

Riba and A General Theory of Interest

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The prohibition of *riba* is clear from well-known statements in the original sources.¹ However, the Qur'an did not define it – the same way it had not defined gambling, theft or adultery. What was meant was assumed understood. Any amount demanded and/or received by the lender, in addition to his principal, is *riba* and is prohibited in Islam. For the purpose of this article we will accept this strict and comprehensive definition and proceed.

Does borrowing involve any other costs besides *riba*? If so, who is to pay these costs, and is it *riba*? We propose to answer both the questions by analogy, using a scene that is played out all over the world, every day — one equally true today as in the time of the Prophet (pbuh).

1. The cost of borrowing

Suppose a man (or woman) asked a friend of his (or hers) to lend him (her) some money. The friend agreed. But the friend (now the lender) lived in a distant place. So our man (now the borrower) has to travel (say, by train) to the lender's place. It is necessary to pay the train fare and it is the traveller who must pay it. The traveller in this case is the borrower, and it is neither customary nor fair to ask the lender to lend money as well as to pay for the train; nor would one ask him to bring the money to the borrower. In fact the borrower has to travel again to return the loan. It is obvious that the borrower had to spend some money to obtain the loan, but that was not *riba* by any stretch of imagination because the lender did not ask for or receive any amount besides his principal. The borrower did spend some extra money to obtain the loan, but that was paid to the train operator, not to the lender. It is clear then that borrowers sometimes do incur expenses in obtaining loans and they are not necessarily *riba*.

On the other hand, if the borrower and the lender lived in the same city or village and met each other in the course of their daily activities, such as in the market, the mosque, the work-place, the bath-house, the eating house, etc., the question of travel and extra expense would not arise. Similarly, if they lived close by and the borrower could reach the lender by foot or by using his own transport such as a horse, camel, donkey, bicycle, or car, the travel cost would be nil or negligible and hence goes unmentioned. This is a person-to-person transaction in a small geographical area. This occurs everyday in numerous locations all over the world, and will continue to take place for all time to come. These were also the situations in the small towns of Mecca and Medina 1400 years ago. It was against this background that the Qur'anic prohibition of *riba* was promulgated. Even then, if, for example, the lender lived in Mecca and the borrower in Medina, the earlier scenario would have come into play and the borrower would have had to incur extra expenses, which were not *riba*.

Let us now take our scenario a step further. Suppose our borrower, instead of going himself to meet the lender, employed someone else to do the job for him. He has to pay the same train fare and, in addition, remuneration to the one he employed. The latter is an intermediary — a courier of money — and he is paid his costs and remuneration by the borrower. Again this has nothing to do with the lender. Therefore it is obvious that these cannot be regarded as *riba*.

¹ The Qur'an (the Holy Book of Islam) and Hadith (the sayings, doings and approvals/prohibitions of the Prophet (pbuh)) are the only original sources of all laws in Islam.

Now, let us go another step further. Suppose the law of the land requires that for any money transaction beyond a certain amount to be valid an attorney should attest it.² The attorney has to be paid. Who will pay the bill? Naturally it is the borrower. Similarly, if the collateral for the loan has to be evaluated or its title checked, a payment has to be made. Again it will be on the shoulders of the borrower. It is of course, obvious that these are not going to the lender, and are therefore nothing to do with *riba*.

From the above we have come to the point that there are at least three different kinds of costs incurred by the borrower that are not *riba*. Now, suppose the borrower asks the courier to go to the attorney as well to get the transaction attested and also to have the title checked by a notary or attorney, and the courier agrees. This will make the borrowing process easier and quicker, and the borrower need to deal with only the courier; and he could pay all the costs to, and through, the courier. Since none of the above costs are *riba*, and since the lender did not demand any *riba* and the borrower did not pay any *riba* and therefore the courier did not carry any, there is no *riba* involved in the entire transaction. Yet it did cost the borrower some extra money to obtain the loan. The loan was *riba*-free, but not cost-free.

