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**TITLE: INTEREST AND NON-INTEREST BANKING: THEISSUES AND THE CONTROVERSIES**

**Introduction**

A bank is any financial institution that mobilizes savings and channels same to productive units. In discharging these functions, the banks undergo three transformations: risk, liquidity and maturity transformations. Risk transformation, in terms of providing a safety net for surplus unit, hedges depositors against any potential security risks, such as theft, fire, etc. It ensures liquidity transformation through reduction of search cost for a potential borrower. Thus, the bank provides an access to credit facility and as well provides a consumption smoothing against income shock of a deficit unit or borrower. It performs the maturity transformation by guaranteeing both the saver and the borrower of immediate fund when needed. To this end, borrowers often want to borrow for a longer period while lenders only wish to lend for a short period of time. The banks thus guarantee both parties of their funds at the period of maturity or when they need it. This makes the bank acts as an investment smoother for long term development projects. For these roles, the bank becomes an important financial institution for enhancing growth and development in an economy, but not without cost (Mobolaji, 2010).The way conventional banking institutions have attempted to perform these functions has been a serious source of concern, since it is premised on the institution of interest rate which is less humane in outlook and exploitative in practice. This has led to financial exclusion, low financial depth and poor access to financial services with its attendant negative impacts on the economic development of several countries[[1]](#footnote-2). Thus, the introduction of non – interest banking that attempts to reduce or remove the negative impacts of the convectional banking system on the economy.

The module is designed to expose students to the concept of interest and non interest banking in Nigeria. Such as various definitions of interest and non interest banking, convectional practice of interest rates and its effect on Nigerian economy, evolution of interest and non interest banking, financial instruments of non interest banks and Islamic banks, and controversies surrounding the concept in Nigeria.

**Learning Outcomes**

By the end of this module, you should be able to:

(i) explain the concept of banking

1. explain the concept of interest rate;
2. mention seven (7) reasons why interest was abolished
3. mention five (5) verses in the Bible where interest rate was condemned
4. mention five (5) verses in the Qu’ran where interest rate was condemned.
5. explain the concept of non-interest banking (NIB);
6. explain non-interest banking from the financial inclusion perspectives;
7. explain the relationship between non-interest banking and Islamic banking; and
8. mention five (5) challenges of non-interest rate in the economy.

**UNIT I: Concept and controversy of Interest Rate from Economic point of view, concept and controversy of Interest Rate from Religion point of view, and why interest rate was abolished**

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**Introduction**

The unit is designed to expose students to the concepts of interest rate from both economic and religion points of view, as well as why interest rate was abolished.

**Learning Outcomes:**

By the end of this module, you should be able to:

(i) explain the concept of interest rate;

(ii) mention five (5) verses in the Bible where interest rate was condemned

(iii) mention five (5) verses in the Qu’ran where interest rate was condemned.

(iv) mention five reasons why interest rate was abolished

**The Concept of Interest Rate: A Controversial Concept in Economics**

One of the most controversial issues in the conventional practice is the institution of interest rate that has further worsened financial exclusion on two bases: (i) it is highly exploitative; (ii) and it is morally and religiously detestable. This position has thus led to the advocacy of a non-interest banking system in Nigeria in general rather than the partial application of the system in just some few banks.

The origins of “interest” are deeply connected to the changing meaning of “usury.” Canon law in the Middle Ages forbade usury, which was generally interpreted as a loan repayment exceeding the principal amount. The modern term “interest” is derived from the Medieval Latin *interesse*. The *Oxford English Dictionary* explains that *interesse* originally meant a penalty for the default on or latepayment of an otherwise legitimate, non-usurious loan. As more and more sophisticated commercial and financial practices spread through Europe, “interest” became the generic term for all legitimate and accepted payments on loans.

The concept of interest rate which has undergone several transformations in contemporary economic thought started in part in the early 16th Century with wide condemnation. In the era of Adam Smith the rates were put at a maximum of 5 percent. In the 18th Century the position of Jeremy Bentham was total elimination of interest rate ceiling. Within the same period many States restricted it on loans between persons and corporations, while others condemned it out rightly. But now it has been defined as a rental income of money.

