contractual obligation). This model based on voluntary contribution, replacing commutative contractual obligations with legally binding unilateral promises, raises a host of legal and juristic problems that have not yet been resolved fully. While insurance providers are typically characterized as investment agents of the stockholders, Bank Al-Jazira in Saudi Arabia has pioneered a characterization of insurance provider as pure agent (*wakil*, rather than *mudarib*). This can be a step toward eventual mutualization, where the insurance provider can act as a pure agent for shareholders who are themselves the policyholders. This would satisfy the most widely accepted means of eliminating *gharar* from insurance, by negating the commutative financial nature of the transaction through mutuality. How-

ever, there seems to be precious little initiative for mutualization in the Islamic insurance industry today.

9.2 A Call for Mutuality in Banking and Insurance

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 (1999) sympathized with arguments by Sami Humud, Baqir Al-Sadr, and others, who aimed to find alternatives within the *mudaraba* 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 noted correctly that most Islamic economists and bankers feared that this approach would remove the most important perceived substantive distinctions 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." Besides, he pointed out correctly, Islamic banks benefited from the provision that investment account holders (as investors) bear the financial risk.

Hence, the best Islamic alternative for conventional commercial banking may in fact be adopting mutual banking structures that have been in existence in the west for well over a century, and for which corporate governance and regulatory issues and methods have become well understood. Hence, Western governance and regulatory frameworks for mutual banks may be adopted to this version of Islamic finance with relative ease. In this regard, 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 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.¹³

Allen and Gale (2000) have argued persuasively that 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.

The phenomenal growth of Islamic finance at the hands of large multinational banks, such as HSBC and Citi, 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 nonbanking 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.

Mutuality in Banking

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 nontradable, 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.¹⁴

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, stocks of which 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.¹⁵

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 nonpecuniary forms, including more leisure, better office furniture, and business automobiles.¹⁶ 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.¹⁷ 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.¹⁸

Thus there appears to be no secular reason to question the economic merits of mutualization of Islamic banks. On the contrary, 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.¹⁹ Many, if not most, mutuals are also structured as nonprofit 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 this regard, the nonprofit 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 were 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. Of course, one cannot make a general claim that all for-profit financial intermediaries would engage in usurious lending if they could. However, recent evidence suggests that the profit motive may indeed drive financial providers in the direction of discriminatory and predatory lending practices, especially when it is difficult legally to prove such accusations.²⁰

Mutuality in Insurance

In the area of insurance, it is worthwhile noting that mutual insurance companies have played a major role in many insurance lines in the United States during the

1990s, even gaining market share in some property and casualty insurance lines.²¹ Empirical evidence suggests that stock insurance companies bore more risk and provided higher returns through higher cost efficiency.²² Those results are consistent with theoretical analyses of agency problems of mutuality in insurance companies.²³ Naturally, those results for mutuality in insurance mirrored those discussed in the previous section for mutuality in banking: Mutual insurance companies provide better insurance value (higher loss ratios) for policy holders, since managers answer to them rather than to separate profit-seeking stockholders. Of course, by choosing portfolios of lower risk, mutual insurance companies generate lower profits than their stock counterparts. However, being themselves insurance policy holders, owners of those mutual insurance companies are perfectly happy to have a lower risk and lower return profile arising from provision of better insurance coverage with advantageous loss ratios.

Mutuality in Islamic banking and insurance can play an important role in redefining the “Islamic” brand name of Islamic finance. In this regard, many areas of Islamic finance (e.g., in investment banking and fund management) differ only very slightly from conventional financial practice. Differences in those fields, where they exist, can be sold on substantive grounds (e.g., lower tolerance for debt and leverage, ethical investment bias), which would widen its potential market. Thus, those areas would be better served by dropping the “Islamic” distinction. In the meantime, Islamic finance in the areas of banking and insurance can benefit significantly from highlighting a social agenda for improving the plight of Muslims, who are among the poorest and least educated people in the world today. In that respect, redefining Islamic banking and insurance in terms of mutual community efforts can integrate those institutions seamlessly with charitable activities of the Muslim community (e.g., *zakah* payments can be utilized to provide microcredit at affordable rates). Thus, “Islamic” finance may focus less on forms of contracts (the primary feature of rent-seeking Shari‘a arbitrage discussed in earlier chapters) and turn its focus to substantive developmental and community initiatives in finance. In Chapter 10 we shall argue that this redefinition of Islamic finance is important, since the industry’s current Shari‘a-arbitrage path is both unsustainable and dangerous.