

Understanding *Riba* in Islamic Finance

AZZAD ASSET MANAGEMENT WHITE PAPER SERIES

SUMMARY

Riba is one of the most often misunderstood terms in Islamic finance. More education on this fundamental concept is not only necessary for the preservation of a halal livelihood; it is also important for the preservation of the proper practice of Islam. *Riba* is prohibited by the Qur'an, *Sunnah* (Prophetic example), and consensus of the scholarly community. It is mentioned in a number of Qur'anic verses and is contrasted with acts of charity. (*Zakah* is in fact the opposite of *riba*.) There is even a narration from the Prophet Muhammad (peace be upon him) that calls deceit in the marketplace a type of *riba*. In juristic writings, *riba* is seen as a means of devouring the wealth of others. The process of money creation in a fractional reserve banking system is *riba*-based and can lead to the devouring of wealth through inflation. And, of course, an interest-based loan (both simple and compound), where a lender charges a borrower for the privilege of using money, is one of the major transactions dealing in *riba*, according to our scholars.

RIBA EXPLAINED

What do we really mean when we use the Arabic term *riba*? The literal translation of the word is "increase, addition or growth," though it is often translated as "usury." English speakers typically understand usury as the charging of an exploitative interest rate. But *riba* refers to any excess value in transactions that Islamic Sacred Law has prohibited. The prohibition of those transactions is determined with the aid of interpretation of the Qur'an and *Sunnah* by qualified scholars of *fiqh al-muamalat* (jurisprudence of transactions).

Several methodologies exist in traditional and modern literature for understanding *riba* and its many types. However, two common elements of *riba* that are identified by almost all Muslim scholars and that all Shariah-sensitive investors should know are *riba al-fadl* and *riba al-nasee'ah*.

The latter term, *riba al-nasee'ah*, is commonly referred to as compound interest. Also known as Qur'anic interest, it is considered the most harmful and unethical of all forms of *riba*. Simply put, *riba al-nasee'ah* is an increase in the amount of a commodity due to the mere passage of time.

This is the category in which interest-based loans fall. Conventional mortgages, car loans and student loans are all examples of *riba al-nasee'ah*. *Riba al-nasee'ah* is so odious that the other types of *riba* are prohibited simply because of the possibility that they may lead to *riba al-nasee'ah*. This includes *riba al-fadl*, which is the type of *riba* prohibited in the narrations of the Prophet Muhammad (peace be upon him).

Riba al-fadl involves an immediate exchange of unequal quantities of the same commodity (e.g., gold, silver, wheat, barley, etc.), and could therefore be described as the *riba* of surplus, as opposed to *riba al-nasee'ah*, which involves the passage of time.



Invest with faith

Omar ibn al-Khattab (may God be pleased with him) prohibited buyers and sellers from entering the marketplace without first knowing the rules of riba. He did this out of a profound sense of responsibility toward the most vulnerable in society.

Some have said that Jesus Christ (peace be upon him) evicted the money changers from the Temple in Jerusalem for engaging in *riba al-fadl*. Jewish pilgrims arriving in Jerusalem were required to pay the Temple tax but preferred to use a half shekel coin since it was the only silver coin that did not feature the image of a pagan Roman emperor. The money changers in the Temple made a business of receiving silver coins of greater value and giving silver half shekels in return. The exchange was simultaneous, but money changers took more silver from the pilgrims than they gave—the definition of *riba al-fadl*.

WHY IT MATTERS

It is essential for a Shariah-sensitive individual to learn these forms of *riba* and to understand their impact. The next step is to then apply the rules regarding *riba* in one's daily transactions. This is an essential part of the proper practice of Islam and of doing right by others in society. Omar ibn al-Khattab (may God be pleased with him) prohibited buyers and sellers from entering the marketplace without first knowing the rules of *riba*. He did this out of a profound sense of responsibility toward those who were most vulnerable—people who could be exploited without knowing it. And he also knew that

avoiding *riba* was fundamental to the implementation of God's command to stand up for economic justice.

DO THE RULES OF *RIBA* APPLY TODAY?

Islamic guidance pertaining to *riba* is as important today as it has ever been.

Not only did our classical jurists warn against doing business before learning the rules of *riba*; qualified, credentialed scholars like the members of the Accounting and Auditing Organization for Islamic Financial Institutions, or AAOIFI, say the same today. Of course, even though the rules are timeless, there are certainly modern circumstances that must be taken into consideration as one applies the rules regarding *riba* to daily transactions. Groups like AAOIFI help Shariah-conscious investors to do that, and that is why Azzad Asset Management abides by AAOIFI guidelines when evaluating securities for investment.

Finally, for those who want to invest according to Islamic guidance but have amassed debts, it is important to pay back the outstanding amount as soon as possible. This is essential from both a spiritual and financial point of view. And it is important to remember that the one who gives *riba* out of an obligation to repay past debts is less sinful than the one who takes *riba*. Both, however, are problematic from an Islamic ethical perspective. So, if you are in debt, remove the potential harm that stems from dealing in *riba* by repaying immediately, and then resolve to never return to it again. If you are a creditor, refrain from charging interest altogether. As the Holy Qur'an says:

"... Oh ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from riba, if ye are (in truth) believers." (2:278)

Keep your trade *halal* and avoid *riba* in all of your transactions. It's the right thing to do.

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