

Riba, Interest, and Usury

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It is a common practice in the modern economy to borrow money on interest to buy big ticket items or for a new venture, or. Even big corporations borrow money for their projects and for their expansion. Most of the feasibility study for any venture or project is measured against interest rate. The venture or the project is considered feasible if its rate of return is significantly higher than the prevailing interest rate. Even Shariah compliant financial institutions use the prevailing interest as the yardstick to determine their profit payment to investors.¹ Most of the people who work on wages cannot buy big ticket items (a house or a car) on cash. Since the price of house mostly goes up, waiting to save enough money to buy a house almost becomes an unachievable dream. Borrowing money is the most convenient form for financing big ticket items. The fact is interest is the bread and butter of the modern economy.

Traditional scholars consider any excess charge on the capital as unacceptable. They make no distinction between reasonable (interest) and exorbitant (usury) rates of interest.²

Interest:

Interest is the extra amount a borrower pays for the use of money (principal) they borrow from a lender and the return a lender receives for deferring the use of funds, by lending it to the borrower. It is based on an interest rate that is normally expressed as a percentage rate over the period of one year.

Interest rate is basically the time value of money which takes into account the following³:

- The risk-free cost of capital: depending upon how the economy is performing, there is an expectation that the investment should on average yield certain return. It also depends upon the money supply in the economy. Higher the money supply, lower the cost of capital and vice versa.
- Inflationary expectations: Most of the economies are inflationary in nature. Investors make sure that their buying power remains intact.
- The level of risk in the investment: There is a risk associated with every investment, higher the risk, higher the probability of defaulting. This is compensated by charging higher interest rate for high risk investment. This is to insure that the investor, on average, will get the return he expects with an investment with an average risk.
- The costs of the transaction: This covers the overhead needed to run the financial institutions.

Thus if an economy is generating on average five percent return, inflation is expected to be two percent, and the cost of operating the financial institution is one percent. The interest rate, excluding the risk factor, should be eight percent.

Even in the past, the time value of money has been recognized. Currencies that were based on guarantees by a government to honor the stated value (i.e. fiat currency) or based on other materials such as paper or base metals were allowed to have interest applied to them.⁴

In the past two centuries, interest rates have been variously set either by national governments or central banks. For example, the Federal Reserve federal funds rate in the United States has varied between about 0.25% to 19% from 1954 to 2008, while the Bank of England base rate varied between 0.5% and 15% from 1989 to 2009.⁵

Murabahah (Mark-up):

Time value of money has been recognized by Islamic scholars and is the backbone of Islamic financing. Most of the Islamic banks use *Murabahah*, usually called cost plus, as their instrument for lending.⁶ When a client (borrower) wants to own a tangible asset e.g. a machinery or a house, the bank buys the asset and then instantaneously sells the client (borrower/buyer) at a mark-up price to be paid (in installment) over a certain period. In many cases it is the buyer who identifies the property and negotiates the price. Only then does the bank enter into the picture, pays the price and adds the mark up to convert it into *Murabahah*. For example, if I wanted to buy a car that is priced at \$15,000, but cannot afford it. I can go to the bank. They will buy it for \$15,000 and then instantly sell it to me for \$20,000 to be paid over five years.

The concept *Murabahah* is still evolving. *Murabahah* was originally developed for a transaction in which a buyer purchased items from a trader at a specified profit margin. In this type of transaction, the traders acted on behalf of another party in buying goods and *Murabahah* (mark-up) may be seen as a payment for the trader's service in locating, transporting, and delivering the goods.

Islamic banks are using this concept for a transaction in which a bank or financier buys an item and simultaneously sells it at a profit to a customer. To some commentators, this type of transaction 'is a controversial technique since it can easily be used as a means of circumventing the prohibition on *riba*. Here the objective is to rent money, not to trade goods, and as with most modern Islamic finance transactions the objective is achieved by means of a combination of otherwise halal contracts'⁷: buying the property and selling the property with some profit. 'Although both transactions are permissible under Shari`ah when viewed separately, when combined, they produce the equivalent of an interest-bearing loan from a bank's perspective.'⁸ Compared to the original concept where traders located, transported, and delivered the goods, the banker is just sitting on a heap of money. The buyer is the one who is locating the item and negotiating the price. The banker only steps in to write the check. He is making money on money under the guise of a property. The only difference being, *Murabahah* has been blessed by respected scholars, interest is not.⁹

Murabahah has the following characteristics¹⁰:

- Both parties agree upon a profit margin.
- The purchase and selling price, other costs, and the profit margin are clearly stated at the time of the sale agreement.

