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Riba and interest in Islamic finance: semantic and terminological issue

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Abstract

Purpose – The aim of this paper is to argue analytically that interest and *riba* are not exactly the same and not an interchangeable terminology. There are similarities and differences between the two at the conceptual level.

Design/methodology/approach – To support the argument, the paper shows that it is possible to prove cases where the *riba* is involved but the interest is not. Hence, there is a situation of the presence of *riba* without interest. Furthermore, it is also possible to prove cases where the interest is involved but the *riba* is not. Hence, there is a situation of the presence of interest without *riba*. The notion and concept of interest in finance are analysed critically in comparison with *riba* in Islamic jurisprudence (fiqh Islami). So a comparative conceptual analysis is the main methodology of the paper.

Findings – The paper finally suggests that the correct expression should be that Islamic banking and finance is "a ribawi free of banking and finance" instead of "interest free of banking and finance" as it is popularised.

Research limitations/implications – The paper is conceptual in nature. No empirical analysis is pursued.

Practical implications – Islamic finance should not claim it self as interest-free finance, rather *riba*-free finance.

Social implications – It is more truthful to the society to say that Islamic finance is *riba*-free finance.

Originality/value – The paper is expected to contribute in the conceptual level of Islamic banking and finance's understanding by clearing up the basic confusion and misconception about *riba* and interest. This would consequently minimise or even eliminate the taken-for-granted tendency of denoting the semantic of *riba* and interest as an interchangeable term, especially when writing in English and addressing the finance's students and scholars. The semantic clarification between interest and riba hopefully becomes the main contribution of this paper.

Keywords Interest-free banking, Future value, Interest-riba, Islamic jurisprudende, Present value, Time value of money

Paper type Viewpoint

1. Introduction

The terms interest and *riba* are normally considered interchengeable. It is quite common to notice this tendency even within the scholarly writings. Institute of Islamic Banking and Insurance (1995), for example, includes articles with the titles such as "Islamic Interest-Free Banking", "Developing an Interest-Free Economy", and "Conversion of Interest-Based Banking to Islamic Interest Free Banking". The aim of this paper is, therefore, to critically caution that the terms interest and *riba* are not really interchangeable. In fact, the two terms

I am thankful to Prof. Monzer Kahf who commented on this issue when the paper was presented in 2015 in Sakarya University, Turkey.

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come from two different disciplines and languages. They have similarities, but they have also differences. This paper looks not only into similarities, but more importantly, their differences. Ultimately, the purpose of the paper is to advise Islamic banks and Islamic financial institutions not to attribute their character as "interest-free" institutions. For this term would confuse finance students and their disciplines, especially when they communicate in English. As "interest" is an English term and "*riba*" is Arabic, fusing the two is confusing, especially when Islamic financial institutions claim to practice "interest-free" finance in their operations.

Part of the confusion comes from the English Law itself which distinguishes between "interest" and "usury" on the basis of subjective thinking. It says:

> When money is lent on a contract to receive not only the principal sum again, but also an increase by way of compensation for the use, the increase is called *interest* by those who *think* it lawful, and *usury* by those who do not (Blackstone, 1769).

To make it more specific, every western country has its own law on usury depending on the rate of interest. If it is more than the maximum rate, then it is a usury and hence illegal. Otherwise, it is just an interest and consequently legal.

From the Islamic legal point of view, the term "*riba*", like usury, is always associated with its unlawfulness. In other words, it is unlawful to deal with "*riba*" for Islamic banking. However, there is a tendency to equate *riba* and interest in the thinking of Islamic banking and finance. This is perhaps because of the influence of the above subjective definition of usury and interest in the English Law. Because from the Islamic legal point of view, the usury and interest are claimed not be different, consequently there is no difference between *riba* and interest. To claim lawfulness, the Islamic bank, therefore, must be characterised with "interest-free" bank. This claim can be justified from the legal point of view, but not from the economics and finance point of view.

