

Understanding Riba and Gharar in Islamic Finance

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Abstract

The philosophical and conceptual foundations behind the prohibition on *riba* (interest) and *gharar* (uncertainty) can be derived through the *Shuratic* process in discursive interpretation of the *Qu'ran* and *Sunnah*. *Riba* (interest) is in fact just a form of *gharar* (uncertainty). *Gharar* (uncertainty) opens the door for speculation, ruthless greed, immorality, and social decay. Both *riba* (interest) and *gharar* (uncertainty) result in social harm in the form of inflation, unemployment, volatility, instability, and environmental degradation. *Riba* (interest) and *gharar* (uncertainty) are both prohibited under *Shari'ah* as their harm outweighs any benefit, however, *gharar* (uncertainty) is allowed in instances where the benefit outweighs the harm.

Keywords: Riba (Interest); Gharar (Uncertainty), Islamic Finance, Shari'ah

Introduction

In Islam, it is permissible to trade money for commodity, commodity for commodity, however, not money for money as this produces *riba* (interest). *Riba* (interest) is in fact just a form of *gharar* (uncertainty). *Riba* (interest) and *gharar* (uncertainty) are both prohibited under *Shari'ah* as their harm outweighs any benefit, however, *gharar* (uncertainty) is allowed in instances where the benefit outweighs the harm.

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Riba

The *Shari'ah* allows for transactions where both counter-values are transacted at the time of the dealing or one counter-value now and one in the future, however, not both counter-values in the future as this creates *gharar* (uncertainty) about the fulfillment of the contract. However, this is allowed where the benefit outweighs the harm.

Since in interest financing, one counter-value is certain, the interest on the loan, and one counter-value is uncertain, the yield from investing the loan by the creditor, interest-finance is in fact an extreme case of *gharar* (uncertainty) and is prohibited under the *Shari'ah* as the harm outweighs the benefit. Saadallah says that in the case of *riba* (interest), the "variance in certitude between the two counter-values, the interest on the one hand and the opportunity cost on the other, constitutes the essence of the injustice of imposing interest on loans" (2009:111). Debt-finance replicates the result of interest-based financing and does not fulfill the requirements of the *Shari'ah*. Dusuki says "For a contract to be valid, there should be *Iwadh* or counter value present. Three elements of *iwadh* that should exist are risk (*ghorm*), work and effort (*ikhtiar*) and liability (*daman*). In the majority of debt-financing contracts, one or more of these elements of *Iwadh* are missing. If there is no risk, effort and liability, then such a contract cannot be considered to contain any element of justice" (2011:3).

Ridha Saadallah states that an often-cited reason for the *Qu'ranic* ban on interest is to "forestall injustice, since increasing the amount is in return of the time-term" (2009:111). Islam does not recognize the time value of money as time cannot be the sole consideration for an excess amount claimed in an exchange. Saadaallah says the excess amount must be claimed against an asset or commodity and not time as this would result in a money-money transaction. Taqi Usmani explains "Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money" (2000:10). Commodity-commodity and money-commodity transactions are allowed, however, not money-money transactions as this may result in (*riba*) interest. Interest financing leads to a false economy, creating instability, inflation, unemployment, and cyclical crashes. Islamic finance is asset-backed, which creates a real economy with real assets and inventories and promotes stability as well as creates an economy where speculators and bankers cannot crash markets for profit through greedy and reckless behavior.

According to Taqi Usmani "Interest-based financing does not necessarily create real assets, therefore, the supply of money through the loans advanced by the financial institutions does not normally match with the real goods and services produced in the society, because the supply is increased, and sometimes multiplied without creating real assets in the same quantity" (2011:10). Usmani explains that "This gap between the supply of money and production of real assets creates or fuels inflation" (2011:10). In contrast, Usmani says "Since financing in an Islamic system is backed by assets, it is always matched with corresponding goods and services" (2011:10).

In an interest- based loan, the creditor receives a fixed rate of return no matter how much profit or loss the venture makes. If the venture makes a lot of money, the creditor receives a fixed rate of return. It would be more just if the creditor shared in the profits rather than just receiving a low fixed rate of return in the form of interest. If the venture makes a loss, the creditor still receives a fixed rate of return and the debtor bears the risk of the loss. It would be more equitable if the creditor shared in the loss rather than receiving an abnormally high rate of return in the form of interest. *Riba* (interest) results in a financial system where the debtors bear the majority of the risk and the creditor most of the reward.

