

CHAPTER 2

LITERATURE REVIEW

2.1 INTEREST, *RIBA* AND INTEREST-FREE

Some technical Arabic terms will be constantly encountered in the study of Islamic banking and it will be essential to define them and translate them into English terms. For this chapter, the Arabic term *riba* is the most commonly discussed and the definition of it is necessary.

Generally *riba* is translated into English as interest or usury (exorbitant interest) but it has a much broader meaning under the *Shari'ah* as it literally means 'increase in' or 'addition to' anything. In Islam, there is no segregation between interest and usury. There is now general consensus among Muslim scholars and theologians that the term *riba* covers both interest and usury¹.

Technically, interest is what the creditor charges at a fixed rate on the principal that he lends out to the debtor. At the time of the revelation of the *Qur'an*, interest was charged in several ways. For example, a person sold something and fixed a time limit for the payment of its price, and if the buyer failed to pay it within the fixed period, he was allowed more time but had to pay an additional sum. Or a person lent a sum of money and asked the debtor to pay it back together with an agreed additional sum of money within a fixed period. Or a rate of interest was fixed for a specific period and if the principal along with the interest was not paid within that period, the rate of interest was enhanced for the extended period, and so on².

The term *riba* is used in the *Shari'ah* into two senses i.e. *riba al-nasi'ah* and *riba al-fadl*³. This is in accordance with the interpretation of religious scholars toward four verses of the *Qur'an*. The first of these (the *Qur'anic* verse 30:39), revealed

in Mecca, emphasized that while interest deprived of wealth of God's blessings, charity raised it manifold. The second (the *Qur'anic* verse 4:161), in the early Madinah period, severely condemned it, in line with its prohibition in the previous scriptures. It placed those who took *riba* in conjunction with those who wrongfully appropriated other people's property and threatened both with severe punishment from God. Third revelation (the *Qur'anic* verse 3:130-132), around the second or third year after *Hijrah*, enjoined Muslims to keep away from *riba* if they desire their own welfare (in the comprehensive Islamic sense). The fourth revelation (the *Qur'anic* verse 2: 275-281), near the completion of the Prophet's mission, severely censured those who take *riba*, established a clear distinction between trade and *riba*, and required Muslims to annul all outstanding *riba*, instructing them to take only the principal amount, and forego even this in case of the borrowers' hardship.

2.1.1 *Riba Al-Nasi'ah*

Riba al-nasi'ah means to postpone, defer, or wait and refers to the time is allowed for the borrower to repay the loan in return for the 'addition' or the 'premium'⁴. From the economic perspective, *riba* is an excess of income (additional income on top of the principal) that a creditor receives from a debtor as a gift arising from the waiting time or parting from the money for a period of time⁵. Hence *riba al-nasi'ah* refers to the interest on loans.

After studying various forms of business and credit transactions, containing the element of *riba* which were in vogue in Arabia during the time of the Holy Messenger, *riba* may be defined as a predetermined excess or surplus over and above the loan capital received by the creditor conditionally in relation to a specific period. It contains the following three elements:

1. Excess or surplus over and above the loan capital (i.e. principal);
2. Determination of this surplus in relation to time; and

interest is predetermined and certain. The profit may or may not be realized. Hence there can be no doubt that the payment of something definite in return for something uncertain inflicts a harm”⁸.

Accordingly, *riba* is essentially in conflict with the clear Islamic practice on socio-economic justice. Financiers who do not wish to take the risk are entitled to only the principal and no more. Islam abolished the interest-based nature in business activities and reorganized them on a profit and loss sharing basis. The financier receives a just share and the entrepreneur does not receive any unfavorable outcome if his effort turns out to be unfruitful.

The *Qur'an* has delivered a severe verdict against interest because of the importance of establishing an economic system where all forms of exploitation are eliminated. In particular the injustice perpetuated in the form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and entrepreneur.