When Islamic banks claims to be "interest-free" banks, the intended impression is that all kinds of interest are unlawful and prohibited. This impression is infact misleading from the discipline of finance. Perhaps the first essay to question this impression is the article entitled "Are all forms of interest prohibited?" by al-Masri (2004). He argued in this article that not all forms of interest are unlawful. Although the purpose of his article is to separate between the concept of interest and profit, suggesting that Islamic bank should be honest in calling its *Murabahah*'s mark-up as interest rather than profit, his article is beneficial in supporting the argument that interest and *riba* are not always the same. The conclusion of the article is that not all forms of interests are prohibited, unlike *riba*.

A more critical comment comes from El-Gamal (2006) with his sub-title question "Finance without interest?" right in the introductory chapter of his book. To him, a statement such as "Islam (or the Qur'an) forbids interest" is grossly simplistic and a false reductionism. His evaluation is in line with the essence of the present paper that the term "interest-free" finance is confusing and hence the "uninitiated reader [is] more perplexed about the 'interest-free' characterization" (pp. 2-3) of Islamic finance. So this "call a spade a spade" argument might clarify the confusion.

2. Conceptual and semantic analysis of interest and *riba*

Interest is an English word while *riba* is Arabic. The former comes from the discipline of economics and finance whereas the latter from the Islamic jurisprudence (*al-fiqh al-islami*). When the English word "interest" is translated into Arabic, it is normally rendered as "*al-fa'idah*" while when the Arabic word "*riba*" is translated into English, it usually renders as "usury". Abdulla Yusuf Ali, the well-known tranlator of the Qur'an into English, for example, uses consistently the term "usury" for all the words "*riba*" in the Qur'an. He does not use the term "interest' for "*riba*" in his translation. Among the scholars and practitioners, Hamoud (1985) and Vogel and Hayes (1998) are very careful in using the words usury and interest, respectively. All this evidence has shown the distinction between the concept of *riba* and that of interest.

Although conceptually the terms "*riba*" and "interest" have more things in common than in difference, to ignore the differences between the two is a kind of intellectual negligence. This is especially true when the characterisation of Islamic finance as interest-free finance has been used as a justification to distinguish between Islamic finance and conventional finance. The issue is whether it is possible to do finance without involving interest at all, or as they say interest-free. This paper would argue that there is a difference between claiming interest-free and *riba*-free. This paper will prove that Islamic finance is more proper to be called a *riba*-free finance than an interest-free finance. It is not merely a semantic issue, but more importantly a conceptual one. Let us analyse this issue.

There are so many definitions and descriptions of interest in economics and finance. One of the descriptions which is relevent to our discussion is "compensation for the time value of money" (Farlex, 2015). In fact according to a well-known Austrian economist, Backhouse (2002), the rate of interest is essentially the price of time (Backhouse, 2002, p. 211). This would lead us to the discussion of the concept of the present value and future value in the discipline of finance. In finance, the mere difference between the present value and the future value is the interest itself. This difference is not only recognised in conventional finance, but also in Islamic finance. There is an old debate among the Islamic scholars (Al-Masri, 1990; Saadallah, 1994; Kahf, 1994; Khan, 2005) about the concept of time value of money and whether it is acceptable in the *Shari'ah*; recently, Abdul Khir (2013) from the International Shari'ah Research Academy for Islamic Finance (ISRA) revisited the debate[1]. In this paper, he concluded that "Islam recognizes the legitimacy of the time value of money emanating from deferral (*ajal*) and acceleration *('ajal)* in Islamic financial transactions such as deferred sale and bilateral rebate (*da'wata'ajjal*)" (p. 1).

The issue with Islamic finance is, nevertheless, not about the definition of interest which is the compensation for the time value of money. Islamic finance in fact agrees with the definition. The real issue in Islamic finance is, however, with its compensation. It is this compensation issue, which distinguishes between Islamic finance and conventional finance. The former only approves compensation for credit sale and not for loan, while the latter approves both for credit sale as well as loan. Islamic finance literatures recognise that the time has a share in price "*inna lil zaman hissatun min al-thaman*" (Al-Masri, 2012, p. 203; Suharto, 2014). In fact, this price of the time or the value of the time is permissible to be compensated in Islamic jurisprudence. It is especially true with Islamic finance when the transaction is based on the sale contract (*al-bay'*), especially the credit sale of *Murabahah*.

