The definition of Riba

Although Riba-free transactions are one of the cornerstones of Islamic finance, many people in and around the industry do not have a proper understanding of what Riba is. Since there is an absence of a clear understanding of Riba-free features of Islamic finance, people sometimes highlight elements which do not reflect the true identity of this industry when characterizing Islamic finance. In this article, MABROOR MAHMOOD explains the definition of Riba with appropriate examples.

RIBA

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Basic definition

By analyzing historical accounts as well as the sayings of Prophet Muhammad (pbuh), the following can be said about Riba: "In any contractual transaction, if currencies are exchanged with currencies in higher amounts, either spot or forward, then the additional amount of the currency exchanged is called Riba." This is the most common form of Riba nowadays. Note the following examples:

- If US$100 is exchanged with US$110 one year from now, then the additional US$10 is termed as Riba.
- If US$100 is exchanged with EUR100 (US$114.03) today, the additional amount of US dollars gained from the transaction is Riba.

> ***"Riba usually originates from transactions between currency with currency or commodity with commodity. These type of transactions are not treated as trade in Islam, and therefore, are not legal"***

The first one is a typical banking transaction. Here, US$100 is lent with a 10% interest rate and US$110 is returned one year from now. Since US$100 has been exchanged with a higher amount of dollars, the additional amount of US$10 gained is considered Riba, and is thus illegal and unlawful under Shariah principles. This is the reason why today's banking 'interest' is considered as unlawful by Islam.

The second one involves transacting one currency with another currency of a higher value (due to the prevailing exchange rate). In this case, since one party is gaining by a higher amount of one currency, the additional amount of that currency is Riba. In this case, in order to avoid Riba, the amount of both the currencies exchanged should be equal at a spot exchange rate.

Others forms of Riba

Besides the aforementioned, there are also other forms of Riba, which are not very common today. If under a contractual arrangement, a commodity is exchanged with the same commodity in higher amounts, either spot or forward, then the additional amount of the commodity exchanged is also considered Riba.

Note the following examples:
1. If one kilogram of wheat is exchanged with two kilograms of wheat one month from now, then the additional amount of wheat exchanged is Riba.

2. If 1 kilogram of salt is exchanged with two kilograms of salt today, then the additional amount of the salt exchanged is Riba.

From the aforementioned examples, we see that Riba usually originates from transactions between currency with currency or commodity with commodity. These type of transactions are not treated as trade in Islam, and therefore, are not legal.

However, Riba might also originate while trading a commodity with a currency. Note the following example:

- One commodity is sold today at US$100 but the price will be paid one year from now. On maturity date, the buyer defaults to pay the price on time. So the seller allows him a grace period of another two months in exchange of an additional US$20. Therefore, the total price to be paid now stands at US$120.

In the aforementioned example, although the sale takes place legally between a commodity and a currency and there is no Islamic prohibition on deferring the payment of the sale price, but when the buyer defaults on the payment, the seller charges an additional amount, which is Riba, and is thus prohibited.

Elements to consider

In order to determine whether a transaction involves Riba, the following elements must be present in a transaction:

- Firstly, there has to be a contract between parties. If there is no contract between parties where one party agrees to exchange a higher amount of the same currency or commodity, then there is no Riba involved in the transaction.

For example, one party borrows US$100 from the second party for one year with no agreement to repay higher sums on maturity. Once the repayment is due, the first party repays US$100 to the lender and out of his free will, he pays US$10 extra. This will not be considered as Riba because there was no prior contract between the parties to exchange extra amount. This flexibility in the definition of Riba allows Islamic banks to offer periodic returns on saving deposits.

- Secondly, the items to be exchanged have to be like-for-like in order to generate Riba. They either have to be the same currency or the same commodity. If the currencies differ, then there is no Riba as long as the currencies are exchanged at a spot exchange rate.

The views expressed here are the author's own and do not necessarily represent the views of the institution where he works.