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Principles of Islamic Finance: Prohibition of Riba, Gharar and Maysir

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Abstract

Islamic finance, a complete rule based financial system, fundamentals of which are originated from revealed verses of the Holy Quran considered direct ordinance from the God and the practices of Prophet Muhammad (PBUH) commonly known as ahadith. Although the concept of Islamic finance is as old as the religion itself but in the Middle Ages Muslims diverted from the original teachings of Islam, only recently Islamic finance has started to reemerge. Therefore, it is necessary to understand the fundamental rules that make Islamic finance different from its counterpart. In this paper an attempt has been made to discuss briefly fundamental principles of Islamic finance namely prohibition of Riba (interest), Gharar(uncertainty) and Maysir (gambling). It is found in the study that these principles are based on the fundamental sources and early Islamic jurists, scholars and contemporary researchers uphold them in carrying out financial transactions. In order to run financial system according to the Islamic principles these concepts must be understood clearly and all transactions must be free from them.

Key words: Islamic finance, Riba, Gharar, Maysir

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Introduction:

Prohibition of Riba, Gharar and Maysir in financial transactions is the fundamental of Islamic finance which distinguishes it from conventional finance. These unique features of Islamic finance are going to be discussed from the Shari'ah, Quran and Sunnah, perspective; a brief literature review has been conducted to clarify these concepts, current practices and controversial issues in not only conventional but also Islamic finance industry.

Riba:

Riba is derived from the derivative word "raba-wa" it has certain meanings as "to increase; to grow; to grow up, to exceed, be more than. In the specific sense, Riba is generally translated into English as usury or interest but in fact it has a much broader sense under Shari'ah (Haqqi, 2009; p.123-124).

Usurious transactions were classified into two categories: a) Riba al-fadl, the excess over and above the loan paid in kind. It lies in the payment of an addition by the debtor to the creditor in exchange of commodities of the same kind and b) Riba al-nasi'ah, refers to the interest on loans; its prohibition essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted in Islam. Haqqi(2009) states that some scholars added a third category of Riba named Riba al-jahiliyah or pre-islamic Riba, often manifested by the lender asking the borrower at maturity date if he will settle the debt or increase it.

On Riba, the direct Quranic references are to be found in four surahs or chapters. These verse are an ascending scale which starts with a mere judgment of value, followed by an implicit prohibition, then a limited one and finally, a total and conclusive prohibition (Al-Rum, 30:39; Al-Nisa, 4:161; Ali-Imran, 3:130 and Al-Bakarah, 2:275-9). Moreover, the detailed varieties of usurious transactions as well as such prohibition have explained and elaborated by the Sunnah. For example, the Messenger of Allah (s.a.w.) has cursed the one who accepted Riba, the one who paid it, the one who recorded it, and the two witness of it, saying they were all alike.² It is also reported that the Prophet (s.a.w.) has said to the effect:

"(Exchange) gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, measure for measure and hand to hand. If the (exchanged) articles belong to different genera, the exchange is without restraint provided it takes place in a hand to hand transaction."³

It is more than evident from the above discussion that Riba i.e., interest in the modern world is categorically prohibited in the Holy Quran and practices of the Prophet (s.a.w.).

Riba arises with loan: car loan, home loan, term loan or overdraft, hire purchase loan and personal loan; Riba in savings and fixed deposit account; Riba in credit card. More often than not Riba is intertwined with modern banking and finance.

² Muslim, Sahih, vol. III, p.1218, hadith no. 1597; al-Bukhari, Muhammad ibn Ismail, (1407/1987), 1st ed., vol. III – al-Shaikh Qasim al-Rifai(edt), Beirut: Dar al-Qalam, pp. 128-9, hadith no.337

³ Muslim, Shahih, vol. III, p.1211

Gharar:

The Arabic word Gharar is a fairly broad concept that literally means deceit, risk, fraud, uncertainty or hazard that might lead to destruction or loss. Hanafi scholars have defined Gharar as “something which its consequence is undetermined.” While Shafi’i scholars have described it as “something which in its manner and its consequence is hidden. According to Al-Sarakshi, “anything that the end result is hidden or the risk is equally uncommon, whether it exists or not.” Therefore, Gharar in Islam refers to any transaction of probable objects whose existence or description are not certain, due to lack of information and knowledge of the ultimate outcome of the contract or the nature and quality of the subject matter of it.

