Interest - “Loan Cost” or “Sin”?

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**ARTICLE INFO**

**ABSTRACT**

Interest has appeared from the need to borrow agricultural products. Over time, it has been the subject for many theories - for interest, and against interest- all of them having various reasons. Church has, in general, forbidden interest, but the economic reasons have won, considering fair to reward the creditor for the time passed from the moment of loaning, for the monetary devaluation because of inflation, and for the reason that money is a good which must produce profit. Nowadays, the interest rate and the way how it modifies the report between demand and supply, is a very debated subject. The interest rate is an instrument in the hand of Governments and International Financial Organisms, and interest is used in the conventional banks from the entire world. But, in the system of Islamic Economy, interest is considered "a sin", and the appearance of Islamic Banks is a proof for the efforts to introduce in the banking system of Muslim countries, a modality of financing which respects, from the religious point of view, what is allowed and what is forbidden.

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1. Introduction

The term of “interest” is a part of our daily life. We are paying interest, without asking ourselves if it’s correct or if it’s moral. Because of the fact that the need of borrowed sources is bigger and bigger, interest is always present in the financial activity of companies, and the costs of borrowing are systematically charging their expenses. This is the situation in the capitalist economic systems.

But, there are also economic systems where the moral aspect of using interest is very disputed, and interest is considered a forbidden thing.

2. History of interest

Loans are used in the Middle East since 5000 B.C., having as object seeds and animals, which were given back in a bigger quantity or number.

The Eshnunna laws from the IIrd millennium B.C., inscribed on cuneiform tablets discovered in Baghdad, introduced the rate of interest, fact possible because of using silver coins in transactions with grain and livestock. But later, the religious councils have forbidden the use of interest. The opposition of Catholic Church became bigger in the Scholastic period, when, Toma d’Aquino, a Dominican friar from XIII century, explained that, using interest is wrong, because this one represented “a double charging”.

Loaning in the Middle Age economy was a justified act because of bad harvests or fires, and in these conditions, the interest charging was immoral, especially because of the fact that, loaning wasn’t a productive activity, like farming, for example. Because of the same reason, interest was considered a bad thing also in the Islamic world, where the Qur’an has explicit forbidden the use of interest.

As a result, many Middle Age jurists have invented financial instruments which encouraged loans, without using interest.

In the Renaissance period, the increase of people movements permitted the development of trade and business setting up. Because of the fact that loans weren’t used only for consumption, but also for production, the point of view about interest has changed.

In this respect, the school of Salamanca, formed by Spanish and Portuguese theologians, provided reasons for using interest, which would has been considered:

- A “premium” paid in order to cover the risk of the creditor.
- An opportunity cost, because the creditor, by loaning money, lost the possibility to use it in other purposes.

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An other reason was that, money was considered goods which had to provide profit. There were scientists who have taken into consideration “the time”, like the Spanish theologian Martin de Azpilcueta, an early economist from the XVI century who developed for the first time the monetarist theory.

From their point of view, interest was the payment for the time when the creditor couldn’t use his money.

The French Central Bank, tried to control the interest rate, for the first time, in 1847, and the first studies about the interest rate and its impact on the society were made by Adam Smith, Jeremy Bentham and Mirabeau (representatives for the classic economic thought).

At the end of XIX century, the work “Interest and Prices” written by the Swedish Kunt Wicksell, contained the explanation for the theory of the economic crises, based on differences between the nominal rate and the real rate of interest. The idea is also analyzed by Irving Fisher at the begging of XX century.

In the second half of XX century, the increase of Islamic Banks started a movement based on applying religious laws in the banking system. There are many Muslim countries which make efforts to erase interest from their financial system, by introducing modalities of financing based on partnership and commercial transactions with their clients, sharing profit and loss with them, because, according to the Islamic law, every financial transaction must be based on assets and the loan service must be without interest. Their religion forbids the interest use and making profit in the change of money.

