Avoiding Riba is not rocket science

Since Riba-based transactions are more apparent in the banking sector, in this article, MABROOR MAHMOOD gives some examples of how both the financier and the borrower can avoid such unlawful transactions by bringing some changes to the mechanisms of dealing with each other.

RIBA

By Mabroor Mahmood

In my last two articles published in IFN, I have explained in detail the definition of Riba and texts of various religious scriptures prohibiting Riba, which is a synonym of usury or modern-day 'banking interest'. So in order to conduct a transaction in an ethical manner, it is very important to devise mechanisms that will help us to avoid the presence of Riba. This is applicable not only for Muslims, but for Jews, Christians, Hindus and Buddhists alike. Islamic banking emerged on the basis of this premise. It offers financing modes that are free from Riba, but at the same time, helps concerned parties to generate enough returns to make profits.

As an example, we can start with a typical Riba-based transaction which you can find in any modern conventional commercial bank. Suppose Amir wants to expand his business that needs a total capital of US$500. He already has US$250, but to complete the project, he still needs another US$ 250. So he approaches a conventional bank and requests for a loan of US$250 for five years.

After assessing the proposal, the bank decides to give him a five-year loan of US$250 at a 10% interest rate. After signing the agreement, both parties agreed to exchange US$250 with a higher amount of US dollars in five years' time.

Since this transaction involves exchanging currencies with higher amount of currencies, the transaction involves Riba, and is thus unlawful according to Shariah. Now the question is, how can both the financier (in this case the bank) and the borrower carry out the same transaction without involving Riba?

There are many avenues to make this transaction Riba-free, but the following three are the most popular ones among Islamic bankers:

1. Equity investment

In order to make the transaction Riba-free, the financier might opt to become an investor in the business and invest US$250 to Amir's new business with an agreement that both investors will share profit and loss at a 50:50 ratio. This proposition is a bit risky for the financier because here the financier is not sure that it will be able to recover its total investment of US$250 with sufficient profit in a five-year period.

So the financier can opt for either of the following avenues:

2. Deferred sale

After assessing the business potentials of the new business, the financier finds that Amir is planning to buy a set of equipment with the proposed loan of US$250. So instead of giving Amir a cash loan of US$250, the financier does the following:

(1) The financier enters into an agreement with the equipment supplier to buy the equipment at US$250 under the financier's name.
(2) The financier then sells the equipment to Amir at cost plus profit, which will be paid in equal installments in the next five years. The profit rate can be the same 10% as before.
(3) After negotiating the agreement, the financier pays to the equipment supplier who in turn ships the equipment to Amir, and Amir then starts using the equipment and repays the sale price in installments.

3. Leasing

The same transaction can also be done through leasing, where the financier retains ownership of the equipment throughout the five years, and Amir uses the equipment and gives the financier a lease rental periodically.

This lease rental will include the actual amount paid by the financier plus a profit. The profit rate can be set at the same 10% rate as before. After the tenor of five years is over, the financier then sells the equipment to Amir at a very nominal price.

Although the aforementioned three mechanisms are the most popular

for avoiding Riba in a typical Islamic banking transaction, investment mechanisms involving 'profit and loss sharing' are slowly losing their foothold due to the high-risk nature. Deferred sale (or Murabahah) and leasing (or Ijarah) are more popular financing modes nowadays for making a loan transaction Riba-free.

As you can see in the example, the rate of profit of the financier on a transaction can be the same 10% as that offered by the conventional bank, but still the transaction can be made Riba-free. Here the pricing is not a matter of concern; the main concern is whether you are avoiding the exchange of currencies with higher amount of currencies that involves Riba.

So avoiding Riba is not rocket science, is it?

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

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