Gharar is divided into two types: Gharar fahish (excess Gharar) and Gharar yasir (light Gharar). Examples of Gharar fahish in contracts are plenty as shown by the Al-Hadith and normally is associated with the reasons why Gharar sales are prohibited. On the other hand, Gharar yasir, which means small in amount or trivial is the uncertainty that is always present in all contracts and conducts, thus its existence is tolerated. All scholars agree that every transaction have some amount of Gharar in it but they start to differ when referring to the amount of Gharar contained in each.

There is no specific evidence from the Quran which connotes Gharar, however, Allah (s.w.t) mention “Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you by mutual consent (Al-Bakarah, 2:188; Al-Nisa, 4:29). The Quran has categorically prohibited gambling (Al-Bakarah, 2:219 and Al-Maidah, 5:93). Many scholars argue that Gharar is one of the branches of gambling (Rahman, 2010; p.71). In addition to that tradition of our beloved Prophet (s.a.w.) on many occasions forbade many transactions which included Gharar. For example, the Prophet (s.a.w.) has forbidden the purchase of the unborn animal in the mother’s womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.

Gharar occurs in all sorts of transactions where the subject matter, the price or the two, are not determined and fixed in advance. Speculative activities in capital market, derivatives instruments and short-selling contracts are bright examples of Gharar in modern finance.

Moreover, Gharar in practice relates potentially to issues such as pricing, delivery, quantity and quality of assets that are transactional-based and would affect the degree or quality of consent of the parties to a contract. For example, one cannot buy an ‘option’ at a certain price to have the right to purchase its underlying shares, as an ‘option’ is not ascertainable and is thus uncertain. An option is just a right. It is not an asset whose specifications are clear and attainable. In conventional insurance, the premium paid by policyholders and the indemnity provided by the insurer upon a claim are equally uncertain, thus making conventional insurance non-compliant from an Islamic legal perspective.

Maysir:

Maysir, literally means gambling. Islam has also categorically prohibited all forms of gambling. Maysir refers to the easy acquisition of wealth by chance, whether or not it deprives the other's right. Hameed (2009, p.44) defines Maysir as gambling, also, any form of business activity where monetary gains are derived from mere chance, speculation or conjecture.

As noted earlier in the Quran, Allah (s.w.t) clearly prohibit gambling (Al-Bakarah, 2:219 and Al-Maidah, 5:93). For example, uncertainty of the timing of benefits of a pure life insurance contract creates an element of Maysir. Casinos are also common example of Maysir, where simply transfer of wealth take place from losers to winner without creating a new stock of wealth. In brief, contracts involving pure speculation, conventional insurance and derivatives are examples of Maysir.

In the following section a brief review of the current literature on Riba, Gharar and Maysir and various controversies related with current practices in Islamic finance industry will be discussed.

Literature Review on Riba, Gharar and Maysir and Debatable Issues:

The principle of prohibition of Riba differentiates between Islamic and conventional financial institutions and association with Islamic finance indicates religious identity (El-Gamal, 2007). While defining Riba, El-Gamal(2006) argues that Riba has no precise translation in English dictionary and criticizes those who misinterpret it simply as excessive or usurious payment of interest. He further argues that prohibition of Riba should be interpreted as an institution for improving economic efficiency and social justice. For example, requiring contracts to clearly specify fluctuating equity stakes (i.e., marking asset values to current market prices), without using conventional credit and interest rate financing, may help avoid counter-party risk and save costs of contract enforcement in the event of bankruptcy. Similarly, prohibition of Riba can be interpreted as incentivizing myopic decision makers to use mutually owned profit/loss sharing as a commitment device that helps avoid temptation and produces greater accumulations of capital, anticipating by centuries the literature in behavioral economics on dynamic inconsistency.

Aziz and Fatima (2012) argue that term Riba indicates that particular increment in capital is due to capital or wealth. However, it is a common misconception that, the Quran has prohibited a specific type of Riba which prevailing at that time in the Arabia but the actual fact is that, the Quran prohibited reward of capital with taking due risk and allowed reward of human labour i.e., al-bay.

While comparing Islamic and conventional accounting Velayutham (2014) confirms that the Islamic principle that has had the greatest impact on Islamic economics is the prohibition on the payment of interest (*Riba*), sale of risky assets (*Gharar*) and gambling or speculation (*Maysir*).