2.1.2 *Riba Al-Fadl*

Riba al-fadl is defined by the majority of early Islamic jurists as *riba* other than *riba al-nasiah*. *Riba al-fadl* would thus mean any *riba* other than the *riba* recognized during the days of *Jahiliyyah*⁹ - which is described by the well-known maxim, “Give me time and I shall pay you double”, and “any *riba* where the borrower is expected to return to the lender something more than what was originally lent”¹⁰. Under the latter definition, it would include any arrangement whereby the borrower would be expected to pay back in satisfaction something more in quantity than what was originally borrowed, although the thing borrowed may even be different. Thus an arrangement whereby a person borrows 1 lb. of good quality dates on the understanding that he should return to the lender 2 lb.

of inferior quality dates would be *riba al-fadl*. Similarly, an arrangement whereby the borrower of a sum of money would be expected to return to the lender at the end of a few years the original sum advanced plus a small sum in respect of the respite given him for payment of the loan would be *riba al-fadl*. Some jurists hold that this definition of *riba al-fadl* covers all transactions whereby the borrower would be expected to pay back to the lender more than what was borrowed, with the exception of known saying of the Prophet Muhammad (pbuh), viz., dates, wheat, barley, salt, gold and silver:

Abu Said Al-Khudri reported Allah's Messenger (pbuh) as saying, "Gold is to be paid 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. He who made an addition to it, or asked for an addition, in fact dealt in usury. The receiver and the giver are equally guilty."

Sahih Muslim Vol. 3 pp. 833-834

In this sense, all commodities exchanged in the market would be subject to *riba al-fadl*. One would then tend to agree with the jurists who have not confined *riba al-fadl* only to the six commodities mentioned but have tried to extend the coverage on the basis of certain inherent characteristics of these six commodities. The more staple the food item or the greater its need for sustaining life, the greater the injustice inflicted in an unfair exchange. Similarly the greater the capability of a good or service to be weighed or measured, the greater would be the buyer's or seller's exposure to *riba al-fadl* if the just weight or measure is not given in exchange for the money or the countervalue received.

The prohibition of *riba al-fadl* is thus intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to *riba* because, in the *Shari'ah*, anything that serves as a means to the unlawful is also unlawful. The Holy Prophet (pbuh), equated *riba* even with the cheating of

an unsophisticated entrant into the market and the rigging of prices in an auction with the help of agents, implying thereby that the extra money earned through such exploitation and deception is nothing else but *riba al-fadl*.

2.1.3 The Fundamental Differences between Profit and Interest

1. The settlement of profit between the buyer and the seller is made on equal terms. The buyer purchases the article he needs and the seller earns profit for the time, labor and skills he employs in providing that article to the buyers. In contrast to this, in the case of interest, obviously the debtor cannot settle the transaction on equal terms with the creditor because of his weaker position. As far as the money lender is concerned, he gets that fixed sum of interest, which he considers as his profit. If the debtor spends the borrowed money in fulfilling his personal needs, the time factor definitely does not bring any profit at all. And if he invests that money in trade, commerce, industry etc, then there are equal chances of profit or loss. Thus lending money at interest might bring a guaranteed and fixed profit to one party and loss to the other, or a guaranteed and fixed profit to one party and uncertain and indefinite profit to the other.
2. The trader charges his profit, however high it may be, once and for all, but the money lender can continually charge and increase it with the passage of time. The profit, which the debtor makes on the money from the creditors, however, extensive it may be, has after all its own limits, but there is no limit to the interest that the creditor may charge on his money. The creditor may, in actual, receive all the earnings of the debtor, may even deprive him of his means of livelihood or of articles of his personal use but the debtor might still have the same amount of debt against him as at the time of borrowing.