The example of practice of *Murabahah* sale by Islamic banking is legion. Hence, as far as the sale contracts are concerned, and more specifically credit sale contracts, there is no difference between Islamic finance and conventional finance with regard to the compensation for the time value of money. Both finances are compensating time value of money, hence charging interest. But legally speaking, this kind of interest is not prohibited in Islamic finance, as it is a permissible (*halal*) interest. Therefore, from this point of view, the claim that Islamic finance is an interest-free finance is not right. Islamic finance should rather claim a *riba*-free finance instead.

This would bring us to the conceptual difference and similarity between *riba* and interest. In Islamic jurisprudence (*fiqh Islami*) the definition and description of *riba* are attached to the two types of *riba*; *riba al-qurudh* (*riba* related to loans) and *riba al-buyu'* (*riba* related to sales)[2]. Based on the Qur'an and Hadith, some scholars (Chapra, 1985; Usmani, 2000) divide the types of *riba* into *riba al-nasi'ah* and *riba al-fadhl*. *Riba al-nasi'ah* is the one related to loans. They describe that *riba* related to loans is only present when three elements of it are there. The elements are loan contract (*qardh*), additional charge (*ziyadah*) and stipulation (*shart*). If one of these elements is missing, the *riba* is not present in the transaction. Let us take an example. When a lender advances a loan of US$1,000 and after a year the borrower agrees to return the money for US$1,100, this transaction is *ribawi* (usurius) and prohibited in Islam. There is no difference between *riba* and interest in this case. The three elements are there; loan contract (US$1,000), additional charge (US$100) and stipulation agreed by the lender and the borrower to charge the loan. From the Islamic point of view, this compensation for the time value of money is not permissible. The compensation of US$100 from the present value of US$1,000 to the future value of US$1,100 with the three elements under discussion is not lawful.

With the above example, now we are able again to show the possibility to have a case where interest is present but *riba* is not present. In other words, it is possible to have interest without *riba*. Let us analyse the earlier example. When the borrower returns the loan for US $1,100, now this is merely out of his thankfulness, not based on stipulation by the lender nor by the pre-agreement of both parties; hence, there is no *shart* in it. Then this transaction is permissible, as there is no *riba* in it. From the Islamic legal point of view, when the stipulation (*shart*) is missing from the loan contract, even with the additional payment, this addition is not considered *riba*. However, from the finance point of view, this is still considered interest. Why? Because finance is different from Islamic legal discipline. Finance simply looks at the issue of present velue and future value. When there is a difference between the two, there is interest in it.

With the above example and the example on *Murabahah*, we can even add more examples of cases where there is interest but there is no *riba* in it. When a *wadi'ah* or *amanah* or *qard al-hasan* depositor in Islamic banking, for example, receives a financial reward from the Islamic bank in the form of gift (*hibah*), this financial reward is in fact a form of interest from the finance point of view, although not a form of *riba* from the Islamic legal point of view. It is interest because there is a difference between the present value and the future value, but it is not *riba* because there is no stipulation (*shart*) in it. With all these examples, especially with the *Murabahah* and the financial gift from *wadi'ah* or *amanah* deposit, we cannot claim that Islamic banking is interest-free banking. For the financial gift and the mark-up are nothing but forms of interest from the finance point of view. This form of interest is, however, permissible.

One important note, however, has to be added here. If granting *hibah* on *qard al-hasan* has become a customary practice by the Islamic banks, so that it is expected that the banks would grant the *hibah*, or to attract more deposits, this habit would render the practice of granting *hibah* as a form of *riba*. The judgement is based on the legal maxim which says "*al-'urf ka shart*" or "custom is like [contractual] stipulation" (Laldin, 2013). In this regard, there is no difference between interest and *riba*

3. Interest in the mark-up of *Murabahah*

There is interest in the difference between the cash price (present value) and the credit price (future value) in the *Murabahah* of Islamic banking. Islamic banks can always use the general formula of $FV = PV (1 + r)^n$ or the usual financial calculator to fix the *Murabahah*'s price. As long as the transaction is a sale contract, and the conditions of the contract are fulfiled, using the general formula or the financial calculator will have no legal problem in

Shari'ah. The "r" in the above formula is interest rate, though it is called rate of profit in the Islamic finance. Let us analyse further this concept of profit in *Murabahah*.