The concept of interest rate has gone through four stages, starting with a stage of wide condemnation from the early to 17th Century to a stage of restrictive permission in the late 18th century. This later became a basis for financial transactions in the 19th to 21st Century. And in the late 21st Century, there was a resurgence of the call to zero interest rate (see Schumpeter 1934)[[2]](#footnote-3). This concept remains inconclusive in the literature. Persky (2007) concludes that the controversial concept is a modest dispute between a failing master (Smith died in 1790) and an over-eager disciple (Jeremy Bentham).

Some Classical Economists rationalize interest rate on the basis of abstinence theory, as it is considered a compensation for waiting or delayed consumption or sacrifice of savers. Keynessians rationalize it on time preference theory of money. They suggest that a rational economic agent prefers the present to the future. For this reason, he needs to be compensated for discounting his future holding. It is compensation to the lender and impatient cost to the borrower. However, these positions have been faulted by Siddiqi (1983) who observes that this position suggests that there is no existence of a voluntary sector where individuals advance a good without anticipating a reciprocal benefit. Hausmann and Macpherson (2000) aptly demonstrate that individuals engage in so many economic activities not for their pecuniary interest only but for other social and personal considerations (for example people donate blood not for material benefit but for other considerations).

**The Concept of Interest Rate: Religious Perspectives**

From a religious perspective, the institution of interest and its application on financial transaction is condemned by both Christianity and Islam. References to this in the Bible include Luke 6:34-35; Levictus25:36-37, Exodus 25:25). The verses in the Qu’ran that condemn same include Q30:39; Q4:161; Q3:130 and then Q2:275-278. However, Deuteronomy 23:19-23suggest that interest can be imposed on commercial transactions involving non-Jews, and this has received world condemnation, nevertheless.

Below are instances of verses in both the Bible and Qu’ran that condemn usury.

* Thou shalt not lend to thy brother with usury, nor corn, nor any other thing , but to the stranger. To thy brother, thou shall lend that which he wanted without usury. That the lord thy God may bless thee in all thy works in the land ... (Deut 23: 19-23).
* “If Thou lend money to any of my people that is poor, that dwell with thee, thou shall not be hard upon them as an extortioner nor oppress them with usuries” (Exodus 25:25).
* “Take not usury of him nor more than thou gravest, fear thy God, that thy brother may live with thee, thou shall not give money upon usury, nor exact of him any increase of fruits” (Leviticus 25:36-37).
* And if you lend to them of whom you hope to receive, what thanks are that of you? For the sinner also to lend to sinners, for to receive is much. Love ye your enemies, do good and lend hoping for nothing thereby, and your reward shall be great and you shall be the sons of the highest (Luke 6:34-35).
* The prohibition of ‘riba’ is mentioned in four different chapters Q30:39; 4:161; 3:130-132 and 2:275-278.
* The first revelation emphasizes that interest deprives wealth of God’s blessing.
* The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others.
* The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare.
* The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum.
* O you who believe! Do not consume ‘Riba’ doubled and multiplied, but fear Allah that you may be successful.(Q3:130)
* Those who eat ‘Riba’ will not stand (on the Day of Resurrection) except like the standing of a person beaten by ‘Shaytan’ leading him to insanity. That is because they say: "Trading is only like ‘Riba’,'' whereas Allah has permitted trading and forbidden Riba.(Q2:275)

**Interest Rate and why it was abolished on the Economy**

This section briefly outlines some economic rationale for the abolition of interest rate:

* it increases cost of production through increase in cost of capital;
* it imposes unilateral risk, reduces capacity utilization and sometimes discourages investment;
* it worsens both internal and external debt burden;
* it worsens unemployment position;
* it makes economies vulnerable to external manipulations;
* it leads to loss of competitiveness at international level and worsens financial exclusion;
* it worsens high debt profile and widens income inequality;
* it strangulates innovation and entrepreneurship;
* It creates an idle class of people who earn income from accumulated wealth
* It worsens debt burden. President Olusegun Obasanjo lamented that: “all that we had borrowed up to 1985 was around $5billion and we have paid about $16 billion, yet we are being told we still owe $28billion. That $28billion came about because of the injustice in the foreign creditors interest rates. If you ask me what the worst thing in the world is, I will say it is interest rate” ( Daily Trust 2008). This is the mournful effect of the monster call ‘interest’.