2. The courier becomes a bank

Now, suppose this courier does a good job, the word spreads, and more borrowers retain him to do similar jobs for them. He grows, he no longer runs the errands himself but employs others, and as time passes and the business grows, he employs his own attorney and notary so that their work can be done in-house. Now he is an institution. His couriers travel to many towns and cities, his institution is well known and trusted. On account of the economies of scale his per-transaction cost is reduced, and the borrowers find his charges cheaper compared to employing a private courier; and more convenient too.

As time passes he discovers that there are borrowers and lenders in every location, and even though a borrower in a particular location may be borrowing from a lender in a distant location, since money is the same wherever it comes from, the courier could give the amount to the borrower in a particular place from the money obtained from the same location. This would reduce his costs, transaction time, and transport risks. His services become even cheaper.

In course of time, borrowers and lenders discover that they need not deal with each other directly, nor even know each other, and that they could approach this courier institution for their respective needs. Borrowers go to the courier to obtain loans, and they can get from this courier more funds than they can from any specific lender known to them, and trusting and willing. They are no longer obliged to any particular friend-lender. The lenders now deposit their funds with the courier, for safety and with the knowledge that their money will possibly be used by others, including their friends, while they are not in need of it. The courier assures the safe and full return of their funds whenever needed. The courier no longer sends his staff to the lenders and borrowers but they come to him. A bank is born!

But this bank has two distinguishing features. One, its progenitor is a courier of money rather than the moneylender of old as is the case with the conventional bank. It started as a courier of money and remains a courier of money — it is no moneylender. Two, this bank is not involved in any *riba* transaction, and the fee it charges the borrower is not *riba*.

3. The operational costs of a bank

Our arguments that the bank may charge a fee for its services, and that it is not *riba* have been based on common sense and general knowledge. However, it is good to know if there are any other supporting voices.

3.1 Current approaches

² It should be noted here that making a written and witnessed record of any loan transaction is a Qur'anic injunction. Qur'an (2:282).

Iran is one country where *riba* is prohibited and which has a comprehensive law on usury. Pakistan is another country where *riba* is prohibited. Siddiqi is the most referred-to author on interest-free banking. On examining the provisions in the Iranian, Pakistani and the Siddiqi models, we find all three of them providing for loans with a service charge.³ Though the specific rules are not identical, the principle is the same. All three models agree on the need for having cash loans as one mode of interest-free financing, and that this service should be paid for by the borrower. Therefore we are not alone in our conclusions.

3.2 Another approach

A more comprehensive and direct approach has been employed in Gafoor (1995). Here, the usual interest charged by the conventional banks has been taken and split into six distinct components, the purpose of each component is determined, each is examined to see if it contained any elements of the prohibited *riba*, and then a formula is developed with respect to each component in order to compute its value. It has been shown that, of the six components only one is *riba* and all the other five belong to the category of costs and remuneration. On account of this the usual interest charged by conventional banks is called the cost of borrowing. Its six components are: interest paid to the depositor,⁴ cost of overheads, cost of services, a risk premium, profit (or remuneration to the bank), and compensation for the value loss of capital due to inflation. The reader is best referred to the original for details, and for how this model of the cost of borrowing is used for many analyses. For the present we will examine the components of the model briefly with the above courier-bank in mind.

3.2.1 Interest

In normal commercial banking practice, the funds used for lending are mainly derived through the savings deposits. The bank pays a certain percentage as interest to the depositors and recovers it from the borrowers when it lends. This interest is the first component in our model of the cost of borrowing. Of all the six components of the cost of borrowing, only this component is received by (or paid to) the depositor, in addition to his capital (deposit). In the general case, this component is positive and is dependent on the interest rates the bank pays its depositors.⁵

In the case of a Muslim community, this component is *riba* because any addition to the capital has been defined to be *riba*. Therefore, a Muslim depositor will not demand or accept this component. Hence, this component will be zero in our version of the model. The implication is that the bank will not collect this component from the borrowers in order to pass it onto the depositors.

