

Understanding Riba (Draft)

A simplified introduction to the concept of Riba (Usury or Interest) in Islam



Presented by eGold (Pvt.) Ltd. Pakistan

<http://www.egold.pk>

Quranic Ruling

Those who devour usury will not stand except as stand one whom the Evil one by his touch has driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever).

Verse: 2:275, Translation: Yusuf Ali

In this verse, the Quran has expressly forbidden *Riba*, and allowed trade.

Now in order to conform to this Quranic injunction, it is incumbent upon us to first arrive at a commonly agreed upon conceptual understanding of the term *Riba*, and then to apply that conceptual meaning to determine if a certain financial transaction or practice is permissible in Islam or not.



الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقْوَمُونَ إِلَّا كَمَا يَقْوَمُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ
مِنَ النَّعْسِ ذَلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا وَأَحَلَّ اللَّهُ الْبَيْعَ
وَحَرَّمَ الرِّبَا فَمَنْ جَاءَهُ مَوْعِظَةٌ مِّن رَّبِّهِ فَانْتَهَى فَلَهُ مَا سَلَفَ وَأَمْرُهُ
إِلَى اللَّهِ وَمَنْ عَادَ فَأُولَئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا خَالِدُونَ ﴿٢٧٥﴾

Concept of Riba

While the term Riba is mentioned in the Quran, it has not been comprehensively defined. Because of this, there has been some disagreement between scholars on it this subject. While we do not claim to have the last word on the subject, what will try to do is walk our readers through a series of easily understandable situations and concepts, and then guide them to arriving at a common understand of what Riba really means.

We have two sources from which we can derive our understanding of Riba:

1. Characteristics of Riba identifiable directly from the Quran.
2. Characteristics of Riba derived by analyzing those financial practices which have traditionally been considered to involve Riba, and on which there is near universal agreement in all the major schools of thought.

We will start by looking at what we can tell about Riba directly from the Quran. Before doing that, let us first define another concept which the Quran has mentioned in opposition to Riba: *Tijarat*, or Trade.



Characteristics of Trade

A simple, commonly agreeable definition of trade is the “exchange of goods for money, or goods for goods”. In the first case it is a simple purchase, while in the later, it is barter. The term “goods” will be used here to include its wider meaning of encompassing physical items (e.g. apples), non-physical items (e.g. photograph copyrights) as well as services (e.g. haircut). The term “money” will be used to denote anything which a society commonly uses as a medium of exchange (e.g. Rupees, Dollars, and historically, gold and silver coins).

Yet another kind of trade practice is a “forward” trade, where the delivery of goods is deferred to a future date, e.g. the purchase of a custom-tailored suit, or a gift card redeemable in the future.

Trade therefore, constitutes the following category of transactions:

- a) Spot exchange of goods for money
- b) Spot exchange of goods for goods
- c) Forward exchange of goods for money
- d) Forward exchange of goods for goods

Usually, two parties agree to trade with each other when the relative “value” of the exchanged items is different for each of them. E.g. a fruit seller values Rs. 10/- more than a dozen mangoes, and the purchaser values a dozen mangoes more than Rs. 10/-, so they exchange these two between themselves. Therefore, both parties to a trade, from their own point of view, usually consider themselves at an advantage at the conclusion of the trade, because they have gained something they coveted, goods in one case, and money (or the ability to purchase a variety of other goods) in the other.

Trade occurs when goods are exchanged for goods, or goods are exchanged for money, either in a spot a forward transaction, for a mutually agreed fixed price.

Another point we would like to make is that a transaction qualifies as “trade” irrespective of whether it is above or below the market price of the goods being exchanged, as long as the price is fixed, and the participants voluntarily agree to that price.

In summary, a trade transaction is characterized by two basic concepts:

- a) Must involve goods
- b) Price is predetermined and known



Traditional Meaning of Riba

After analyzing Trade, we will look at Riba in its traditional meaning, before differentiating the two as suggested by the Quran.

Our readers would already be familiar with the most common form of Riba, the practice of money lenders giving a loan to a borrower, and then demanding a repayment of the original capital, plus a compound interest “increase” (literal meaning of Riba) on the borrowed capital.

As an example, if A borrows Rs. 100/- from B, and after one month, returns Rs. 120/-, then Riba is supposed to have occurred. Alternatively, A could be required to pay Rs. 20/- as interest every month to B, until such time that the balance of Rs. 100/- is paid off, making the total amount paid back arbitrarily larger than the capital.

In contemporary times, the term “time-value of money” has come to be associated with interest, suggesting that the increase to the original capital is the time-value of the original capital.

