

Mutual Banking Institutions in light of Sharia Law

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Abstract:

Mutual banking institutions engage in a diverse array of banking activities aim to achieve economic and social development. These institutions are predicated on a cooperative principle, which fundamentally differentiates them from their commercial banking counterparts. Such a cooperative ethos closely aligns mutual banks with Islamic financial institutions. Nonetheless, their failure to incorporate Sharia as the foundational basis for their transactions, coupled with the absence of Sharia supervisory board compliance, categorically excludes them from the Islamic financial sector.

Keywords: Bank; Finance; Islamic; cooperative; Mutual; Sharia; commercial banking; financial institutions.

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Introduction

The discourse on banking or financial institutions represents one of the most intricate¹ subjects in transactional studies, characterized by considerable contention and ambiguity. Specifically, mutual or cooperative banking institutions embody a central aspect of this debate, necessitating thorough analysis due to the distinct nature of their transactional frameworks as compared to profit-oriented commercial banks.

Islamic financial institutions are predicated upon the tenets of Sharia, deriving their rulings from these religious laws. These entities are not merely financial instruments but are envisioned as developmental agents operating within the ethical confines of Islamic law. Their aim is to foster profit through the stewardship of licit funds, managing these resources with efficacy within the bounds of sound economic governance. By aggregating capital and directing it in accordance with Sharia principles, these institutions strive to bolster the Islamic community of mutual support, ensuring that financial activities align with Islamic ethical standards².

Mutual banking entities align nominally with Islamic banks, with some referred to as 'banks' and others as 'banking institutions,' both terms being synonymous in this context. They are uniformly subject to the regulatory oversight of the national central bank, complying with directives that frame the country's financial and monetary policies.

Both types of entities provide a spectrum of banking services and engage in investment activities designed to promote economic and social development within their respective societies³. Nevertheless, a critical divergence arises from the mutual banking institutions' non-compliance with Islamic Sharia law. What, then, are the manifestations of this distinction?

This paper will delve into two primary areas: firstly, the lack of Sharia compliance in the operational transactions of mutual banking institutions, and secondly, the absence of Islamic legal principles as a legislative foundation for their transactions. Prior to discussing these points, it is essential to elucidate the definition of these institutions.

I. Definition of Mutual Banking Institutions

Mutual banking institutions, also known as cooperative banks, are banks that are owned by their customers, who are also referred to as members. Mutual banks offer the same types of products and services as traditional banks, such as transaction accounts, savings accounts, home loans and credit cards. They are also typically community-focused⁴.

They are also defined by certain jurists as: “entities that facilitate the issuance of advances and act as intermediaries between capital holders and borrowers in need. They operate as apparatuses for conducting contemporary banking activities, which have expanded and evolved alongside the agricultural, industrial, distribution, and service sectors.

These institutions aggregate savings and manage essential banking functions for their clients, including managing current accounts, handling deposits, discounting bills of exchange, and facilitating letters of credit”. However, this definition has been critiqued for its failure to differentiate clearly between commercial, governmental, and philanthropic banks, as well as its insufficient distinction from cooperative associations that undertake similar banking functions.⁵

A mutual banking institution is formally established as a legal entity composed of members who collaborate to pool and manage capital, focusing their interactions on achieving the collective objectives of the cooperative.

These institutions are pivotal in offering several critical services: they provide loans at reduced interest rates, support various functions such as procurement and marketing, and accept deposits on which they pay interest.

Subsequently, they employ these deposits in investment ventures akin to those undertaken by commercial banks. Occasionally, these institutions may resemble cooperative associations tailored to the needs of small-scale traders, craftsmen, and professionals such as fishermen and manufacturers⁶.

II. Divergences Between Mutual Banking Institutions and Islamic Banks

Mutual banking institutions are distinct from Islamic banks, particularly because their operations are non-compliant with sharia nor are governed by Islamic legal statutes.

1. Non-Compliance with Sharia Supervision in Mutual Banking Institutions

The Fatwa and Sharia Supervisory Board is a quintessential feature that distinguishes Islamic banks from other financial institutions. It ensures that all banking transactions comply with Sharia law, with the board members appointed under stringent conditions and regulatory frameworks often codified by statutory law⁷.