3. Interest in the conventional conception

Over the time, many definitions were made for interest;

♦ The amount which the debtor pays to his creditor, for the loan.
♦ The price which must be paid for borrowing and using money, for a period.
♦ The cost for using capital.
♦ The profit of the capital owner, as a reward for yelling the use right of money, for a certain period.
♦ A feature of loan, the price of the capital used, or the “rent” paid by the debtor for the right to use the capital.
♦ A form of loan payment, made by the debtor, for using the capital.
♦ The “price” of loan.

The theories concerning interest are built on three directions: (Dardac, Barbu, 2012)

♦ The classic concept (David Ricardo, Alfred Marshall) - analyses interest depending on the profit rate which can be obtain by using capital, or as a price which must be paid for using capital, fixed as balance price between demand and capital supply on the market.
♦ The neoclassic concept (Irving Fisher) - defines interest as the price of money in the present, expressed by the money of “tomorrow”.
♦ The keynesist concept - defines interest as a “reward” for renouncing at money for a certain period.

For companies, the source of interest is the financial results, obtained by investing the capital borrowed, in economic activities, and for population - its own incomes.

Nowadays, the concept of interest has an operational character, given by its various forms:

♦ Interest on monetary market, used for loans between commercial banks, or between these ones and the Central Bank.
♦ Interest for loans given to companies and population
♦ Interest used as discount tax (commercial tax)
♦ Interest for bank deposits
♦ Interest for the bonds market

The conventional banks can be debtors or creditors in the relation with their clients. That means they must pay interest to their clients for the deposit funds, or they must encash loan interest from their clients.

In the first case the bank pays a passive interest, which can be:

♦ Simple, calculated at the initial funds
♦ Accumulated, calculated at the sum between the initial fund and the previous interest.

The passive interest depends on: inflation, refinancing rate, rates used by other commercial banks.

In the second case, the bank enchases an active interest, which can be:

♦ Fixed unchanged during the contract period
♦ Variable, which changes during the contract period, depending on monetary indicators (ROBOR, EURIBOR etc.).

Using the fixed and variable interest, it’s the effect of inflation.

In general, the interest paid by the bank is smaller than the enchased interest.

When calculated interest, it’s used its relative form – the rate of interest – which is an instrument of influencing the demand and loan supply, because:

♦ A small level of interest rate causes an increase of loans demand and, a positive effect on the production and economy;
♦ A high level of interest rate (a big loan cost) causes the decrease of loans demand.
Otherwise, the keynesist concept defines the rate of interest as an instrument of influencing the volume of investments and eradicating the recession and unemployment. (Dardac, Barbu, 2012)

The rate of interest is a market phenomenon – the price paid for disposing of 100 monetary unities during one year, and is calculated as a percentage rapport between the annual interest and the loan.

The rate of interest is one of the most monitored variables in the economy, because its variations influence the daily activity and have important effects on the economic increase. (Boitan, 2011)

Interest depends proportionally on loan, period and interest rate.

This one is established depending on demand and loan supply and, because of inflation, it is recurrently calculated, having a variable character.

By this way, the creditor protects himself against the loss which he could have using a fixed interest.

For short periods (less one year) there is simple interest, and for longer periods (more one year) there is composed interest (interest is capitalized).

Being variable in time, the rate of interest is changing between a minimum and a maximum limit, depending on many objective and subjective factors, on short, medium and long term. (Bistriceanu, 2011)

On long term, the factors are: for decrease (increase of goods supply; promotion of measures against inflation; increase of self-financing for companies) and for increase (increase of costs for banking services, increase of investments, social conflicts).

On short term, the factors are: inflation, period and loan destination, the rapport between demand and capital supply, creditor risk, profit rate, economic policy of the period.

- Profit rate – interest rate must be smaller than this one, otherwise, companies will not ask loans, because they would spend their entire profit in paying interest, making unprofitable their activity.
- Demand and capital supply – the increase of demand causes the increase of interest rate, and the reverse (when demand and supply are equal, there is a balance interest)
- Risk of creditors – if the debtors has a big possibility to pay back the loan, the risk of creditor is small, the rate of interest is small too, and the reverse.
- Inflation – causes the increase of interest rate to cover the monetary devaluation but, it can cause also the increase of capital supply, and the decrease of interest rate.