Three distinguishing characteristics of this transaction can be spotted immediately.

a) Entirely Monetary. No goods are involved in the entire transaction, as opposed to trade. The exchange consists entirely of “money-for-money”.

b) Time Spread. Deferment (Nasiah) or time spread is involved in the transaction i.e. the entire transaction is spread over a length of time, where the money is borrowed first and returned much later. The deferment aspect of it is similar to a forward sale, where one side of the exchange occurs first and the other later.

c) Excess. The exchange occurs in unequal amounts, with the money returned being in excess of the money paid initially. If the money returned is equal, or less than initially paid, then it qualifies as qarad-e-hasana and does not qualify as Riba.



Riba as opposed to Trade

The Quran provides us invaluable insight on understanding Riba by giving us a simple rule of thumb to define it: Riba is different from Trade, one being permissible and the other not. Now we can take the traditional, universally agreed upon denotation of Riba, and use it to analyze how it differs from trade, and thus derive a definition.

To recap our conclusions in tabular form:

Riba	Trade
Exchange of money for money	Exchange of goods for money or goods for goods
Money received is more than money paid. (The increase can either be a fixed higher value, or a time-appreciating formula based increase, both comprise Riba)	Goods received are equal in value to their price paid, as determined by market forces and circumstances of the trade
Money is paid earlier and received back later (time spread)	Money can be paid earlier and goods received later, or money can be paid and goods received immediately (on spot)

Based on the above, we can now formally state our very first working definition of Riba: Riba occurs when a time spread exchange of money for money takes place with the return in excess of what was paid.

Another important point needs to be made here. In order to bypass the prohibition of usury in their religion (both Christianity and Judaism), the western world has adopted a clever gimmickry of words, by claiming that “usury” is different from “interest”, with the difference between them being a subjectively determined, arbitrary limit on what the society considers “reasonable” and “exorbitant”.

Some Muslim scholars, well-versed in religion, but lacking an adequate understanding of modern finance, have been led to concede to this western claim that interest is an indispensable element of modern economy.

These scholars have attempted to uphold this distinction between usury and interest, and said that Riba only refers to usury. Since there is no basis for such an argument either in the Quran, or historical Muslim jurisprudence, and also because the economic justification offered for it is itself controversial and inconclusive, we reject this claim, and will treat any “increase” of capital as Riba, irrespective of its amount.



Rent as a form of Trade and Riba

Now let us illustrate with an example how certain Trade transactions are permissible even though structurally they appear similar to Riba.

Let us say person A owns a house worth Rs. 1000/- and puts that house for rent at Rs.10/- per month. After one year, this person will own Rs. 1000/- (worth of house) + Rs. 120 rent. This transaction is permissible because it falls under the concept of trade, since exchange of “goods” (usufruct of the house) is involved.

Had this been a loan of Rs. 1000/- repaid in one year as Rs. 1120/- it would have been forbidden, even though the amounts, duration and change in wealth of both parties involved would have been equal.

There is a simple intuitive rationale for this distinction between rent-based fixed return on property vs. Riba based fixed return on money. If the renter “loses” the house to a tornado, he simply ceases to pay the rent and is not liable to “return the house”.

If a borrower of money on the other hand loses the money in his business, he is still liable to return both the capital as well as the interest, in traditional Riba arrangements. The risk of loss inherent in “real world goods and services” present in a trade transaction distinguishes them from a Riba based purely monetary transaction. Irrespective of rent being a kind of guaranteed fixed return, we see that it is permissible, because the so-called “guaranteed” return is in reality dependent on real world circumstances.

Because money-to-money transactions are structured to be immune from such risk, some scholars and people have thus taken a position that Riba can be identified / defined by the presence or absence of “risk”.

However, the presence or absence of risk does not constitute a “defining characteristic” of Riba. There may be real world trades that generate a practically risk-free fixed profit, and there may be interest-based loans that are inherently risky and based on variable rate of interest. We should only judge a transaction as being Riba based or not based on the definition of Riba that we are gradually developing, and not its secondary side-effects.

Riba is characterized not by an absence of risk, or absence of fixed returns, but simply by the absence of goods or services (non-monetary elements) in the transaction.



Deferment and Riba

So far we said that “Riba is the exchange of money-for-money between two parties (a borrower and a lender), spread over time, where the exchange occurs in unequal, and purely in monetary units.”

Now based on the above, we can say with confidence that the following instance represents Riba:

A lends Rs. 100/- to B, and B returns Rs. 120/- after 1 Year.

But now consider the following interesting variations to the above:

A lends Rs. 100/- to B, and B returns Rs. 120/- after 6 Months.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 1 Month.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 1 Week.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 1 Day.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 12 Hours.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 5 Minutes.