Sharia supervision represents a pivotal regulatory apparatus within the financial sector, embodying the most rigorous oversight dictated by Islamic jurisprudence. It forms the bedrock of trust for clients who rely on the adherence of these institutions to Sharia edicts⁸.

The purpose of Sharia supervision is to verify that the operational practices of the financial institution align with the edicts and principles of Islamic law. The absence of such oversight in mutual banking institutions unequivocally precludes them from being recognized as Islamic financial entities.

2. Non-Integration of Sharia as the Foundational Legislative Framework for Transactions

For banks operating under Islamic principles, it is imperative that their transactions do not contravene Sharia, such as by engaging in conventional interest-based systems. Furthermore, the nature of their relationships with clients should extend beyond mere debt-based interactions.

-2-1- The Dynamics of Interest-Based Financial Transactions

Mutual banking institutions engage in credit operations that incorporate interest charges, akin to the mechanisms observed in savings and loan cooperatives under Algerian law. These cooperatives extend beyond mere loan disbursement; they also engage in borrowing and sourcing funds from capital markets⁹. These markets comprise a network of financial institutions that manage stock exchanges and the supply and demand for capital, operating under the oversight of central banks, finance ministries, or other regulatory authorities¹⁰. Cooperatives access loans facilitated by the Cooperative Federation as per the provisions of Article 52/5 of Law 07-01 regarding savings and loan cooperatives. Additionally, according to Article 49 of the same law, cooperatives are restricted to sourcing funds from capital markets only within the limits of their assessed permanent capital at the time of funding.

Interest transactions are considered a form of *riba* (usury), unequivocally prohibited by the Quran, which states, "Allah has permitted trade and has forbidden *riba* (usury)." This principle underpins several legislative frameworks, including the stipulation in Article 6 of the 2015 Iraqi Islamic Banking Law No. 43, which mandates, "Islamic banks are forbidden from engaging in interest-based transactions, both as recipients and providers." Similarly, Article 53 of the Jordanian Banking Law No. 28 of 2000 asserts that bank operations must not be founded on interest-based principles. Consequently, the prohibition against both receiving and providing usurious interest implies that charging interest on resources acquired from clientele engagements is not permissible.¹¹

Furthermore, the resolution passed by the Islamic Fiqh Academy during its second conference held in Jeddah on December 28, 1985, articulates that "any increment or interest on a debt at its maturity, when the debtor fails to settle it and a

deferment is granted, as well as any increase or interest from the outset of a loan agreement, both constitute forms of *riba*, which are strictly forbidden by Sharia.¹²

Interest-Based Lending: Mutual banks provide advances and loans to their members, including agriculturalists, paralleling the services of craft banks that furnish production-oriented loans to small-scale craftsmen and traders. Additionally, banks and cooperative housing associations offer long-term financing for the acquisition of land, as well as for construction and development projects. Consumer banks alongside savings and loan associations furnish consumer loans to their members, including employees and workers. These institutions may also participate in interest-bearing lending to governments, associations, or agencies.

2-2- Dynamics of Client Relationships within Islamic Banking Frameworks

The relational dynamics between Islamic banks and their clientele, encompassing both investment account holders and users of financial resources, are predicated on a partnership model. This model is fundamentally characterized by mutual risk-bearing and the shared outcomes of profits or losses, contrasting sharply with the creditor-debtor model prevalent in conventional banking systems¹³.

Contributions from members might manifest as shares or simply as subscriptions, such as service fees, or even as pure or cooperative donations, contingent upon each participant's intent. If a participant is conversant with the terms of the cooperative contract, then those terms govern the relationship. Conversely, if a participant is not privy to the contract terms, their intent determines the nature of their contribution, which may be categorized as follows:

- As an outright donation, rendering the shares as non-retractable donations once accepted by the bank. If donations include both the principal and its profits, retraction is not permissible. If the donation is share-based, it is

treated akin to an endowment (waqf), allowing for the allocation of profits to the endowment's fund.

