Ethics of interest

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Ethics are rules of right conduct. Being ethical entails acting with justice. Knowledge and practice of ethics are required for fulfilling a person’s potential. An ethical person attains and practices virtues. These include piety and fair dealing.

The ethics of interest-based financing merits attention as much as the inherent – yet seldom highlighted – inefficiency of this way of financing. Lending money at interest enables a person to gain value without foregoing anything valuable in exchange. This makes receiving interest unethical.

Justice requires rewarding each person according to his or her efforts. Where a person obtains a reward without effort or taking risk – unless it be by way of charity or inheritance – injustice takes place.

Unlike in a risk sharing partnerships, the lender gets a share of the borrower’s profits without, however, participating in production or even sharing business risk. This is unfair.

Moreover, borrowers may be forced to repay their borrowings in full. In case borrowers are unable to repay, lenders will repossess the assets purchased with borrowed money.

In a typical transaction, value is gained in exchange for a “counter value.” In the case of wages, the “counter value” is work. With rent, the counter value is space. In the case of profits, the counter value is entrepreneurial skill or sharing risk. But what is the counter value exchanged for interest?

Work requires exertion during an extended period. Rental requires doing without a useful asset for a time. Investment requires performing due diligence and sharing risk. Work, leasing, and business enterprise all add value to production. All take place in the real economy.

Moreover, the wages paid to workers are proportionate to the work performed. The amount of rental paid to landlords is proportionate to the amount of rented space. In business, profit – in the absence of market and regulatory failure – is proportionate to the ability of the entrepreneur. In all cases, value is exchanged for a counter value. But what is the value given up for interest?

It has been asserted that this value is time. A lender makes a sum of money available to the borrower “for a time.” The expectation is that the borrower will earn enough to repay the debt and gain profit for himself. However, is time a marketable commodity?

Another view is that the provider of funds has to be rewarded for the “lost opportunity” to earn profit with the funds made available to the borrower. The assumption is that if the lender had not made these funds available to the borrower, the lender could have earned profit with those funds.

This rationale, however, is unconvincing, as there is no way of confirming that the lender would have earned any profit, let alone a profit equal to or greater than the amount of interest paid by the borrower.
The fact that moneylenders gain a reward without work does not mean that it is not possible to earn money in an ethical way without working. Persons that do not have the time, skills, or opportunities to become entrepreneurs may participate in business by investing in enterprises run by professional managers.

They can engage professional managers to invest their wealth. They can also invest in shares or participatory sukuk. By becoming shareholders or partners in businesses, they agree to bear part of the risk. As partners, they share not just profits but also losses. The rewards (profits) paid to them are justified by taking risk.

An experienced entrepreneur knows that risk is a factor in business. Risks arise from the fact that the future is unpredictable and uncertain. Many ambitious business plans and projects have gone awry. Many a hopeful has gone bankrupt due to the inability to perceive and manage risks effectively. The successful management of productive assets is a risky undertaking. It requires knowledge, judgment, patience and other skills. It entails making a range of business decisions of varying degree of complexity.

The entrepreneur must take responsibility for all decisions. If he makes the right decisions, he and his partners (shareholders) will earn profits. If he makes poor decisions, the result is failure. He and his partners may both suffer. In other words, the entrepreneur and shareholders are exposed to market risk. The enterprise becomes a test of the entrepreneur’s acumen, resilience and related traits.

Lending, by contrast, requires proficiency in reading and writing, the ability to ascertain the amount of interest on a loan, and the amount to be repaid. However, financial tasks are facilitated by calculators, reference tables, spread sheets, as well as accounting applications. Even the job of the teller is performed by automated teller machines (ATMs). Thus, the skills required for managing a business are very different from the skills required for lending.

Gaining interest by lending requires no factory, no equipment to operate, and no land to cultivate. There are no stocks, either of finished goods or raw materials. Interest is “earned” without engaging any factors of production, apart from the administration of the credit process. The reason is simple: the lender does not produce any good or service.

In the typical industrial economy, the total amount of interest paid to creditors ranges from 5% to 10% of the GDP. This is a large sum. To ensure that rewards to the providers of capital are earned in an ethical manner, the utilization of equity financing should be expanded.

Rather than being provided in the form of interest-based loans, capital should be provided using risk sharing agreements. This would require the suppliers of capital to share risks with entrepreneurs. The sharing of risk would provide the ethical justification for receiving a part of the entrepreneurs’ profits that is missing from interest-based financing.