3.2.2 Services cost

This is the cost involved in processing the application. This may include legal and other charges paid by the bank for services such as the evaluation of the collateral and checking its title, preparation of loan documents, postage, etc. This cost is specific to the concerned loan, and therefore need be borne entirely by the concerned applicant. This is an actual cost incurred by the bank, and is independent of the size of the loan (except, perhaps charges such as stamp duty) or the period of repayment. Therefore there should be no objection to it on grounds of any resemblance to interest (or *riba*).

3.2.3 Overheads cost

This goes to the maintenance of the bank, including staff salaries and office expenses. This is unavoidable, but it is also difficult to determine the exact amount used up by any given loan. Therefore a method has to be found to charge an average rate. What has been suggested is to

³Laws and regulations relating to interest-free banking in Iran and Pakistan are reproduced in Iqbal and Mirakhor (1987), pp.31-58. For the Siddiqi model, see Siddiqi (1988). The concerned sections are also reproduced in Gafoor (1995 and 2005).

⁴ This is identified with *riba*.

⁵ It also depends on the credit creation factor, of the concerned bank, which, in turn, is dependent on the reserve requirements. These complications are dealt with in Gafoor (1999), where the complete model is presented in its mathematical formulation.

compute the bank's average total running expenses per annum (p.a.) and divide it by the average total assets (loans and advances) of the bank p.a. to obtain a per-dollar-p.a. cost. Then this rate will be used to compute the overheads cost due from the borrower. For example, if this rate works out to be 1.5 cents per dollar per annum, a loan of 5000 dollars paid over two years will entail an overheads component of $0.015 * 5000 * 2 = 150$ dollars. It may sound like the usual interest rate, but we know why and how we arrived at it, and we know that it is not *riba* but a cost necessary to maintain the bank whose services the community, the depositors and the borrowers need. For a more elaborate explanation see Gafoor (1995).

3.2.4 Profit

The proposed bank is a commercial concern providing a service — carrying money from the lender to the borrower and back, keeping it safe, receiving from and paying to both the depositors and the borrowers, keeping accounts, buying and selling services from third parties (e.g. hiring a lawyer for title checking), etc. The costs of these are taken into account in the two preceding components. But, how about remuneration to the courier-bank for arranging these services? Should it do it without any benefit to itself, investing its own money, time, expertise and effort? Is such remuneration *riba*? Obviously not. However, it may give rise to concerns depending on how it is computed. If it is computed as a percentage of the loan amount there may be some room for doubts. But, here it is proposed to be computed as a percentage of the costs of the services the bank provides (i.e. the services and overheads components, seen above). Thus it is a legitimate remuneration or profit.

3.2.5 Risk premium

The proposed approach has already introduced a radical change in the perception of a bank — from a moneylender to a money-courier. Now it introduces another radical innovation in guaranteeing the capital of the depositor by ensuring the full repayment of the loans — now the onus is on the borrower and not on the bank. Instead of the banks joining a deposit insurance scheme, here the borrowers join in a loan default insurance scheme. This is a collective insurance scheme designed to compensate the bank in case of defaults, and to discourage delays and encourage early settlements. The premium is proportional to the size of the loan. But good behaviour increases the credit rating of an individual borrower and decreases his premium rate, and *vice versa*. The scheme is to be run by a third party, and the unused part of the premium is to be returned to the borrowers *pro-rata*. See Gafoor (1995, 2000) for details.

3.2.6 Compensation for inflation

Inflation comes into this model in two different forms: price increases affecting the costs (second and third components), and currency depreciation affecting the value of capital. The first is unavoidable, inseparable and legitimate. Therefore we cannot and need not do anything about it. But the second is value erosion of capital due to currency depreciation. In fact, it is an illegal and surreptitious tax on all cash holdings. In fairness to the capital holders this loss must be compensated, so that their capital is not eroded due to no fault of their own. This component is the amount (in terms of currency) that needs to be paid to the capital holders (depositors) in order to restore their capital to its original value. For the rationale and computational details please see Gafoor (1999). (This model provides for the reverse action too, in case of currency appreciation.) The methodology is illustrated using actual data in Gafoor (2005 and 2006).