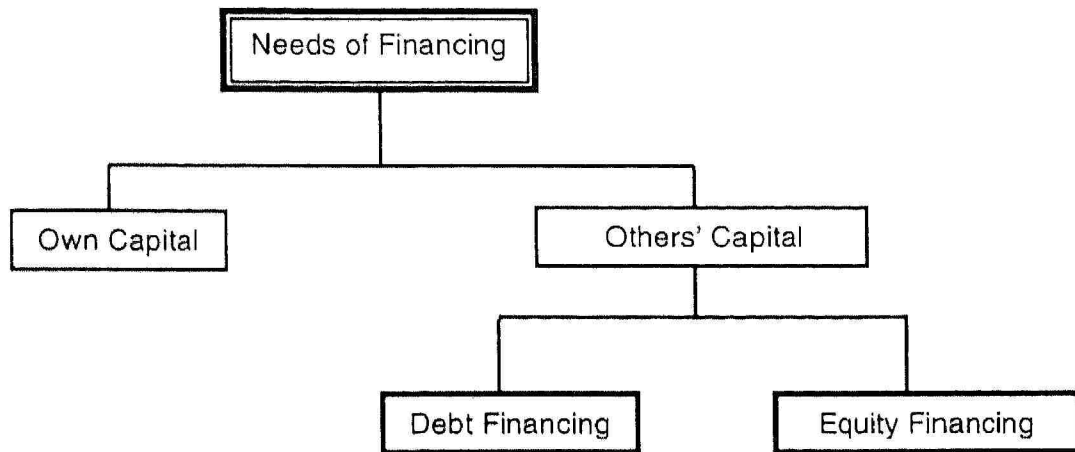
3. The transaction in trade comes to an end as soon as the article and its price change hands. After this the buyer is not required to return anything to the seller. With regards to the rent of furniture, house, land etc, the lent thing is not itself spent up but is returned to the owner after the term. But in the case of the principal the debtor has to spend first and then reproduce it and return it, to the creditor along with the interest. Thus the debtor runs a double risk; he has to reproduce the principal and the additional interest.
4. One engaged in trade, industry, agriculture, etc, earns profit by spending time, labor and skills, but the money lender becomes the stronger party in the earnings of the debtor without any risk or labor on his part simply because he invested the money which is over and above his needs. He is a partner only to the extent that he is entitled to a fixed guaranteed interest, irrespective of whether there is any profit at all or how much there is even a loss¹¹.

2.2 ISLAMIC FINANCING FACILITIES AND LOAN SCHEME

The Islamic financing is becoming one of the main functions in Islamic banks. This activity accounts for 50 percent to 80 percent of the total assets of most of Islamic banks¹². Since Islamic banks are prohibited from making loans with interest, all financing operations are based on principles allowed by *Shari'ah*. *Shari'ah* has laid several financing principles. Some of these principles were prevalent during the early years of Islam and some were developed simultaneously with the emergence of Islamic banking.

As a basic principle in life, people can finance any project or activity in two ways either by using his/her own money/capital or raising capital from other people. It can be illustrated as follows:

Figure 2.1¹³ – Fulfillment of Financing Needs



Based on figure 2.1 above and for the study, the writer will be interested to concentrate on financing raised through others' capital. Loans and financing facilities are common nowadays in economic activities either to finance a big project or to fulfil a need of an individual to buy an appliance. When a person wants to raise money for an economic activity from other people money, he can choose to do it in two ways:

1. Debt financing
2. Equity financing

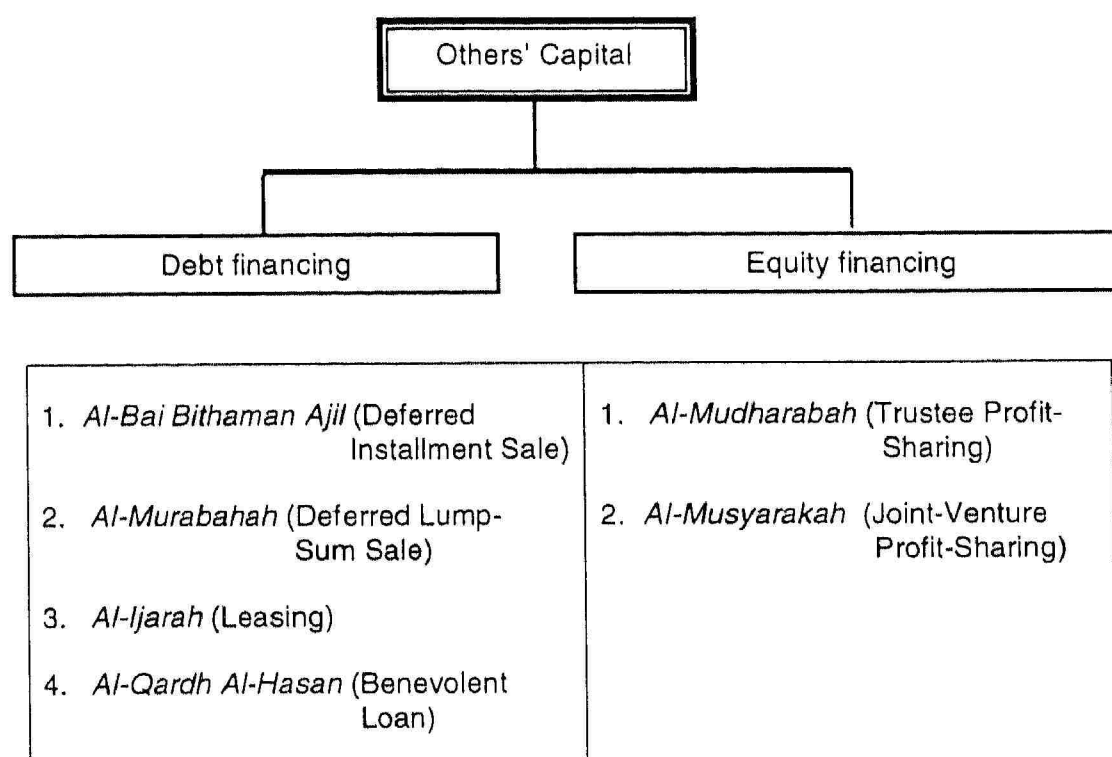
In the case of debt financing, the users of funds are obliged to repay the funds borrowed from the bank. The *Shari'ah* principles which fall within this category include *Al-Bai Bithaman Ajil*, *Al-Murabahah*, *Al-Ijarah* and *Al-Qardh Al-Hasan*.

On the other hand, *Al-Mudharabah* and *Al-Musyarakah* are equity financing. These principles which are known as investment modes of financing do not require the users to repay the total amount of funding. While the debt creating modes involve a debt burden on the users, irrespective of how much they benefit

from the loans, those who enjoy the investment modes are without a debt burden.

Figure 2.2 shows four main concepts of debt financing and two main concepts of equity financing.

Figure 2.2 – Debt Financing and Equity Financing in Islam



The above Islamic principles are briefly explained as follows:

2.2.1 *Al-Mudharabah*

Al-Mudharabah means 'profit-sharing' or 'trust finance' or 'investment through self-employed entrepreneur'. This is basically an agreement between at least two parties, one being a lender or sometimes known as an investor or a banker and an entrepreneur also known as an agent-manager. In the agreement, the bank or the investor agrees to finance or entrust money to the entrepreneur who is to

trade in an agreed manner and then return the bank the principal and pre-agreed proportion of profits and keep the remainder for himself. The distribution of the profit between the two parties must necessarily be on a proportional basis and cannot be a lump sum or a guaranteed amount. In the case of a loss as a result of circumstances beyond the control of the entrepreneur, the bank will bear all financial risks and the entrepreneur's loss will be confined only to the time and his efforts spent.

2.2.2 *Al-Musyarakah*

Al-Musyarakah is normally translated in English as 'partnership'. In the context of Islamic banking, however, *al-musyarakah* means 'participating financing'. Literally, *al-musyarakah* means a joint-venture agreement between two parties to engage in a specific business activity with an aim of making profit. The termination of the agreement may be based on time or after fulfillment of certain conditions. In this principle, both parties will provide the capital and the bank or lender may also participate in the management. As in the case of *al-mudharabah*, all parties agree through negotiation, on the ratio of the distribution of profits generated from the business activity, which need not coincide with the ratio of participation in the financing of the activity. However, in the event of loss, all parties, including the bank, bear the loss in proportion to their share in the financing.