According to Sheikh Wahba al Zuhayli, "*Riba* is a surplus of commodity without counter-value in commutative transaction of property for property" (2006:25). The intent of such a transaction is a surplus of commodities. Therefore, the definition of *riba* includes both credit *riba* and invalid sales, since postponement in either of the indemnities is a legal surplus without perceivable material recompense, the delay usually due to an increase in compensation (Zuhayli, 2006:25). In Islam, money – money transactions are not allowed and there is no time value of money concept. Taqi Usmani explains that "Any excess amount charged against late payment is *riba* only where the subject- matter is money on both sides" (2011:10). Furthermore, "Any excess claimed in a credit transaction (of money exchange of money) is against nothing but time" (Usmani, 2011: 10).

There are two types of *riba* forbidden in Islam, credit and surplus *riba*. "Credit *riba* is taken against a delay in settlement of a due debt, regardless whether the debt be that of goods sold or a loan" (Zuhayli, 2006: 26).

Therefore, "Credit *riba* occurs due to their inclusion of an increase in one of the two exchanged goods without any counter-value (Zuhayli, 2006: 28). The impermissibility of exchanging equal amounts is due to the resulting increase in value. Zuhayli explains that this is because neither of the contracting parties would usually accept to postpone the receiving of the payment save if there were some benefit by increase in the value thereby (Zuhayli, 2006: 28). Credit *riba* represents a violation of the 'hand to hand' rule when one or both counter-values of a transaction are postponed to a future date (of goods of same genus). *Riba* of delay or credit *riba* prohibits sale of commodities in the future even if the counter-values are equal (Ahmed, 2011:32).

Ubida b. al-Simit (Allah be pleased with him) reported Allah's Messenger (may peace be upon him) as saying: Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand (Muslim, book 10, number 3853) (Visser, 2009: 34).

The six goods mentioned in this hadith are *ribawi* goods. Violation of "same for same" can lead to *riba* of excess (*riba al fadh*) or surplus *riba* and not fulfilling "hand to hand" (i.e. spot transaction) would constitute *riba* of delay (*riba al nasi'ah*) or *credit* *riba* (Ahmed, 2011: 31). Furthermore, "gold for gold" and "silver for silver" provides the rules of monetary exchange (*sarf*) during this time (Ahmed, 2011:31). If there is exchange among the same specie of *ribawi* goods, it has to be done on the spot and should be of equal quantities (Ahmed, 2011:31). If the quantities exchanged differ, even in spot transactions, then it will constitute *riba* of excess (*riba al fadh*) or surplus *riba* (Ahmed, 2011:31). Rules of *riba* of excess also prohibit exchange of dissimilar quantities of a genus with different qualities (such as exchanging one unit of high quality dates with two units of low quality dates) (Ahmed, 2011:31). According to Visser, there is a ban on exchanging, for example, two low-quality dates for one high-quality date, even if it is permitted to sell the low-quality dates for money and use the receipts for buying a high-quality date (2009: 35).

Zuhayli says that "Surplus *riba* is the sale of similar items with a disparity in amount in the six canonically-forbidden categories of goods; gold, silver, wheat, barley, salt, and dry dates" (2006: 26). It is the violation of the 'equal for equal' rule in spot transactions of the same goods of a particular genus.

Zuhayli explains that "This type of *riba* is forbidden in order to prevent it being used as a pretext to committing credit *riba*, such that a person sells gold, for example, on credit, then pays back in silver more than the equivalent of what he had taken in gold" (2006: 26). To avoid *riba*, the commodity has to be exchanged with some other genus and then traded with the desired commodity (high quality dates with wheat or silver and then wheat or silver with low quality dates) (Ahmed, 2011: 32).