4. A general theory of interest

The alternative approach presented above is a general model of the cost of borrowing (CoB). In fact, it is a general theory of interest. Here the interest charged by a bank is split into several components, which are all factors every bank takes into consideration in determining its interest rate. However, bringing them all into a comprehensive model is new. In addition, each component is estimated separately and independently of others. This too is new and innovative. In the process, each component of the bank interest is shown to be originating from different considerations. In economic parlance, each component is influenced by a different set of economic variables. In turn,

each component influences another set of economic variables. This should lead to more meaningful economic and econometric modelling and to a deeper understanding of the working of interest in the economy. In this essay, however, we will limit ourselves to a few applications of this theory to situations that concern us. For the sake of simplicity we will assume zero inflation (i.e., no currency depreciation) in what follows.⁶ The complications of inflation are dealt with in Gafoor (1999).

4.1 Person-to-person lending

Person-to-person lending and borrowing is something that takes place everywhere in the world, millions of times every day, from time immemorial to the present. Its essential components are: 1) the lender and the borrower are generally known to each other (or are introduced and guaranteed by mutually trusted acquaintances), meet in person, the transaction is hand-to-hand, and any writing and witnessing is done without cost — hence the second component of the model is zero; 2) since the lender and borrower are generally from the same locality or live in close proximity the travel cost to the borrower is insignificant, and since such transactions are also infrequent there is no cost (such as employing an assistant on account of the large volume of transactions) to the lender — hence the third component is also zero; 3) since the second and third components are zero, the fourth component (profit) which is a percentage of the other two is automatically zero; 4) the lender lends only if he is satisfied that the borrower is able to and will repay the loan in full and in time (he is free to deny a loan if he is not sure) — hence the risk premium (fifth component) is also zero; 5) in the absence of inflation, the sixth component is also zero.

Therefore, in a person-to-person lending/borrowing as described above, all components except the first are zero. Hence, in such a transaction, if the borrower has to make any extra payment to the lender it can only be due to the first component being positive, and that is *riba*. This was the case dealt with in the original injunctions, and this had also been the case in all transactions till the advent of the banks, and even today in millions of transactions outside the banking system. Thus, in the case of a person-to-person lending, the cost of borrowing (CoB), interest, usury and *riba* all turn out to be the same and equal. The model helps us to see this clearly and directly.

4.2 “Low interest” lending

We will now use our model to examine two types of “low-interest” lending schemes to see if they involved *riba*.

4.2.1 Educational loans

Suppose, some philanthropist sets aside a certain sum to help needy students. He could proceed in several ways. Let us take three scenarios. 1) He could hand out a certain amount to every needy student who applies until his money is used up. This is an outright donation and a one-time operation. After that he would not be able to help any more students unless he brings in new funds. 2) He could do as before, but require the students to pay back when they are employed. From the money so recovered he can help more students. This is a loan scheme and a continuing operation. But this would require the employment of a person to disburse the funds, keep records, receive repayments and keep accounts, etc. He needs to be paid and his office expenses met. We are talking here about several years. Unless the philanthropist provides fresh funds every year for the upkeep of the office, the original funds would be used for this purpose as well and, eventually, the operation will shut down. 3) He could proceed as 2) above but require the students to pay for the upkeep of the office as well, in addition to repaying the full amount of the loan. This might be called a “low interest” loan scheme. Since the original fund will remain intact, this is a sustainable continuing operation.

What is common to all the above scenarios is that the philanthropist did not ask or receive any monetary benefit for himself. In Islamic parlance, no *riba* was involved in any of these operations.

⁶ Actually, this is the “normal” situation, for when accounting is done in terms of currency units there is an implicit assumption that its value remains constant over time – no depreciation, no appreciation. This is also legally upheld so that one unit of currency today is the same as one unit tomorrow, day after or ten years later, irrespective of its real purchasing power.