2.2.3 *Al-Bai Bithaman Ajil (BBA)*

Al-Bai Bithaman Ajil means deferred installment sale whereby the bank purchases the items on cash basis and sells such items on deferred payment basis to customers requiring financing. The bank sells the relevant asset to the customer at an agreed price which comprises (1) the actual cost of the asset to the bank and (2) the bank's margin or profit and allows the customer to settle the payment by installments within the period and in the manner so agreed.

Al-Murabahah

Al-Murabahah or 'cost-plus financing' or 'financing resale of goods' refers to the sale of goods at a price covering the purchase price plus a profit agreed upon by both parties concerned. This arrangement transforms a lending activity into sale and purchase agreement, under which the bank sells goods wanted by the customer for resale to the customer at a higher price agreed upon by both parties. In principle, Islamic bank plays the same role as a commercial bank in its business entity i.e. giving services or sale of goods to customers with a view of making profit.

Al-Ijarah

Al-Ijarah is the *Shari'ah's* concept of leasing finance, whereby the bank purchases an asset required by the customer, and then leases the asset to the customer for a fixed period. The lease, rental and other terms and conditions having been agreed upon by both parties.

Al-Qardh Al-Hasan

Al-Qardh Al-Hasan is a benevolent loan that obliges a borrower to repay the lender the principal amount borrowed on maturity of the loan. The borrower however has the discretion to repay the lender for his loan by paying any sum over and above the amount borrowed.

CONVENTIONAL LOAN SCHEMES

The Central Bank is empowered under section 37(1)(b) of the Central Bank of India Act, 1958 to determine the rates of interest payable to or by banks. Since 1978, deposit rates were free from the control of the Central Bank.

For lending rates, the commercial banks began to introduce their own base lending rate (BLR) in 1981, which was a rate based on their cost of fund. In 1983, the BLR system was formally adopted by all banks when the Rules of Association of Banks in Malaysia incorporated a rule requiring commercial banks to tie their lending rates (except loans to special groups or priority sectors) to the BLR¹⁴.

As commercial banks intermediate between investors and savers, the loan rate and deposit rate form the basic interest rate structure of commercial banking and their "spread" determines to a large extent the profit margin of the banks. The loan rate is the agreed minimum rate of interest charged by banks of the Association of Banks in Malaysia (ABM) on loans.

2.3.1 Interest and Its Calculation

Interest is the price paid for the use of money over time. It is usually expressed as a rate charged or earned per period, hence interest rate. In turn, interest rates are typically expressed as a percentage of a principal (initial amount) borrowed or loaned¹⁵. Interest rates can be divided into two categories i.e. simple interest and compound interest:

1. Simple interest

Simple interest is the interest that is paid solely base on the principal. Usually it is charged on short-term loans. The calculation of simple interest is as follow:

$$I = P \times t \times r$$

where

I Interest (RM)

P Principal (RM)

r Interest rate the bank pays on the account per year

t Time period involved

(r and t must be consistent, if r is calculated on yearly basis then t must follow the same way)

Example:

Company A has borrowed RM20,000.00 from Bank X for the period of 5 years with 10% interest rate per annum. Interest that Company A must pay to Bank X is as below:

$$\begin{aligned} I &= P \times t \times r \\ I &= 20,000.00 \times 5 \times 10\% \\ I &= \text{RM } 10,000.00 \end{aligned}$$

2. Compound interest

Compound interest is related to interest on interest. It means that any given principal and interest rate will result in larger sums, the more frequent and prolonged the compounding is. To illustrate the compound interest, let's take the above example:

$$\begin{aligned} I &= P (1 + r)^t - P \\ I &= 20,000.00 (1 + 10\%)^5 - P \\ I &= 20,000.00 (1.1)^5 - P \\ I &= 20,000.00 (1.61051) - 20,000.00 \\ I &= 32,210.20 - 20,000.00 \\ I &= \text{RM}12,210.20 \end{aligned}$$

where

I Interest (RM)
P Principal (RM)
r Interest rate the bank pays on the account per year
t Time period involved

(r and t must be consistent, if r is calculated on yearly basis then t must follow the same way)

illustrated above, it can be seen that compound interest results in more interest than simple interest and the difference is RM2,210.20. This happens because compound interest takes the interest earned during the first year as part of the loan for the calculation of the second year's interest. The usage of compound interest has been considered as practical applications in conventional banking system throughout the world including Malaysia.