- The bank is compensated for the time value of its money in the form of the profit margin.
- This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin.
- The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled.

Murabahah, except for circumventing the Islamic injunction that money cannot be simply traded for money, is not much different from interest rate (especially fixed interest rate). In interest based transactions:

- Both parties agree upon the interest rate (a profit margin).
- The principal (purchase price), the total payment (selling price that includes the profit margin and other costs) are clearly stated at the time of the agreement.
- The bank is compensated for the time value of its money in the form of interest rate (the profit margin).
- This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed interest rate (rate of profit determined by the profit margin).

The only difference is that in *Murabahah*, the bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments). Usmani¹¹ goes in detail about what do in case of default. He proposes all kinds of penalties and punishments. He fails to realize that the defaulter may not be able to pay for a genuine reason for example, loss of a job. Financial institutions are in the business of making profit, not to dole out punishment or run a charity. They will have to recover their investment to survive. Since *Murabahah* system of financing is still evolving, in case of a default, ultimately they will either opt for a foreclosure or will renegotiate a new mark-up price. Either option will be not much different from what regular banks do. Thus, except for circumventing the Islamic injunction that money cannot be simply traded for money, *Murabahah* is not much different from interest based transaction. The difference between the interest based financing and *Murabahah* is only on paper, the real test is when the borrower defaults and that is where Shariah based financing will show its true color. The Quranic term for circumventing is '*heelah*.' following the letter of the law, but not the spirit. *Murabahah* system of financing follows the letter, but not the spirit as per defined by the traditional scholars.

***Musharakah* (Declining Balance Co-ownership / Rent-to-Own):**

In *Musharakah* financing, also known as Declining Balance Co-ownership and Rent to Own, the investor and the buyer of the property co-own the property and share the profit according to their share in the property. The buyer makes monthly payment to the investor. A part of the payment goes towards the rent the buyer owes to the investor based on the investor's share in the property and the rest goes towards increasing the ownership in the property. When the buyer's share reaches one hundred percent, the buyer becomes the owner of the property.

This method of financing is good as long as the price of the property does not increase faster than the interest rate. In interest based financing the borrower is counting on the fact that the price of the property will rise faster than the interest rate and the borrower will be able to build equity in the property, which normally happens. *Musharakh* financing will become a Catch 22, if the price of the property increases faster than the interest rate, which normally happens, since the rent has to go up to keep up with the price. If the payment is fixed, more of the buyer's payment will go towards the rent than towards the ownership of the property. For example, let us say that the owner's monthly payment is \$1500, \$1000 of which is rent and \$500 goes towards the ownership of the property. Let us assume that with this schedule, the buyer will own the property in 15 years. If the price of the property goes up by 20%, the rent will also go up by the same percentage rate. The rent will thus increase to \$1200. The buyer is now only paying \$300 towards the ownership of the property. Assuming other things do not change, it will take buyer 25 years to own the property. This is a simplistic calculation, actual calculation is little complicated.

As mentioned earlier, the difference between interest-based financing and Shariah compliant financing is only a paper shuffle. The real test comes in case of default. According to the prospectus of one of the *Musharakah* based investor (Guidance), in case of foreclosure, the investor (co-owner) "recovers the funds that it would have obtained, had the customer fully bought out its share of the property as well as other amounts that may be due. After the co-owner (investor) has been compensated, any surplus from the sales proceeds would be given to the customer."¹² Let us assume that the price of the property was \$100,000, the investor's share was 60 percent (\$60,000) and the buyer's share was 40 percent (40,000). In case of a foreclosure, if the property was sold for \$80,000, the investor will keep \$60,000 and give the buyer only \$20,000. The proceeds from the sale in true *Musharakah* should have been divided based on percent ownership i.e. the investor should have received only \$48,000 and the buyer should have received \$32,000. Just like mortgage lender, the *Musharakah* based investor is only interested in recovering its share. Only the leftover is given to the borrower/buyer. Here again Shariah based financing show its true color when the borrower defaults.