While discussing risk sharing and risk shifting from historical prospect Murat Çizakça (2014) argues that iltizam, tax farming, contained elements of Gharar; Gharar is a level of unshared uncertainty that Islamic law prohibits. What makes Gharar illegal is not only the level of uncertainty but also the fact that risk is not shared among the contracting parties. At the same time, Esham, early Islamic bond, was considered

nonusurious as redemption was at the discretion of the state, i.e., the state, paid back the principal at its convenience. There was no pre-fixed and obligatory date of redemption.

Ahmad and Marhaini (2008) study issues of Gharar in insurance and conclude that conventional insurance does carry excessive Gharar. They argue that in conventional insurance subject matters exchange in the contract are between money and money which is a kind of buying and selling contract thus making the contract exposed to conditions or requirements of reasonable knowledge in the subject matters' quantum as well as the ability to deliver them. Moreover, the uncertainty comes in the form of pure risk which is implicated with fear of risk, for example the death of the policy holder or the incident insured is not vague and is identified before the commencement of a policy (Billah, 2001).

Ahmed and Aleshaikh (2014) state that as the substance of *tawarruq* resembles that of an interest-based loan, there is a debate on its permissibility from a Shari'ah perspective. They further argue that the current rulings concur with the majority view of the past scholars. The practice of organized *tawarruq* by the Islamic financial industry, however, appears to be inconsistent with both the contemporary and historical rulings.

By studying Islamic banks in Malaysia, Chong and Liu (2009) argue that theoretically Islamic banking is different from conventional banking as interest (Riba) is prohibited in Islam, i.e., banks are not allowed to offer a fixed rate of return on deposits and are not allowed to charge interest on loans. They argue that only a negligible portion of Islamic bank financing is strictly Profit and Loss Sharing based and that Islamic deposits are not interest-free, but are closely pegged to conventional deposits.

They further state that Gharar is not permitted in Islamic contracting i.e., the terms of the contract should be well defined and without ambiguity. The prohibition of Gharar is designed to prevent the weak from being exploited and, thus, a zero-sum game in which one gains at the expense of another is not sanctioned. Gambling and derivatives such as futures and options, therefore, are considered un-Islamic because of the prohibition of Gharar. Most of the contemporary scholars are against forwards, futures and options contracts because these are almost always settled in price differences only. Therefore, these are used more as tools of gambling than as tools of risk management. Although exist little settlement risk in both forwards and futures but it is significant only in forwards (Obaidullah, 2005, p.34). In addition to that, Razali argues that there is element of Gharar in Bay al Inah and Bay al Dayn contracts. It is due to the fact that intention of the transaction is to create cash not true sale but supported by Shafi school and widely practiced in Malaysia but started to phase out with *tawarruq* (tri-party sale) which is not beyond criticism as most of the cases third party is mere observer while it is a legal trick (*hiyal*) to bypass Riba. Many scholars highly criticized *tawarruq* practice as well.

On the other hand, Nordin et al. (2014) argue that even though Muslim scholars differ on the permissibility of forward contract because of Gharar, the value of the contract is derived from the values of underlying assets such as commodities, equities and currencies. They further argue that not all contracts containing the element of Gharar void the contract. By analyzing crude palm oil forward contracts in Malaysia, they conclude that the issue of Gharar that exists in forward contracts does not void the contracts.

Hearn et al. (2012) assert that financial markets arbitrageurs often use short sales, that is borrow stock in order to execute a trading strategy and make a profit. Often their actions are speculative and used to exploit differences in price, thus increasing information efficiencies and reducing overall transactions costs. However, in an Islamic market short-selling is considered to be unacceptable as is gambling and speculation (El-Din & El-Din, 2002).

Conclusion:

The understanding of Islamic finance principles has gained importance since the Islamic finance industry has been growing rapidly for the last two decades, more specifically, Islamic banking has emerged as viable alternative of conventional banking in many Muslim and non-Muslim countries. As this is a rule based financial system, one must understand clearly what the fundamental rules are and how it is different from others. Riba, Gharar and Maysir are the three most important principles according to the revealed texts and practices of the Prophet Muhammad (PBUH) and financial transactions must be free from these three elements otherwise transactions would be void. In addition to that, literature shows that early Islamic jurists, scholars and contemporary researchers uphold them in Islamic financial transactions. In conclusion, we can argue that Islamic financial transactions must be free from Riba, Gharar and Maysir, this is not only due to inherent injustice in this mechanisms but also they create social harm in the form of inflation, unemployment, volatility, instability, and environmental degradation (Camille Paldi, 2014). It would be interesting to further investigate how prohibitions of these relate to real economic activity, equitable distribution of wealth, and financial stability.

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