2 Types of Loans and Advances in Conventional Banks

Banks offers many kinds of loans and advances to customers in order to fulfil their needs. The loans and advances can be categorized into two types i.e. long-term and short-term depending on their features and characteristics. For the purpose of this study, only related loans and advances would be briefly incorporated in order to narrow down the scope of the discussion. The common types are as discussed below:

1. Overdraft (O/D)

A customer can open a current account and he may arrange with his banker to permit him to overdraw his account. The amount overdrawn is known as an overdraft. In this particular case, if it is a temporary overdraft the customer is required to settle the outstanding debt within a few days. However overdrafts are given for many purposes such as short term financing for working capital for a business entity and for private investment for individuals.

Bank customers are given a limit where the customers may use the funds available up to the said limit. Whenever the customers have surplus funds, they

may pay into their current account to reduce or even settle the overdraft balance. As far as the interest is concerned, the bank would calculate the interest amount daily. It is accrued daily and debited to the account on the last day of the month. Interest is only charged (accrued) if the account is overdrawn. If on any particular day or days, the account shows a credit balance or balances, no interest is applicable for those particular day or days.

Interest is calculated based on the simple interest formula:

$$I = (P \times t \times r) / 100 \times (1/365)$$

where

I	Interest
P	Amount overdrawn at the end of the day
t	Number of days
r	Interest rate agreed upon

2. Housing Loan

Banks provide loans for customers to purchase houses. Housing loan is a loan given to a purchaser in order to enable him/her to meet the full purchase price of a house for his/her own residence. The loan is secured against a first legal charge on the property purchased.

A housing loan is basically a term loan (or fixed loan as it is known) on a long term basis, ranging from ten years to as long as thirty years depending upon the actual requirements and age of the applicant, and is repayable by monthly installments.

3. Term Loan (Fixed Loan)

A term loan is generally required for a commercial purpose, for example, to meet the purchase price of a commercial building, shophouse or even a factory building. A term loan is an advance granted for a fixed period. The loan may be disbursed in a lump sum or disbursements may be made progressively, for example to meet the progressive payments on a shophouse. For a business, a term loan is generally required for financing productive investments, such as plant and machinery, factory land, a shophouse and other fixed assets. Repayment is by monthly installments spread over a number of years,

4. Personal Loan

An individual may occasionally have short-term personal financial difficulties or may have to further his/her study but does not have ready cash. A personal loan can be used to solve the problem. Personal loan is a short-term loan, granted to a person, repayable by monthly installment over a few years period, normally between two to five years.

2.4 SUMMARY

In the first part of the chapter, the writer discussed the concepts of interest, *riba* and profit. The second chapter, the writer went on elaborating about Islamic financing. Finally, the conventional loan scheme was discussed.

Based on these three discussions, it can be seen that the concepts used under the two systems are significantly different. In the Islamic banking system, the concepts used, are based on trading i.e. buying and selling. Based on the Islamic concepts that have been discussed, the Islamic banking system stresses more on giving financing facilities rather than loan schemes.

However, under the conventional banking system, the concept used, is mainly based on the loan concept, which involves interest. In Islam, the loan concept is specifically meant to fulfil social responsibilities and less emphasis is given for commercial purposes. When a loan is given for a certain period of time, only the principal amount needs to be paid back to the lender. If there is a pre-condition to pay more on top of the principal amount, this constitutes interest or *riba* which, is prohibited in Islam. However, the above loan concept is the most important practice under the conventional banking system.