When a trader sells a commodity by a cash sale, he will charge a profit directly on the buyer. Assume the former buys a commodity for $100, and then he sells it to the latter for $110. So, he makes $10 profit. However, when the trader sells the same commodity by a credit sale for one year, he will sell it for $120. The reason is clear. The earlier example is a cash sale and the other example is a credit sale which is more expensive because of compensation for time value of money. In the cash sale, the selling price of $110 includes only the profit of $10, but in the credit sale of $120, it also includes the interest besides the profit. Hence in the *Murabahah* price, the component of the mark-up includes the profit ($10) and the interest ($10) as well. But again, this form of interest is the permissible interest.

To prove further that the additional $10 for the credit sale is a form of interest, let us assume that the credit period is extended to 5 years instead of 1 year. Now the *Murabahah* price will surely become more than $120. Assume that the *Murabahah* price is now $160, so with the time the interest is also increasing. The profit remains $10, but the interest is now $50. For interest is nothing but a compensation for the time value of money or as Böhm-Bawerk says it is the price of time. As we say time and again, this form of interest is allowed in Islamic finance and this is what being practiced by Islamic banks. Interestingly, the fact that in the mark-up of *Murabahah* there are two components of profit and interest is also acknowledged by Vogel and Hayes (1998). Both are saying that "[. . .] it can be argued that a credit sale involves two transactions, one pertaining to the article being sold and the other to the time for which credit is extended [. . .]" (p. 202).

The analysis of *Murabahah* above is comparable to the installment sale described by the Internal Revenue Service (IRS) in the USA. Part of the so-called profit in the installment sale is the interest it self. Investopedia has defined installment sale as:

> A method of sale that allows for partial deferral of any capital gain to future taxation years. Installment sales require the buyer to make regular payments, or installments, on an annual basis, plus interest if installment payments are to be made in subsequent taxation years[3].

The IRS states that:

> Each payment on an installment sale usually consists of the following three parts; Interest income, Return of your adjusted basis in the property, Gain on the sale. In each year you receive a payment, you must include in income both the interest part and the part that is your gain on the sale[4].

4. *Riba* without interest

The forgoing discussion is evidence for a case where interest is present but the *riba* is not. In other words, the above discussion only shows a case of interest without *riba*. What about the reverse? It is possible to have a case where the *riba* is there but the interest is not there? This section will give evidence that there is a possibility to have *riba* without interest. This should bring us to the discussion of the second type of *riba*, namely *riba al-buyu'* (*riba* on sales) which we have not discussed.

The concept of *riba* on sales is derived from the *hadith* on the six *ribawi* items and the rules of exchanging them. Of the six items, gold and silver are identified as currencies. The ruling is that when gold is exchanged for gold or silver is exchanged for silver, they must be equal weight and on-the-spot sale. However, when gold is exchanged for silver, the rule is only on-the-spot sale. If the rules are violated, then the transaction falls into *riba*. Because gold and silver are representing currencies, we can replace gold for one currency and silver for other currency. Let assume gold is Bahrain Dinar and silver is US Dollar. Whenever we want to exchange Bahrain Dinar (BHD) for USD the only rule is the spot exchange. If the exchange is delayed, then there is *riba* in it. This type of riba is more specifically called *riba al-nasa'* (riba because of delay)[5]. For example, when a person exchanges BHD 100 today and he receives USD 265 the next month, the transaction is *ribawi* as the rule of spot exchange is violated.

We know that BaHD is pegged to USD. The exchange rate is currently BHD 1 = USD 2.65. So, if a person exchanges BHD 100, he will get USD 265 on the spot. This is a good example to show a case that there is a possibility of having *riba* but there is no interest in it. By exchanging BHD for USD with delay, there is *riba* without interest. BHD 100 today for USD 265 the next month is *ribawi*, though there is no interest in it. So now we have proven that it is possible to show *riba* without involving interest.