Financing Non-Material Items:

Not only is *Murabahah* or *Musharakah* a slippery slope, it is not a cure-all for all the financial needs. There are situations when money is needed not to buy things but for other purposes, for example student loan, paying bills, home improvement, and etc. I can borrow money on interest and take care of these issues. How would *Murabahah* or *Musharakah* deal with it?

One of the intent of *Shariah* is to ease the hardship.¹³ Would the hardship be eased by not allowing the student to take loan for higher education and let him have a low paying job for the rest of the life or by allowing him to take loan, get good education to lead a comfortable life? What if I need an extra room to ease my family's living accommodation? Would the hardship be eased by adding an extra room by borrowing money if I can afford it or by living miserably?

Quranic Injunctions:

The following are the Quranic injunctions about interest:

O ye who believe! Devour not usury doubled and multiplied; but fear Allah; that ye may (really) prosper. (3:130)

Those who (in charity) spend of their goods by night and by day in secret and in public have their reward with their Lord: on them shall be no fear nor shall they grieve. (2:274)

Those who devour usury (*riba*) will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: "Trade (*Bai'*) 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 (forever). (2:275)

Allah will deprive usury (*riba*) of all blessing but will give increase for deeds of charity (*sadaqa*): for He loves not creatures ungrateful and wicked. (2:276)

Those who believe and do deeds of righteousness and establish regular prayers and regular charity will have their reward with their Lord: on them shall be no fear nor shall they grieve. (2:277)

O ye who believe! fear Allah and give up what remains of your demand for usury if ye are indeed believers. (2:278)

If ye do it not take notice of war from Allah and his Apostle: but if ye turn back ye shall have your capital sums; deal not unjustly and ye shall not be dealt with unjustly. (2:279)

If the debtor is in a difficulty grant him time till it is easy for him to repay. But if ye remit it by way of charity that is best for you if ye only knew. (2:280)

And fear the day when ye shall be brought back to Allah. Then shall every soul be paid what it earned and none shall be dealt with unjustly. (2:281)

That which ye lay out for increase (*riba*) through the property of (other) people will have no increase with Allah: but that which ye lay out for charity seeking the Countenance of Allah (will increase): it is these who will get a recompense multiplied. (30:39)

For the iniquity of the Jews We made unlawful for them certain (foods) good and wholesome which had been lawful for them; in that they hindered many from Allah's way. (4:160)

That they took usury (*riba*), though they were forbidden; and that they devoured men's substance wrongfully; We have prepared for those among them who reject faith a grievous punishment. (4:161)

The Quran has used the term '*riba*,' which has been translated as interest or usury. Literally it means to increase, to grow, to grow up, to exceed.¹⁴

The Quranic verses suggest the following:

- *Riba* stands opposed to charity (2:276, 30:39)
- Charging double and multiple in '*riba*' will promote poverty (3:130)
- AllahST has permitted trade and forbidden '*riba*' (2:275).

Financially speaking a society can be divided into three categories:

- The poor and the needy, who cannot meet their basic needs.
- The middle class, who earn their living and can meet their basic needs, but need to borrow money to buy big ticket items.
- The wealthy.

Considering that *riba* stands opposed to charity (2:276, 30:39), the main intent of the commandment was to eliminate exploitation of the poor and the needy. When a rich person gives charity to a needy, the money flows from the rich to the needy without the needy compensating the wealthy in terms of material or services. When a rich person charges *riba* from a needy person, the needy is expected to return not only the principal, but an additional amount. Thus net flow of money is from the needy to the rich without the rich compensating the needy in terms of material or services.

The Meccan society was an unjust society, where the wealthy oppressed the poor by charging exorbitant interest. It is in this context the Quran has:

- Urged the believers to help the needy and the poor through *zakah* (required charity)¹⁵ and *sadqah* (optional charity).¹⁶
- Only demand from the poor to return the principal
- If they cannot return the principal, allow them ease in payment; still better leave with them the principal as charity.
- Oppressing the poor and the needy amounts to waging war against AllahST and the Prophet^{SAW}.