Depending on inflation, we are talking about a nominal rate (mentioned in the loan contract), and a real rate. The interest rate must be bigger than the inflation rate (nominal rate = real rate + inflation rate). The must correct measure of loans cost is given by the real interest rate, calculated depending on nominal rate, minus the estimated inflation rate. (Bistriceanu, 2011)

The level for real interest depends on: fiscal pressure, budgetary deficit, currency, commercial balance, payments balance etc.

If the interest rate is bigger than the inflation rate, real interest is positive, that means, the monetary devaluation is recovered and the bank obtains also a sum representing real interest (much more smaller than nominal interest). There could be also negative effects, like: expensive loans and unprofitable investments.

If the interest rate is smaller than the inflation rate, real interest negative, that means, the bank doesn’t obtain profit by loaning, but a big loss, because of monetary devaluation. This is a good situation for debtors, but the trust of population in the national currency decreases.

A strong increase of the interest rate can be stopped by calculating a maximum limit for it, which will cause the decrease of loan supply and the increase of capital demand.

The investments will be stimulated, and also the activity for medium and small producers. (Boitan, 2011)

4. Interest in the Islamic conception (Riba)

Islamic Economy is based on Şaria, the Islamic law, which, by its rules, stops the injustice in obtaining and distributing material resources, in order to offer satisfaction to the people and to allow them to accomplish their duties for God and society.

Şaria is based on two sources: Qur’an (the holy book of Islam) and Sunna (the example of Prophet Muhammad’s life, which means, all that he has done, said or allowed, 1400 years ago).

In the Islamic Economy, what is allowed and what is forbidden don’t change depending on situation, like in the other conventional economic systems. (Al-Quaradawy, 1997)

A special feature of this economy is the interdiction of interest, which it’s considering to cause negative economic effects on long term.

Interest (Riba) is a very actual and debated subject, being compared with usury, that means the “premium” which must be paid by the debtor to his creditor, over the loan, as a condition of loaning. Interest doesn’t result from an increase of work or goods; it is obtained without any effort or risk by the creditor (in the financial system, it is named Riba al-Nasiah) (Chapra, 2006)

Also, in the Islamic conception, interest is considered an undeserved surplus which is paid in the same time with the loan and – no matter its level and the intention for using it, interest is forbidden (haram).

According to Sunna, between those who pay Riba and those who receive it, the blame is shared, because all of them help to spread it.
Interest is tied on "time" factor, because the loan is given for a period of time and it is paid by the debtor to the creditor, in change of this one waiting.

Moreover, its rate is established in the moment of loaning, as a condition, fact forbidden by Şaria. The same treatment is applied for the penalties.

The subject is analyzed both, by the Muslim economists and by the muftis and imams.

The Grand Mufti of Saudi Arabia, in his book "Warning against transactions based on Riba", denies the idea according which, if the debtor can't pay, the creditor can give him another term, in change of a surplus.

But, everybody agrees that, if the debtor wants to pay to his creditor, at the end of the period, more money, or to give him a gift, or to make a service for him – as a reward for the loan, this fact is allowed. The explanation is that, when he has given the loan, the creditor hadn't the purpose to obtain more money, gifts, or services. (Chapra, 2006)

Qur'an urges Muslim people to the moral revolt against Riba – this one being opposite to Zakat (charity).

When Zakat is a way to help people and to receive reward from God, Riba is a way to take unjustly the people's fortune. Qur'an gives punishments for those who use Riba.

"Allah destroys usury and increases charity".

Sunna says that, in time, Riba loses its value, becoming useless for the creditor, but the negative moral aspect still remains.

Riba is also analyzed from wrong points of you, like (Soare, 2013):

♦ Inflation – paying Riba at the end of loaning period – is a compensation for monetary devaluation. According to Islamic conception, debtor and creditor are equally affected (if the creditor had kept the money instead loaning it, after the period, he would has bought still a smaller quantity of goods).

♦ Sharia forbids only usury (with a very big interest rate) and not interest (with normal rates). According to Islamic conception, interest is considered a sin, no matter big it is, fact mentioned in the Qur'an.