However, of the three schemes, only the third is sustainable. In terms of the above theory, in the absence of inflation, all components of the CoB except the overheads component are zero. Accordingly, though the cost of borrowing is positive, it is not *riba*. In customary language, however, it is called interest, *albeit* low.

Unfortunately, Muslims take the word interest literally and equate it to *riba*. In the process they lose out on the benefits of a useful and sustainable system devised by a sympathetic and well-meaning philanthropist. This is not being true to the faith or is the strict practice of its rules, but refusing a helping hand due to ignorance. This is not to say that the ordinary Muslim who wishes to be faithful to his creed is wrong, but that he had not been given the knowledge about what is meant by *riba* and what is meant by interest as understood today, and that there is a difference. Showing this difference, however, is not possible if interest is treated as one single item. Neither the bankers, nor the economists, nor the Islamic scholars have been of help here. Hence the need and relevance of the above model which sees present-day interest as consisting of several components, only one of which is the prohibited *riba*.

The theory should help explain to the believing Muslims that all that is called interest is not necessarily *riba* and provide them with a tool to examine any interest to see if it contained *riba* or not. Its practical application will enable them to set up sustainable endowments for useful purposes. Such an understanding and use of the tool will also help them to examine and benefit from several so-called low-interest loan schemes (which many currently reject out of hand), without any qualms about getting involved in *riba* dealings.

4.2.2 Housing loans

One such low-interest scheme which many good Muslims reject and deny themselves an important basic necessity is the housing loans organized by some well-meaning governments. Essentially they act exactly like the philanthropist in the above example, and use the third option in order to have a sustainable and continuing system. However, on account of the large size of the loans, its long term nature (20 to 30 years to recover the capital in monthly instalments) and the geographical spread of the coverage, the Government will prefer to make use of the well established infrastructure of the banking system. It is cheaper, more convenient and reliable than setting up one for this single purpose. The Government simply deposits a certain amount of money with a bank, gives the specifications as to who qualifies etc, and leaves the rest to the bank. The Government does not require any interest on its deposit but the bank must make sure that the original capital remains intact (and is used again and again to give fresh loans) by ensuring proper loan recovery. The bank may also recover from the borrowers all its own processing costs. This arrangement brings about the low-interest on the loan and ensures the continuation of the scheme.

The fact that it is called interest and, more importantly, that it is (seemingly) coming from a bank frightens off Muslims. If we apply our model to this scheme we will see that no *riba* is involved in this loan, since the real lender (the government) does not demand or receive any amount in addition to its capital. What is recovered from the borrower is the operational costs of the bank. In this case too, both the CoB and “interest” are positive and equal but they are not *riba*.

4.3 Non-profit community lending

In addition to the individual person-to-person lending and the philanthropic long-term lending by individuals or Governments as seen above, one could also think of the members of a small community helping each other in a collective manner. Suppose the members of a small community decide to set up a savings and loans society. Members deposit their savings with the society in order that other members who need some loan for a short period could be helped from this fund. This is a mutual fund; a depositor at one time may become a borrower at another time and vice versa. Members are free to withdraw some or all of their deposits if and when they want (or at short notice). No depositor demands or receives any amount in addition to his/her capital. Assume that this society is a non-profit organization, and that the members are known to each other and trustworthy and therefore there is no room for default on loans. Assume also no inflation. In this case all the components of the cost of borrowing, except the services and overheads costs, will be

zero. Even if the operations of the society are run by volunteers, using some free office space, there may still be some costs for stamps, stationery, transport, communication and so on. Who pays these costs? Cannot ask the depositors for it! They already do a favour by making their savings available to the borrowers free of interest. Naturally the borrowers have to pay the costs.

Here too we see that even where the capital is cost-free the loan is not. It is *riba*-free but not cost-free. Again, the model enables us to see the difference clearly. In this case too the CoB and what some might prefer to call “interest” are positive and equal, but they are not *riba*. This should help small communities to set up their own savings and loans societies and serve their members in their needs, with clear conscience about not getting involved in *riba*.