In situations where the wealth of one party (wealthy) is used to create the wealth (house, car, and etc.) for another party (middle class) who has regular earning and is not qualified to accept Zakah, the lender must be compensated for the lost opportunity. Interest rate is a reflection of that lost opportunity. It takes into account the average profit the lender could have made, the inflation, and the transaction expenses. Time value of money or lost opportunity has been recognized by Islamic scholars causing them to modify and promote the concept of *Murabahah*.

Even in this situation, charging two hundred percent or higher in interest is forbidden. The economy on average does not generate two hundred percent in profit. The normal profit is about ten percent or less. When a trader sells an item to a buyer, the seller has located the item, invested his money in the item, and transported the item to bring it to consumer. The seller is therefore charging the customer for not only the price he has paid for the item, but also for his effort and for tying up his money, aka lost opportunity, in the item. Charging interest in excess of what trade on average will yield is exploitive and is therefore forbidden. It will result in inflation and hence poverty. What is condemnable in this situation is the exploitive interest, which is commonly known as usury.¹⁷

Conclusion:

The analysis suggests the following:

- The poor and needy should not be charged interest to meet their basic needs. Instead the institution of Zakah should be strengthened to help them.
- The interest rate which reflects the time value of money and the average profit an economy can generate should be acceptable.
- In situations where the wealth of one (rich) is used to create the wealth for others (middle class), interest based financing should be acceptable. Even then charging exorbitant interest rate, also known as usury, is condemnable and is prohibited.

About the Writer:

The writer has authored “Secrets of Angels, Demons, Satan, and Jinns – Decoding their Nature through Quran and Science,” and “Atom to Adam – How, When and Where in the Light of Quran, Bible and Science (A Study of Human Origin),” both published by InstantPublishers.com (<http://instantpublisher.com/>) and “Lessons from the Qur’an,” published by Ta-Ha Publishers (<http://www.taha.co.uk/>). These books are available from Amazon.com (<http://www.amazon.com/>) and Ta-Ha Publishers (<http://www.taha.co.uk/>), respectively. He has also published many essays on religious issues in the Charleston Gazette, West Virginia and written quite a few Islamic satires. He is a Chemical Engineer and possesses Bachelor and Master of Science degrees in Chemical Engineering and has Professional Engineers license from the State of Texas. His e-mail address is mnajawaid@yahoo.com. His website address is mahmodjawaid.com.

Reference:

¹ <http://www.guidanceresidential.com/learning-center/white-papers>, “The Declining Balance Co-ownership Program.” P.4, Item No. 2.

“The Declining Balance Co-ownership Program has been designed to provide a Sharia-compliant alternative to conventional mortgage lending. Despite the distinct nature of this program, customers will naturally insist that their monthly payments be competitive with what they would have to pay in the conventional market. For this reason, Guidance determines the Profit Payment offered to its customers to be competitive with prevailing interest rates. -----

Profit Payments may even be adjustable and linked to an interest rate index (subject to certain caps).”

² Ali, A. Y., “The Meaning of the Holy Quran,” Amana Corporation, Maryland, Explanatory Note No. 326.

³ http://en.wikipedia.org/wiki/Interest_rate

⁴ http://en.wikipedia.org/wiki/Islamic_banking

⁵ http://en.wikipedia.org/wiki/Interest_rate
 moneyextra.com [Interest Rate History](#). Retrieved 2008-10-27
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⁶ www.intracen.org/publications/Free.../Islamic_Banking.pdf
 “Islamic Banking – A Guide for Small and Medium-Sized Enterprise,” International Trade Center.
www.accountancy.com.pk/docs/islam_murabahah.pdf (*Murabahah by Maulana Taqi Usmani*)
http://www.islamic-finance.com/item_murabaha_f.htm

⁷ http://www.islamic-finance.com/item_murabaha_f.htm

⁸ http://www.islamic-finance.com/item_murabaha_f.htm

⁹ See past reference on Murahabah.

¹⁰http://en.wikipedia.org/wiki/Islamic_banking

¹¹www.accountancy.com.pk/docs/islam_murabahah.pdf (Murabahah by Maulana Taqi Usmani), pp. 19-23.