Narrated by Abu Said Al-Khudri and Abu Huraira: Allah's Apostle appointed somebody as a governor of Khaibar. That governor brought to him an excellent kind of dates (from Khaibar). The Prophet asked, 'Are all the dates of Khaibar like this?' He replied, 'By Allah, no, Oh Allah's Apostle! But we bartered one Sa of this type (type of dates) for two Sas of dates of ours and two Sas of it for three of ours.' Allah's Apostle said, 'Do not do so (as that is a kind of usury) but sell the mixed dates (of inferior quality) for money, and then buy good dates with that money' (Bukhari, vol. 3, book 34, no. 405; see also Muslim, book 10, number 3875)(Visser, 2009:34).

The legal cause for the impermissibility of exchanging different amounts of edibles is, according to the Hanafi and Hanbali Schools, volume and weight; according to Imam Malik, its qualities being nutritious and storable; and for Imam Shafi, the mere fact that it is edible (Zuhayli, 2006: 39).

Gharar

Gharar (uncertainty) originates from the Arabic verb *gharra*, which means to deceive. The word for gambling in Arabic, *maysir*, comes from the word *yasira*, which means to be easy and *yassara*, which means lucky chance or easy success at getting something of value without earning it (Kamali, 2000: 151). Various classifications of *gharar* (uncertainty) include pure speculation where the outcome depends on chance or gambling, uncertain outcome where the counter-value is uncertain or not realized, inexactitude of object, and unknown future of object. Speculation according to Kamali is the purchase and sale of an asset in the expectation of a gain from changes in the price of that asset (2000: 147). These conditions allow for the use of deception for material gain at the expense of the well-being of one of the parties and humanity as a whole.

According to Kamali "The *Qu'ranic* prohibition of *maysir* is based on the premise that an apparent agreement between the two parties is in actuality the result of unclean and immoral inducement, which is driven by the hope of making a profit at the expense of the other party to the agreement" (2000:152). "The gambling parties thus court a risk, which is of their own creation and which involves both the hope of gain as well as the fear of loss in a way that is not a necessary part of any of the normal activities in life" (Kamali, 2000:152). Kamali explains that "If in a contract of sale one party receives what was due to him, but the other does not and the latter's side of the bargain is open to risk-taking (*mukhatarah*) of a kind that frustrates and nullifies his right, then the sale partakes both in *gharar* and gambling at the same time" (2000:154).

Gharar (uncertainty) can be related to risks arising from lack of knowledge about the contract (object, price, time of delivery), uncertainty about the existence and delivery of the object, and /or uncertainty of the outcome. Basically, *gharar* (uncertainty) relates to risks arising in contracts that dilute the pillars and objective of sale. Al Karshi states that the legal cause (*illah*) of the prohibition of *gharar* (uncertainty) are the inability to complete the sale, fairness in contracts including preventing the unjust devouring of people's wealth (*akl al-mal bi'l-batil*) and the inequality in the counter-values of sale, and preventing the potential for dispute and hatred. Kamali explains that " *Gharar* occurs in a contract when one of the parties takes what is due to him but the other does not receive his entitlement. If his right continues to be unfulfilled, the first becomes guilty of the wrongful devouring of the property (*akl al-mal bi'l-batil*) of his counterpart in the transaction, and a *gharar* sale of this kind engages in gambling and punting (*al-qimar wa'l maysir*), which the *Shari'ah* has forbidden (2000:90). Devour not each other's properties unlawfully unless it be through trading by your mutual consent (*al Nisa*, 4:29).

Kamali emphasizes that gambling or *qimar* is a combative relationship between two contracting parties, each of whom undertakes the risk of loss and the loss of one means gain for the other (2000:151). Kamali says that it is a violation of the law of equivalence, a kind of robbery by mutual agreement, like dueling, which is murder by mutual agreement (2000:151). "Gambling also consists of an appeal to chance, and making chance the arbiter of one's conduct is to subvert the moral order and stability of life. It focuses attention on material gain and unwarranted reward in a way that is usually impulsive and can be so overwhelming as to divert attention from the pursuit of worthier activities in life" (Kamali, 2000:151).

Kamali elaborates "Gambling destroys cooperation and fraternity in favor of combativeness and the desire to win, and it has no harmony with the normal processes that are important to civilization. It is characterized as a morally unclean activity, which sows the seeds of enmity and hatred among fellow human beings, as well as creating a barrier to piety, spiritual awareness, and the remembrance of God" (2000:151).