♦ Nowadays, debtors are richer than in the past, so, they can pay interest. According to Islamic conception, the person who asks a loan hasn't enough money, and, even he would have, interest would spend his fortune in an unjustified way.

♦ Riba for commercial loans is allowed (halal), and for consumption loans is forbidden (haram). The theory is based on the fact that the commercial loans didn't exist in the Prophet period and, they couldn't be forbidden. Historical proofs show that the Arabs have made trade with the merchants from Byzantium and Persia, who were using this kind of loans, that means, Arabs also were using them.

♦ Interest would be allowed because, in a global banking system based on interest, it can't be avoided. The reality is that, in the last decades, the Muslim economists have made big efforts to sustain the Islamic modality of financing, without interest. The effect was the increase of Islamic banks number, which offer various types of financial products (in the preset, there are also European banks which started to offer Islamic banking products for their clients.

5. Reasons for interest interdiction in Islam

♦ Moral reasons:

★ Qur'an forbids interest "...because of spending unjustly the people's fortune".

When the creditor gives the loan to the debtor, he gives to this one a part of his fortune and, when the debtor pays back the money, which means he gives back to the creditor that part of fortune. The demand of the creditor is justified. But, if the creditor asks also interest, that surplus doesn't belong to him, but it is a part of debtor's fortune.

★ Interest stimulates human greed, making people to desire to be rich on the others work, instead helping the poor. The effect is that charity and help disappear. Unfortunately, nowadays, interest is a think so spreaded, that people accept it without thinking at its immoral feature.

♦ Religious reasons:

Using Riba put people in a conflictual position with God and His Prophet. Qur'an put Riba among the worst sins in the world like: venerating other persons beside God; witchcraft; crime (without the case of a fair reason), spending the orphans fortune, betraying and running from the battlefield, accusing a chaste woman.

In the Islamic conception, all the bad things like: bankruptcy, recession, economic stagnation, high level of unemployment, impossibility to pay back the loans, the fact that the daily activity became a fight for paying interests – are faces of God punishment for those who use interest. (El Gamal, 2005)

♦ Historical reasons

History proved that interest is an instrument through the creditor transforms the debtor into a slave, who reaches to work for paying a debt in a continuous increase.
A big example, in this respect, is the loan given to the Ottoman Empire, in 1854, during the Russian-Turk war, by the banks of France, England and Germany, in order to build a modern infrastructure and to sustain the expenses of the Imperial Court. (Soare, 2013)

After only two decades, interest for this loan represented a half from the annual income of the Empire and, few years later, the setting up of the Administration of Public Debt, ruled by the European creditors – put the Empire under their economic control. In the 1923, the Empire which had lasted 600 years, collapsed.

The examples can continue – with the loans given by International Monetary Fund, that reaches to decide the economic policies of many countries (Romania is among them).

♦ Economic reasons

★ Prices instability – which causes inflation or overproduction

Şaria considers that the market must approaches to the ideal situation, thus the selling prices will tend to the balance price. In the conventional systems, interest is an important factor in prices calculation. A small interest rate causes the increase of loans demand and forward, the increase of goods demand. In this situation, demand will be bigger than supply, and the results is – the increase of prices (that means inflation), or the increase of production (that means overproduction). In this context, the banks increase the interest rates – and, in the other hand, they give loans easily, without verifying the debtors' solvency.

The big rates of interest cause the decrease of loans demand, and the insolvent clients can’t pay their debts, so, the financial crisis is starting.

★ Appearance of social parasites

Islam considers work – an activity done with good intention, in order to help family and society.

When Riba is used, there appears a class which lives from the work of people who pay Riba, and this class won't make anymore efforts to do a productive work. (El Gamal, 2005)

★ The population pauperization (by spending the money “for tomorrow”) etc.

6. Model of Islamic Bank

In the present, the Islamic Banks function also in Muslim countries and in capitalist countries, as well, there are conventional banks which offer Islamic products.

But, an entirely Islamic banking system, can’t be found anywhere.

The clients of Islamic banks are Muslim people – for whom, using interest represents a moral problem because of their religion, and also non-Muslims, which follow strictly economic advantages.