¹² <http://www.guidanceresidential.com/learning-center/white-papers>, "The Declining Balance Co-ownership Program," p. 5, Item No. 5.

¹³ Alwani, T. J. "The Ethics of Disagreement in Islam," The International Institute of Islamic Thought, Herndon, Virginia, 2000, p. 64.

El Fadl, K. M. A, "Conference of the Books," University Press of America, New York, 2001, pp. 295-297.

¹⁴ Wehr, Hans, Arabic-English Dictionary, 1976, p. 324.

¹⁵ Al-Qaradawi, Yusuf, "Fiqh az-Zakat – A Comparative Study," Dar Al Taqwa Ltd, 1999, p. 345.

¹⁶ Piety does not lie in turning your face to East or West; Piety lies in believing in Allah, and the Last Day, and the Angels, and the Book, and the Messengers; and disbursing your wealth out of love for Allah, among your kin, and the orphans, the needy, the wayfarers, and the beggars, freeing the slaves; observing your devotional obligations (*salah*), and practicing regular charity (*zakah*), fulfilling a pledge you have given, and being patient in hardship, adversity, and times of peril. These are the people who affirm the truth, and they are those who follow the straight path. (2:177)

The parable of those who spend their wealth in the way of Allah is that of a grain of corn: it grows seven ears, and each ear has a hundred grains. Allah gives manifold increase to who He pleases and Allah cares for all and He knows all things. (2:261)

Those who spend their wealth in the cause of Allah, and follow not up their gifts with reminders of generosity or with injury, for them their reward is with their Lord, on them shall be no fear, nor shall they grieve. Kind words and covering of faults are better than charity followed by injury. Allah is free of all wants, and He is most Forbearing.

O you who believe! Cancel not your charity by reminders of your generosity or by injury like those who spend their wealth to be seen of men, but believe neither in Allah nor in the Last Day. They are in parable like a hard barren rock, on which is a little soil, on it falls heavy rain, which leaves it (just) a bare stone. They shall be able to do nothing with what they have earned. Allah does not guide those who reject faith. (2:262-264)

And the parable of those who spend their wealth to seek the pleasure of Allah and to strengthen their souls, is that of a garden, high and fertile. When heavy rain falls, it brings forth its fruit twofold and if it does not heavy rain, then light moisture suffices it. Allah sees well whatever you do. (2:265)

O you who believe! Give of the good things which you have (honorably) earned, and of the fruits of the earth which We have produced for you, and do not even aim at getting anything which is bad, in order that out of it you may give away something, when you yourselves would not receive it except with closed eyes. And know that Allah is free of all wants, and worthy of all praise. (2:267)

And whatever you spend in charity or devotion, be sure Allah knows it all. But the wrongdoers have no helpers. If you disclose (acts of charity), even so it is well. But if you conceal them, and make them reach those (really) in need, that is best for you. It will remove from you some of your (stains of) evil. And Allah is well acquainted with what you do. (2:270-271)

(Charity) is for those in need, who, in Allah's cause are restricted (from travel), and cannot move about in the land, seeking (for trade or work). The ignorant man thinks, because of their modesty, that they are free from

want. You shall know them by their (unfailing) mark. They beg not importunately from all and sundry, and whatever of good you give, be assured that Allah knows it well. (2:273)

Those who (in charity) spend of their goods by night and by day, in secret and in public, have their reward with their Lord. On them shall be no fear, nor shall they grieve. (2:274)

Alms are for the poor and the needy, and those employed to administer the (funds); for those whose hearts have been (recently) reconciled (to the Truth); for those in bondage and in debt; in the cause of Allah; for the wayfarer. Thus it is ordained by Allah. And Allah has full knowledge and wisdom. (9:60)

¹⁷ Usury originally was the charging of interest on loans. Today, usury refers to the charging of unreasonable or relatively high rates of interest. The term is largely derived from Christian religious principles; *Riba* (double and multiple interest) is the corresponding Arabic term and *ribbit* is the Hebrew word.¹⁷ Whereas interest rate is determined by market forces, usury is not. Usury is exploitive and falls under the category of double and multiple *riba* (The Quran 3:130).