Prohibited *gharar* (uncertainty) must fulfill four conditions. *Gharar* has to be large as small amounts do not invalidate a contract; *gharar* must be in commutative (exchange) contracts; *gharar* should be linked to the principle object of the contract and not something attached to it; and *gharar* is allowed in cases of public need or necessity. Kamali states "*Gharar* is, however, a broad concept and may carry different shades of meanings in different kinds of transactions" (2011: 84). For instance, there may exist strong, medium, or weak *gharar* (uncertainty) in a contract and according to various scholars and schools, each form of *gharar* (uncertainty) may be permissible or impermissible. Mawil Izzi Dien explains that "This prohibition (on *gharar*) is deduced by examining various contracts, which are prohibited because of inherent *gharar*, such as the prohibition of exchange of that which is not measurable for that which is measurable, *makil*, and the prohibition of exchanging dry dates for fresh ones" (2004:74).

Gharar (uncertainty) can be found in the essence or object of the contract. It occurs in the essence of the contract when there are two sales in one, down-payment (*Arbun*) sales, conditional sales, or pebble, touch, or toss sales where the sale depends on an unrelated event, suspended (*mu'allaq*) sales where the sale is realized based on the outcome of a random event, and future sales, where the delivery of both counter-values occurs in the future and there is a sale of debt- for- debt or *bai al kali bi al kali*. Kamali says that in terms of pebble, touch, and toss sales (*al-mulamasah wa'l munabadh*), sales such as the offspring of an unborn animal (*habal al-habala*) or the sale of fruit prior to its ripening, sale of the unseen, sale of that which is unknown (*bai al-ma'dum wa'l-majhul*), and sales in which the vendor cannot deliver are forbidden because of the presence of risk-taking (*mukhatarah*) that involves devouring the property of others (2000:90). In terms of *Arbun* sale, it refers to a sale in which the buyer deposits money with the seller as part payment of the price in advance, but agrees that if he fails to ratify the contract, he will forfeit the deposit money, which the seller can then keep (Kamali, 2000:90).

The question to be asked in all of these is whether they involve unlawful appropriation (*alk al-mal bi'l-batil*) and, if so, the sale is invalid and partakes of gambling (Kamali, 2000:154).

In terms of *gharar* in the object of the contract, ignorance of the object can exist in the object itself, the type of object, or the attributes and features of the object. There can be ignorance of the genus, species, attributes, quantity of the object, specific identity of the object; time of payment in deferred sales, inability to deliver object; time of payment in deferred sales; inability to deliver object; contracting on a non-existent object, and not seeing the object (Ayub, 2007:60). Even if all conditions of contract are fulfilled, the object has to be seen. In relation to non-existent objects, Ibn Qayyim and Sanhuri classified four cases: (1) When the object exists in essence, but comes into completion thereafter; (2) when the object is non-existent at the time of contract, but certainly exists in the future; (3) when the object is non-existent at the time of contract and the existence in the future is uncertain; and (4) when the object is non-existent at the time of contract and is expected not to exist in the future. Kamali elaborates that "of these four types, only the last two present situations in which *gharar* is deemed to be excessive and would, therefore, invalidate the contract (2000:91). Kamali explains that "as for the first two, Ibn Qayyim and al-Sanhuri have both concluded that *gharar* in them is negligible and the sale in both cases is therefore valid" (2000:91). Ayub says that in order to avoid uncertainty, Islamic law denies the power to sell (1) Things which, as the object of a legal transaction, do not exist; (2) Things which exist, but which are not in possession of the seller or the availability of which may not be expected; (3) Things which are exchanged on the basis of uncertain delivery and payment (2007: 60).

The lack of knowledge in terms of contract and object and non-existence of object creates risk (*gharar*). In *Shari'ah*, risks cannot be sold separately (unbundled) as this does not fall under the category of *mal* (property). Ignorance and non-existence of object cannot be compensated with price and risk itself cannot be priced and sold, but risk associated with sale can be priced and sold (bundled risk). In order to illustrate this point, Kamali interestingly points out that in the case of options, the sale is valid even though one of the counter-values consists merely of granting a right, or a privilege, as opposed to a tangible asset, service or usufruct (*manfa'ah*) that has no concrete reality and existence at the time of contract as it can be bought and sold in the same way as a tangible asset, or *mal*" (2009:194). This is of course debatable amongst the scholars and the different schools of Islamic jurisprudence.