How does the Islamic Bank function?

♦ First modality of financing is based on partnership with the client, both parts contributing with capital and work to accomplish a project. When the contract is signed, the bank promises to sell its part to the client, for a certain price and, finally the client become the only owner. (Al-Quaradawy, 1997) The advantage is that, the bank and the client share proportionally both profit and loss (in the case of the conventional loan, the client bears the entire loss and he must pay back to the bank, the loan and also the interest).

There is also, a special kind of partnership where the bank contributes with 100% capital and the client (named mudarib), with 100% work and management. Sharing profit is made according to the contract, but the loss is entirely bared by the bank (the clients losses only the work).

Islamic Bank can be creditor (financier) when it gives loans, and also mudarib, when the clients make deposit funds.

This kind of financing by partnership has a big factor of risk, thus it is used in the commercial projects, where the profit can be easily estimated.

♦ A second modality of financing is based on commercial transactions with payment on short term (less than a year). It is named “selling of a bigger price”. (Al-Quaradawy, 1997)

In this situation, at the client demand, the bank buys a good from the supplier at the acquisition price and sells the good to the client at a bigger price. The client will pay this bigger price to the bank in rates (it’s not available for currency, gold and silver). The same modality of transaction, but with payment on long term (more than a year) is “the transaction with payment in delay”.

There are opinions according to which, selling goods at a bigger price means, in fact, a hidden interest, and the trend of Islam banks evolution would be the improvement of partnership method.

In the case of selling at a bigger price, the bank informs its client about the price paid to the supplier. There is also a modality of transaction when the bank doesn't inform the client about the acquisition price, but, it can negotiate with the client the selling price. This kind of transaction is used for goods with big values. The client pays to the bank the negotiated price, in rates, without knowing the profit obtained by the bank from this transaction.

The financing by commercial transactions is according to the Qur'an.

“Allah has allowed trade, but has forbidden Riba”
In fact, there are two ways to make these commercial transactions:

1. The bank signs with the supplier two contracts:
   - a contract in which the bank promises to pay him, entirely and in advance, the price of the good, which will be later delivered;
   - a contract of a representation, in which the supplier becomes the representative of the bank, and, on this position, he will manage the selling to the client and will encash the selling price. After selling, the representative pays to the bank the price encashed from the client, and the bank will pay him the commission for his services.

2. The bank signs two contracts, with the same date of delivery, independent one from each other
   - a contract with the supplier, paying him the value of the good entirely, and in advance, at a smaller price – here the bank is on the position of client;
   - a contract with the client, encashing from him the value of the good, entirely and in advance, at a bigger price – here the bank is on the position of seller.

On short term, the Islamic banks can offer to their clients a special kind of loan, named “good loan”, that means the client pays back only the borrowed amount, without any surplus. At the end of the contract, the client can pay a surplus, but only if he wants, as a reward for the bank. (Soare, 2013)

In the case of deposit funds formed by clients, the Islamic banks can’t pay them interests, but, they can offer them gifts or even money, over the deposit value. The bank can use the deposit fund for its own activities, but it must be sure that, if the client asks his money back, the bank can pay it. Using these deposit funds for investment activities produces profit or loss. The bank can offer to its clients a part of this profit, in order to reward its depositors, and to become more attractive for the clients, in general. The profit rate – for bank and client – is established in the moment when the deposit fund is formed (it is, in general, bigger than the interest rate for deposit funds used in the conventional banks). If the result is loss, this one is entirely bared by the depositor, who is considered financier (creditor), and the bank, considered mudarib, looses only the work (in this respect, the deposit funds of clients can be insured against loss).

7. Conclusions

Using interest is a very old practice. Nowadays interest represents a subject very disputed by the economists, because it influences both countries economy and individual life.

If the capitalist system considers interest as a loan cost, depending on the “time” factor and inflation rate, the Islamic system analyses its immoral feature, forbids its use and put interest on the list of worst sins. The reasons taken into consideration for interest interdiction are: moral, religious, historical and economic.

The Islamic banks win more and more trust, applying methods of financing allowed by the Islamic law and offering to their clients various banking products.

References