Some may argue that the above transaction might not happen and not being practiced in real life. It is true that this is not being practiced in the above form as an example. However, we can say that although practically it is not a custom, theoretically it is still possible. This theoretical possibility can be realised and practiced in a different form, such as in the form of currency forward. We know that there are three possible outcomes in the forward contract, namely the seller's loss (the buyer's gain), or the buyer's loss (the seller's gain) or the buyer and the seller both neither lose nor gain. The third possible outcome is when the forward margin is exactly covering and equating the spot rate in the maturity date. In this situation, there is no real interest being paid or received by each counter party. As far as the rate is concerned, they are trading on-the-spot rate; no interest in it. However, because it is the result of forward contract, *riba al-nasa'* on both sides has been committed. This practical example is proving and even strengthening the argument that *riba* is possible without interest.

5. Venn diagramme of *riba* and interest

From the above discussion, we can draw a conclusion that interest is not always the *same* as *riba*. There is *riba* without interest and there is also interest without *riba*. Although most of interests are *ribawi*, we still can distinguish between the two. To simplify and summerise the two, we can draw a Venn Diagramme to show the relationship between riba and interest (Figure 1).

From the above diagramme, it is very clear that *riba* and interest can overlap and intersect. In this case, riba is the same as interest and interest is the same as *riba*. However, it also shows that *riba* and interest can differ. *Riba* may not have element of interest as shown in the left side of the circle, that is, *riba* $\neq$ interest. Similarly, the interest may not have element of *riba* as well, that is, interest $\neq$ *riba* which is shown on the right side of the circle. We have given the examples of thoses cases in section 2 and 3 of this paper.

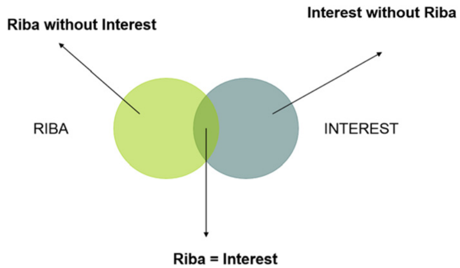

Figure 1.
Venn-diagramme on *riba* and Interest

6. Conclusion

The paper has discussed an issue about *riba* and interest which has been perceived as equal and interchangeable. The related terms such as usury and *al-fa'idah* are also discussed in the light of English Law and *fiqh al-mu'amalat*. Most of the argument is to prove that it is possible to separate between *riba* and interest where there is *riba* without interest and there is also interest without *riba*. The Venn Diagramme at the closing part of the paper shows the relationship between the two. Relating to Islamic finance and using a brief interdisciplinary analysis of law, finance and *fiqh al-mu'amalat*, the Islamic banking finance infact only prohibits *riba* and does not prohibit certain form of interest.

This paper has also proven that the characterisation of Islamic finance as interest-free finance is not right conceptually and semantically. By demonstrating that *riba* can exist without interest and interest can exist without *riba*, the paper suggests that the labelling of Islamic banking and finance as interest-free banking and finance should be changed to "*riba*-free banking and finance" instead. This is not only more truthful to the term, but would also avoid confusion especially to finance students and scholars when they communicate in English. As it is unthinkable to have finance without interest, similarly it is not possible to have Islamic finance without interest. Islamic finance is finance without *riba*, not without interest. It is hoped that the paper makes a core contribution by giving sematic clarification on the issue.

Notes

1. In a conference organised by Sakarya University, Turkey, I remember vividly that Prof. Monzer Kahf did not agree with the term "time value of money". To him, there is "time value of commodity" instead. But I think his argument has been resolved by the research paper of Abdul Khir (2013) above.
2. See for example al-Sa'd (2011).
3. http://www.investopedia.com/terms/i/installment-sale.asp (Accessed 23 January 2017).
4. https://www.irs.gov/publications/p537/ar02.html (Accessed 23 January 2017).
5. *Riba al-nasa'* should be differentiated from *riba al-nasi'ah*. The former is part of *riba al-buyu'* while the latter is equivalent to *riba al-qurudh*. For further discussion, see Al-Masri (1991).

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