A lends Rs. 100/- to B, and B returns Rs. 120/- after 30 seconds.

We are confident that our readers would consider all of the above transactions as Riba too, as the transactions, “in essence” are all the same, differing only “in degree” of the time spread involved.

Our readers would find it surprising that why any sane person would willingly engage in the last transaction, as it equates to nothing but an immediate loss to the borrower. But the point these illustrate is that such transactions, even though never practically undertaken, would still constitute Riba were they to be engaged in. As such, these are forbidden too.

In other words, a “spot” exchange of unequal amounts of money for money is as much Riba, and as much forbidden, as a time spread exchange of it. The concept of “time spread” or “deferment” in our definition of Riba is really redundant. We can thus define Riba as comprising of only two elements of the three that we identified above: exchange of money-for-money and inequality of what is paid and received.

Although this whole argument may seem redundant to a novice reader, fact is that a large subset of modern day Riba transactions are structured in exactly this way e.g. the spot sale and purchase of bonds etc. We will elaborate on this concept of how Riba can exist in “spot” exchanges without involving deferment or time spread.



Riba in Spot Exchanges

Let us assume person L is lending some money to person B, e.g. to pay some bills due before his next salary.

A regular Riba based solution would be that L lends Rs. 100/- to B and then next month, B returns Rs. 120/- to L. This is Riba.

However, there are other ways of cosmetically restructuring this transaction so that it no longer looks like traditional Riba to a casual onlooker. It goes like this.

B takes up a piece of paper, and writes on it that “Holder of this paper is entitled to receive Rs. 120/- from B” and then puts a fancy title over that piece of paper, calling it a “Bond”. Thereafter, instead of obtaining a loan from L, B simply “sells” the bond to L for Rs. 100/- converting this time-deferred loan transaction into a spot sale/purchase transaction.

The above example was purposely kept extremely simplified to illustrate the point. In reality, much more complicated and diverse forms of such “monetary derivatives” exist that are used for such Riba transactions. E.g. if B owns common stock of a company, selling his title to the “next dividend” would also comprise a similar “monetary derivative” whose sale qualifies the same Riba affect as the original loan.

Thus, as we explained above, time deferment is not necessarily a condition of Riba – Riba can exist in spot sale and purchase transactions also. However, such forms of Riba can still be very easily identified by the other two rules that we derived above, something that strengthens a somewhat “universality” of our definition. Let us apply it here.

We had said that Riba occurs whenever, following two conditions are met (the third one of time deferment we had dropped earlier).

a) Exchange consists entirely of “monetary instruments”

b) Amounts involved are unequal.

The basic point is that sale and purchase of “monetary derivatives”, not denoting a specific physical good or “asset”, constitutes Riba.

We can now more fully appreciate how Riba can exist in “spot” transactions also, with the only condition being money-for-money exchange in excess of the original.



Hadith Ratification of Riba in spot transactions

The holy Prophet (sm) explained and exemplified the Quranic principles to people in their true spirit. However, some of his actions portrayed the subtle wisdom of the Quran, which could not easily be related back directly to the Quran by ordinary folks. In good faith, they thus started questioning the “authenticity” of any Hadith that does not hold such a direct implication from the Quran. One victim of such good faith “rationalization” is Riba-al-Fadl.

Traditionally, scholars have referred to Riba Nasia (Riba involved in “deferment” or “loans”) as being the original Quranic concept of it, and Riba Fadl (Riba in spot transactions) as being a later Prophetic addition to the concept. However, as we have just walked our readers towards this concept, there really is no difference between the two. The Quranic judgment of differentiating Riba from regular Trade applies to both equally, and thus both qualify as being Riba. Let us look at the relevant Hadith now.

Narrated Abu Said al-Khudri: Once Bilal brought Barni (i.e. a kind of dates) to the Prophet and the Prophet asked him, "From where have you brought these?" Bilal replied, "I had some inferior type of dates and exchanged two Sas of it for one Sa of Barni dates in order to give it to the Prophet; to eat." Thereupon the Prophet said, "Beware! Beware! This is definitely Riba (usury)! This is definitely Riba (Usury)! Don't do so, but if you want to buy (a superior kind of dates) sell the inferior dates for money and then buy the superior kind of dates with that money."

Sahih Bukhari, Volume 3, Book 38, Number 506

As opposed to the above, the Prophet (sm) allowed the exchange of one camel against another. Scholars have explained that this is because dates were used as a monetary instrument in that time, and thus constituted money. As per our definition, unequal exchange of money-for-money, qualifies as Riba, regardless of it being time spread or spot.