Kamali points that “the *Shafi’s* and *Hanbalis* include usufruct under the definition of (*mal*) property, but the *Hanafis* and *Malikis* do not” (2000:194). According to Kamali, the option price or premium is normally paid in cash and the price is in this case *mal* (property) (2000:201). In a contract of sale, each party must receive the counter-values, the object of sale and price. This is referred to as *qabd* and *taqabud*. The seller must deliver the goods (*taslim*) and the buyer must take possession (*qabd*). In *salam* and *istisnaa*, the requirement of *qabd* has been omitted due to necessity of the people (Kamali, 2009: 122).

According to Visser, “the ban on *gharar* (uncertainty) implies that commercial partners should know exactly the counter-value that is offered in a transaction” (2009:45). Kamali states that *gharar* can be summarized in four main ways. These are on account of uncertainty and risk pertaining to the existence of the subject matter of a sale, or its availability, uncertainty about the quantities involved and lastly, uncertainty about time of completion and delivery (2000:93). Visser says that in order to avoid *gharar* (uncertainty), “one should make sure that both the subject and prices of the sale exist and that parties are able to deliver; specify the characteristics and the amounts of the counter-values; and define the quantity, quality, and date of future delivery” (2009:45). Visser also says that “a seller/financier first must own the goods before they can sell or lease them, which implies that the goods must exist before they can sell or lease them” (2009:75). One should also possess or constructively possess the subject-matter of sale before sale (*qabd*). Another aspect of *gharar* (uncertainty) concerns complexity in contracts. A contract should not cover more than one transaction and thus, there is a prohibition on two sales transactions in one. For example, Visser says that a sales transaction and a lease agreement cannot be combined into one contract (2009:75). Visser explains that Muslim jurists treat the ban on *gharar* (uncertainty) as an injunction to maintain commutative justice or the just price, which is the market price (2009:47). Before entering into a contract, both parties should have full knowledge of relevant facts, including the market price (Visser, 2009:47).

Ayub says that to avoid *gharar* (uncertainty), the contracts must be free from excessive uncertainty about the subject-matter and its counter-value in exchanges; the commodity must be defined, determined and deliverable and clearly known to the contracting parties, quality and quantity must be stipulated, a contract must not be doubtful or uncertain so far as rights and obligations of the contracting parties are concerned, there should be no *Jahl* or uncertainty about availability, existence, and deliverability of goods and the parties should know the actual state of the goods (2007:61).

Mawil Izzi Dien says "The prohibition related to these contracts is established due to the potential for deception that could result from not knowing the quantity of one of the exchanged commodities" (2004:74). *Gharar* (uncertainty) leads the financial system into a zero-sum game, where one's benefit is someone else's loss. However, *gharar* is allowed in circumstances where the harm outweighs the benefit. Kamali says "Should there be a public need for it, *gharar*, even if excess priority by virtue of the *Qu'ranic* principle of removal of hardship" (2011:84). The *Shari'ah* thus validates *salam* (advance purchase) and *istisna'a* (manufacture contract) regardless of the *gharar* (uncertainty) elements therein, simply because of the people's need for them" (2010: 85). However, *gharar* is for the most part prohibited as it promotes immorality, moral and social decay, societal disintegration, volatile markets and financial instability, and opens the door for deception and ruthless greed. In fact, "to Ibn Taymiyyah, the evil of gambling is greater than *riba*, for gambling combines two evils: the unlawful acquisition of property and the playing of an unlawful game, both of which are *haram*" (Kamali, 2000:151).

Conclusion

Despite clear rules on *riba* (interest) and *gharar* (uncertainty) found in the *Shari'ah*, Islamic finance and banking today still incorporates elements of *riba* (interest) and *gharar* (uncertainty) in its practice as well as utilizes debt rather than equity- financing.

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