

## FATAWA ON PROJECT EVALUATION

SUBJECT: Using interest rate as a discount factor in calculations

From: dialogue@islam-online.net

Date: 3/2/2001

**Name of Questioner** Muzna

**Gender** Female

**Age** 31-45

**Education** Post Graduate

**Date Submitted** 2/7/2001

**Email**

**User Ref. No.** BSV7LE

### **Question:**

I am an actuary by profession and engaged in calculating pension and carrying out valuation regarding pension funds. These actuarial valuations are used primarily to arrive at a sustainable contribution rate for the Pension Fund. These pension funds are invested in whatever investments available in the market. The main assumption involved in these calculations is the discount factor or the interest assumption close to the rate of return on the investments. My question is although I do not engage into interest based transactions for myself but my work at times involves such calculations which are based on the interest assumptions and discount factors also at times I have to ascertain the market value of assets of the pension fund which again involves calculations based on interest. Sometimes I doubt that whatever I do is wrong according to Islam since I am an indirect witness of interest if that is the case then all pension earnings and all allowances from social security would also be Un-Islamic. Kindly comment and advise

My Answer:

Dear Sr. Muzna

Assalamu Alaykum wa Rahmatullahi wa Barakatuh.

Al Hamdu li Allah wa al Salatu wa al Salam ala Rasuli Allah.

Using a discount rate for actuarial evaluation, for Project evaluation, for evaluating present value of a future asset or vice versa, and for estimating expected profit is all permissible as long as there is contract between two persons or more that involves a lending transaction with an increment at the time of repayment. This is a calculation in the mind, an abstraction. Riba exists only in exchange contracts between two different legal entities or natural persons.

On the other hand, discounting a commercial paper is a contract between persons; one of them advances an amount of money to the other and takes in exchange the ownership of a debt of larger amount and a future maturity date, as represented in the paper. This is not permissible because the difference between the two amounts is pure Riba.

In Islamic banks, because there are only few within interest-ridden economies we always determine the markup in Murabahah (deferred-payments) Sale Contracts with reference to the prevailing interest rate, and on the international level the mostly used reference is the LIBOR (London Inter Banks Official Rate). It is also permissible to make the calculation that way as long as the contract gives only one price for a sale that is due for payment at a given future date.

WA Allahu A'lam  
Wassalam  
Sincerely,  
Dr. Monzer Kahf

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SUBJECT: Student loans with interest linked to inflation

From: dialogue@islam-online.net

Date: 3/13/2001

**Name of Questioner** Rani

**Gender** Male

**Age** 21-30

**Education** Post Graduate

**Date Submitted** 1/27/2001

**Email**

**country of Origin** United Kingdom

**User Ref. No.** C32DBB

**country of Res.**

**Question:**

Assalamu Alaikum. An issue has risen in regards to the position of Islam regarding student loans which have an Interest linked to inflation. So what is the Shari'ah position regarding this type of interest? (See notes)

**Notes:** The rate of interest charged on loan balance will be equivalent to the rate of inflation. This will mean that what you repay will be no more, in real terms, than the amount you borrowed. The rate of inflation is measured according to the Retail Prices Index (RPI), which varies from time to time. The rate will be set out in the regulations each year. From 1st September it 2000 will be 2.6%. In other terms it is like giving you a loan to what is equivalent to 2g of Gold and I tell you repay me after 1 year the money which is equivalent to 2g of Gold. So if the gold becomes more expensive you end up paying me more than you borrowed.

My Answer:

Dear Br. Rani

Assalamu Alaykum wa Rahmatullahi wa Barakatuh.

Al Hamdu li Allah wa al Salatu wa al Salam ala Rasuli Allah.

In lending the Shari'ah requires that a loan become due in the same currency by which it was given. At the time of payment it may be paid in any other currency, as long as it is paid at the exchange rate of the day of payment. Y cannot change what is due on a person, and any increment in what is due on a person is Riba.

This was easy to apply when gold and silver were the bases of all currencies. The problem started when cheating in the percentage of pure silver in currencies began. Then you had the same Dirham, but not the same quantity of silver in it.

Then we got the paper currencies whose value (purchasing power) varies with changes in many variables the two parties to a loan contract usually don't have any control over.

What do we do? We have to distinguish between two cases, high or big difference in the value of currency between the date the loan is given and date it is paid, and small difference. Small changes in the value of money are usually tolerated by people as we notice that they continue keeping cash and checking accounts when the inflation rate is small.

in Case of small difference in the value of money, the great majority of Muslim Scholars emphasize the principle that if a loan is paid in the same currency, it must be the same

number of units regardless of the change in prices, We must notice that even gold and silver, when they were currencies, had also small changes in their prices from time to time. Any increment in this case is Riba, forbidden.

In case of big differences in the value of money between the day a loan is given and the day it is paid back, We have three opinions: 1) the main stream, you may also say Majority, Same principle applies, Yet any substantial injustice to either party in a loan must be cured, through certain compromises, even if such compromises are imposed by the government, but injustices must be treated on a case by case basis because it is not always the same way or in the same direction and part of it is of the kind of normal expected and unexpected risk people usually undertake. This group object to any general measure, like indexation of loans and banks checking accounts, they argue that at time of high inflation riba minded people love indexation because the real rate of interest is sometimes negative, i.e., inflation is more than nominal interest rate. 2) some argue that unless the currencies canceled absolutely, payment of loans must be in accordance with number of units only regardless of value. 3) and some argue for general indexation.

Come now to the specific question, Increments in a student loan that charges an interest rate equal to the rate of inflation are a form of Riba. It is covered by the definition of Riba as Duyun as: any conditioned increment in a loan. Yet one may argue that while Riba is a price of Money through time, The compensation of inflation is not a price of money, it is rather a cost of lending.

The OIC Fiqh Academy, in five of its annual meeting, including the late one in Sept. 2000, could not solve this controversy, and I don't think is going to. I think it is a Riba, but lighter to tolerate than normal increment, that are not tied to inflation.

By the way, the example you mentioned of giving a loan the equivalent value of 2 ounces and getting back later the value of 2 ounces is not permissible. Shari'ah does not go by such assumptions. If you give dollars, by count, in a loan you just gave dollars and you only get back dollars, if you give gold, by weight, you get back gold too. You may not assume those equivalents why escaping the true, the fact, the real and go to "imagination."

Wa Allahu A'lam  
Wassalam  
Sincerely,  
Dr. Monzer Kahf

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