The concept here is that when you exchange two monetary instruments against each other, both instruments, being “money”, represent a very exact and objective price value attached to them. Imbalances in this exchange would universally represent a net disadvantage to one party who is receiving the undervalued monetary unit. Since Quran does not accept time-value of money, such a net loss to one party is exactly similar to the net loss caused by a time-deferred loan to the party repaying the loan in excess. Thus, our argument that the two are exactly similar!



Companions Ratification of Riba in Spot Transactions

Further to the above, we also have examples where the Companions of the Prophet(sm) also upheld the same understanding of Riba.

Al-Muwatta of Imam Malik contains the following incident related to a Companion (Sahabi) of the Prophet (sm).

'Yahya related to me from Malik that he had heard that receipts (sukukun) were given to people in the time of Marwan ibn al-Hakam for the produce of the market of al-Jar. People bought and sold the receipts among themselves before they took delivery of the goods. Zayd ibn Thabit, one of the Companions of the Messenger of Allah, may Allah bless him and grant him peace, went to Marwan ibn Hakam and said, "Marwan! Do you make usury halal?" He said, "I seek refuge with Allah! What is that?" He said, "These receipts which people buy and sell before they take delivery of the goods." Marwan therefore sent guards to follow them and take them from people's hands and return them to their owners.'

The phrase "before they take delivery of goods" above suggests that these receipts did not represent actual goods of specific weight and measure, but merely claims over the hitherto unknown value of these goods prior to their availability in the market, making them yet another example of "monetary derivatives".

Now we do not claim that Islam prohibits the creation, existence and exchange, per se, of such financial instruments (something without which satisfying the complex requirements of modern economic systems would become difficult). The issuance of such "sukuk" is entirely legitimate, but what is prohibited is the development of a secondary market for the sale and purchase of such transactions, where the instruments cannot be traced back to specifically identifiable "assets".

Now we can state a further refined definition of Riba:

"Riba is the exchange of money-for-money, where the exchange occurs entirely in monetary units, either in a single spot transaction, or multiple transactions spread over time, and where the two sides of the transaction are unequal, either because one monetary instrument represents a higher amount than the other, or because the value of one instrument is unknown at the time of the transaction"



Scholars Ratification of Riba in Spot Transactions

Having derived our prohibition of unequal, spot money-for-money transactions from the Quran, and ratified by both the Prophet(sm) and the Companions, we can also see that the same opinion is held by contemporary scholars also. We reproduce below part of the text in a book authored by Muft Taqi Usmani (Chairman, Centre for Islamic Economics, Pakistan)

“One of the most important characteristics of Islamic Financing is that it is asset-backed financing. The conventional / capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only... Islam on the other hand, does not recognize money as a subject-matter of trade, except in some special cases... therefore there is no room for making profit through the exchange of these units inter se... Profit earned through dealing in money (of the same currency) or papers representing them, is interest, hence prohibited.”

An Introduction to Islamic Finance, Page 12

In fact, the prohibition of bai'-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shari'ah ... The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shari'ah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of bai'-al-dain unanimously without a single dissent.

Ibid Page 150-151

This principle of is extremely important and we shall re-iterate it for the facility of our readers: Exchange of money for money in unequal amounts if Riba!

Now, having gained both, the rules, as well as the intuition, behind this prohibition of money-for-money in spot transactions, it is now time to look at what exactly these “monetary units” are, and how to identify if a particular financial instrument is a monetary derivative (whose sale is prohibited) or a commodity, whose sale is allowed.

Since we have tied the concept of Riba with an unequal exchange of money for money, now it becomes paramount for us to first gain an understanding of what money itself is.



Quran and Money

While the Quran has used the term “maal” to denote wealth, the common meaning of it includes goods and physical assets as well as money. In the more strictly sense of a monetary instrument alone, we only find mention of two such “currencies” in the Quran. The “Dinar”, a gold coin in the time of the Prophet (sm), is mentioned in the verse (3:75) and the “Dirham”, a silver coin of the same period, is mentioned in verse (12:20). Additionally, there are numerous other references to gold and silver as representatives of wealth.

Solely based on the fact of this mention in the Quran, we do not claim that gold thus becomes a mandated currency in Islam, but nevertheless, as Muslims, we will digress to express an opinion on the possible wisdom of the Quran in specifically mentioning them, and thus, indirectly, or subtly, indicating a preference for their use as mediums of exchange, and measures of wealth.