4.4 Bank interests

As we mentioned earlier in this essay, banks pay the depositors interest on their deposits and charge the borrowers interest on their loans. Both are called interest, but they are not equal — the latter is always greater than the former. Let us examine them in turn more closely, using our model of the cost of borrowing and the definition of *riba*. Again, inflation is assumed zero.

4.4.1 Deposit interest

In the first case, depositors are the lenders to the bank and the bank is the borrower. The depositors receive an extra amount from the bank as interest on their capital. According to our definition of *riba*, this is *riba*. Let us call it the deposit interest. This is what the bank pays the depositors to get their funds. Therefore, from the bank’s point of view it is the cost of funds or its CoB. According to our definition of *riba*, this too is *riba*. Hence, in this case, deposit interest, bank’s CoB and *riba* are all the same and equal. As far as Muslims are concerned this falls within the category of the prohibited, and there is no doubt about it.

4.4.2 Loan interest

In the second case, the bank is the lender and its client is the borrower. The bank demands and receives interest from the borrower. Call it the bank’s loan interest. But this “interest” consists of the deposit interest the bank pays the depositors (whose money it lends to its clients), and other components (which are costs incurred by the bank, and the remuneration for its services). The bank collects both the deposit interest and the other components from its borrowers, passes on the former to the depositors, and keeps the rest for itself. While the deposit interest is *riba* the other components have been shown to be no *riba*. According to our model, then, the bank’s loan interest and the borrower’s CoB are both the same and equal. Both of them *contain* the prohibited *riba*, but not all of either is *riba*. Consequently, when deposit interest is zero both of them are free of *riba*, and neither the bank nor the borrower is involved in any *riba* dealing.

Present-day banks’ loan interest might also contain, besides the six components discussed above, an additional component arbitrarily introduced by the bank which will then qualify as *riba*. It may even turn out to be directly proportional to the size and period of the loan. If present this component too should be eliminated to make the transaction truly *riba*-free.

5. Summary and conclusions

In the foregoing paragraphs we looked at a new theory of interest that helped us to understand the meaning of modern bank interests in some detail. This, in turn, helped us to realise that while the bank’s deposit interest is the same as *riba*, its loan interest consisted of both *riba* and the operational costs of the bank. We also used this theory as a tool to examine some lending/borrowing transactions to see if they contained any *riba*. It will also be of use in devising new viable lending systems without becoming involved in *riba*.

A note of caution is necessary at this point. The conclusions about deposit interest and loan interest should not be interpreted to mean that if the bank does not pay any interest to the depositors its loan interest becomes *riba*-free and therefore automatically acceptable, whatever its size. No, for it is subject to an important condition. How each component of the cost of borrowing came into existence was fully explained when formulating the theory and therefore its implementation is

based on the assumption that each component will be separately estimated as explained earlier, and that this will be done transparently. That is, the data necessary for that estimation is routinely collected, the estimated coefficients (this includes the bank's profit/remuneration rate) are made available for public scrutiny (and monitored by the Central Bank), and that each customer is routinely given the value of each component making up his total CoB. Unless this transparency condition is appreciated and strictly adhered to the theory is vulnerable to misunderstanding and misuse.

The transparency condition ensures that the profit rate is known, and any hidden *riba* component is revealed. If a *riba* component is present it will violate the *riba*-free assumption and will be illegal and morally reprehensible. If the profit rate turns out very high (as will be the case if this theory is applied to estimate it using present-day banking data) market forces will step in to correct it, provided there are several independent banks competing in a genuinely free market environment, to the benefit of the borrowers. Thus eliminating another two important aspects of *riba* – exploitation and injustice. The benefits will trickle down to the society through reduced costs, prices and, eventually, help curb inflation. Reduced cost of borrowing will also help on-the-brink enterprises to stand on firmer feet.

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