- As a cooperative donation, where the cooperative contract's stipulations apply.
- As a subscription in exchange for services, which thereby establishes a compensatory transaction. This intent, however, is deemed null due to a fundamental misunderstanding that necessitates correction, hence the shares simply yield their returns.¹⁴

The foundational principle in contractual and conditional engagements is permissibility, a doctrine upheld by the majority of Islamic scholars and the four Sunni schools, in contrast to the literalist (Dhahiri) view. Thus, cooperative contracts are inherently presumed valid and permissible, supported by robust Sharia evidence, such as the Hadith of the Ash'aris and the cases of collecting provisions and Nahd "logistical marshaling", unanimously endorsed by the Companions.¹⁵

Initial public offerings (IPOs) represent a critical financing source in mutual banking institutions, alongside deposits and borrowing. The discussion extends to the Sharia perspective on such offerings.

An IPO is an administrative process by which a subscriber joins a company under formation in exchange for a specified number of shares, contributing to its capital. Local and regional specialized cooperative banks primarily depend on this method for raising capital through member subscriptions. This capital serves as the foundational link between the member and the institution, marking the commencement of the venture. The distinctions between subscriptions in mutual institutions and commercial enterprises include:

- Mutual institutions prioritize service benefits over profit post-establishment, contrary to commercial enterprises where profit is the primary objective.
- Subscriptions in mutual institutions are nominal and symbolic to encourage membership affiliation, with some systems restricting shareholders to a single share to prevent dominance by large stakeholders, unlike in commercial entities where subscriptions are typically unrestricted but may be regulated in high-demand scenarios.
- Mutual banking institutions are dedicated to serving members only, potentially extending services to non-members if capacity permits.
- A common thread among subscribers in mutual institutions is the principle of cooperation and mutual support, absent in commercial enterprise subscriptions.¹⁶

Subscriptions in corporate entities are generally permissible, with historical scholarly consensus affirming the legitimacy of partnership contracts, albeit with some differences in detail. Contemporary scholars, including Sheikh Muhammad ibn Ibrahim, Ibn Baz, Abdul Razzaq Afifi, and Ibn Uthaymeen, have endorsed the permissibility of subscribing to joint-stock companies. Contemporary dissenters advocating against such practices are marginalized by consensus, an obsolete stance that contravenes the numerous legal texts advocating the fundamental permissibility of corporate engagements¹⁷.

Jurisprudential views on subscriptions for lending and financing vary: The first perspective deems it a compensatory contract potentially proscribed, as it implies a benefit for the bank through subscriptions that enable access to services, including lending and financing, resembling a benefit-yielding loan for the lender. An alternative interpretation within this perspective allows for its permissibility

due to the mutual benefits involved, which are predominantly in favor of the borrower and minimal for the cooperative bank due to its limited scale, as any balanced benefit is considered permissible. The second view categorizes it as a donation contract, with any compensatory element being incidental, thus inherently permissible. Greater leniency is afforded in donation contracts than in compensatory ones¹⁸.

Conclusion

Islamic banks are anchored in the principles of Islamic theology “Aqidah”, which inform both their foundational and operational ethos. They draw upon Islamic economic principles, integral to comprehensive legislative frameworks, designed to balance individual benefits with societal welfare¹⁹.

This crucial aspect is absent in mutual banking institutions, which, despite their cooperative objectives, engage in usurious practices proscribed under Islamic law due to the lack of a Sharia supervisory body. Such practices fundamentally conflict with the principles of Islamic financial systems. However, this does not imply that these institutions cannot transition to Islamic cooperative banks, provided they adhere strictly to the established protocols for transitioning to Islamic finance.

Islamic and cooperative banks are united by a common ideological framework that positions financing as a community service, fundamentally opposed to individual exploitation. In both types of banks, the returns to depositors are contingent upon the bank's financial performance. While there are notable operational differences between Islamic and cooperative banks, financial institutions that integrate ownership and management in the manner of cooperative banks can operate within Sharia principles under the auspices of

Islamic cooperative banking models, which prioritize cooperation over profit generation²⁰.

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