The important difference between the usage of gold and silver as currency, as opposed to government issued notes, is that while new notes can be printed by the governments at will, new “gold” cannot be artificially created. With gold as a currency, governments lose the ability to issue more money: Only the existing gold assets of the world represent the available supply of money. With fiat paper money, governments can inflate the money supply at will, whenever they want to e.g. to spend on a war or public project, whose cost is higher than the available financial resources of the government.

One effect of inflating money supply in such a way is to cause inflation in the society: According to a well known economic principle, the quantity theory of money, more money chasing the same amount of goods and services causes the price of such goods and services to increase. This is the root cause of inflation.

In a society where prices of goods continue to increase over time, as a result of inflation, it becomes impossible for a single unit of money to maintain its “purchasing power” or “value”.

A natural effect of this “devaluation” in money is the implicit assignment of a “time value” function to it. E.g. Rs. 100/- in 2009 can only purchase what Rs. 120/- will purchase in 2010. A lender giving you Rs. 100/- now, and required under the prohibition of Riba to be returned only Rs. 100/- three years from now, would definitely stand at a net loss. This is why western economists continue to deny that an interest-free economy is even possible. In the context of an inflationary economy, they have a point! Any attempt to maintain, rationalize, or implement the Riba prohibition in an inflationary society is logically bound to failure.

The existence of inflation thus forces “Islamic financiers” to a clever gimmickry of words and engineering of complex financial arrangements to maintain the time-value effect of money, but only dress it up in a guise of shariah-compliance. The real culprit, however, underneath the existence of Riba in societies, is the continued use of “fiat” currencies that cause inflation in the first place. Let us see how Shariah views fiat currency.



Fiat Currency Money

Fiat currency is any currency that a government declares to be “legal tender” and officially acceptable for settlement of debts. In Pakistan, this is the Pakistani Rupee. Rupees can only be issued by the Government of Pakistan. State Bank cannot issue Rupees: It only issues Bank Notes. This will be elaborate later.

Let us say that being of a worldly, or secular domain, Shariah does not question or prohibit an Islamic government from issuing such fiat currency. The Shariah prohibition is limited only to Riba, so we must ensure that Riba does not exist in this “secular” government function.

Let us first understand the role of the State Bank here. Modern government theory suggests separation of monetary policy regulation from executive and legislative functions of the government, so State Bank exists as a semi-autonomous body responsible for controlling the money supply. But if only the government can issue currency, how does the State Bank control the money supply? Let us understand this.

The role of state bank is to issue “Bank Notes”. These are different from government issued currency in that instead of being actual currency, they are only promissory notes (a promise to pay currency). This is obvious from the Urdu text written on every Bank note e.g. “bank daulat Pakistan hamil-e-haza koe 10 rupiah mutalaba par ada karay ga”.

According to “State Bank of Pakistan Act, 1956”, the Bank has the authority to issue these promissory notes, in only as much quantity, as it has actual reserves. According to section 30 of the Act, a portion of these reserves must be in the form of Gold and Silver, while the rest can be government issued Rupee Coins, or, - most importantly for our purposes – bills of exchange and promissory notes against loans and advances.

And here in lies the rub: These additional instruments, against which State Bank issues its notes, are actually “interest-bearing debt instruments”. E.g. the one form of money creation is when the government issues “treasury bills” to the State Bank, and state bank, in return, issues Bank Notes against the Treasury Bills, or T-Bills, in its reserve. A T-Bill really is a promise issued by the treasury department of the government, that it will pay the holder of that T-bill a certain sum of money (e.g. Rs. 100/- on a future date e.g. 6 months from date of issuance). As such, these T-bills are said to have a maturity of 6 months. However, while they will pay to the bearer Rs. 100 after 6 months, at the time of issuance, T-bills are sold to the State Bank at a discount rate e.g. Rs. 95/-. In other words, the T-bill instrument earns an interest of Rs. 5 over 6 months, which is blatant and explicit Riba. The very issuance of a T-Bill qualifies as Riba, and the exchange of a T-Bill (monetary instrument) against a Bank Note (another monetary instrument) is again Riba.

In short, the Bank Notes circulating as currency (Rs. 1000/- note, Rs. 500/- note) are actually “monetary units issued against other interest bearing monetary instruments” and as per our earlier discussion, qualify squarely as falling under Riba, unless the State Bank clearly distinguishes between those notes which are issued against physical reserves, and not against debt based instruments.

As such, any dealing with paper currency, from the purest standards of Islamic Shariah, is itself prohibited.

This is why we believe that the only sound way of eradicating Riba from modern economy is to return to using Gold and Silver as currencies. Even if paper notes and plastic cards continue to be used as convenient front ends for exchange, they must always be 100% backed by physical assets, and not interest-bearing debt instruments.