**Summary:**

Given the controversies surrounding the concept of interest rates in area of definitions from the religion perspectives and its negative impact on the economy, there is need for an alternative rate that will improve economic performance of countries.

**Self-Assessment Questions**

(i) explain the concept of interest rate;

(ii) mention five (5) verses in the Bible where interest rate was condemned

(iii) mention five (5) verses in the Qu’ran where interest rate was condemned

(iv) mention five reasons why interest rate was abolished

**Tutor-Marked Assignment**

1. Explain the controversies surrounding the concept of interest rate from the religion perspectives.
2. Discuss the reasons for the abolition of interest rate.
3. Discuss the view of classical economists on interest rate.

**Reading List**

Enhancing Financial Innovation and Access (EFInA) (2010) *Access to Financial Services in Nigeria.* www.efina.org.ng

Fakiyesi, T (2011) *Islamic Banking and the Nigerian Financial System.* A Paper presented at a Round Table Workshop at the Nigeria Institute of Advanced Legal Studies, University of Lagos**.**

Hausmann, D and Mcpherson, M. (2000)*Economic Analysis and Moral Philosophy.*Cambridge: Cambridge University Press.

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**Further Reading**

Persky, J (2007) Retrospectives from Usury to Interest. *Journal of Economic Perspectives.* 21 (1): 227-36.

Poldermans, R and Philippe, J (2008) *Study on the Integration of The Financial Sector in the ECOWAS Region.* Final Report submitted to ECOWAS.

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Schumpeter, J. A. (1934). *The Theory of Economic Development*. Cambridge MA: HarvardUniversity Press.

Siddiqi, M. N. (1983): *Banking without Interest*. The Islamic Foundation, Leicester, UK.

**UNIT 2: Non-Interest Banking: Evolution, Financial Inclusion, Financial Instruments and Challenges**

**Introduction**:

The unit is designed to expose students to the concept non- interest banking, its evolution and its effect on financial inclusion, financial instruments of non-interest banking and Islamic banks, and controversies surrounding the concept in Nigeria.

**Learning Outcomes:**

At the end of this unit, you should be able to:

(i) explain the concept of non-interest banking (NIB)

(ii) discuss the evolution of non-interest banking

(iii) mention five (5) financial instruments of noninterest banking

(iv) mention five (5) economic agents of non interest banking

1. mention four (4) challenges of non-interest rate in the economy.

**Main Content:**

**Non-Interest Banking (NIB): A Historical Evolution**

In contrast to the Interest Banking System, the Non-Interest Banking (NIB), is a system of banking where risks are mutually shared by the parties involved. NIB thus is any financial institution that exercises banking practices without the institution of interest rate. There are two types, the non-interest bank according to Islamic values and the other which is based on other values.

The first modern experiment with non-interest banking can be traced to the establishment of the MitGhamr Savings Bank in Egypt in 1963. In the past four decades, however, non-interest banking has grown rapidly in terms of size and the number of players. Non- interest banking is currently practiced in more than 75 countries worldwide especially in the Middle East. In August 2004, the Islamic Bank of Britain became the first bank licensed by a non-Muslim country to engage in non-interest banking. The HSBC, University Bank in Ann Arbor and Devon Bank in Chicago offer Islamic banking products in the United States.Sanusi (2010) observes that recent industrial estimates show that non interest Banking is growing at a rate of 10 – 15 per cent per year and with signs of consistent future growth.Though NIB evolved in the late 1960s in the Middle East, it was however introduced in Nigeria in 1991, with the promulgation of Decree 25, 1991 of Banking and other Financial Institutions Decree (BOFID), after 100 years of conventional interest-based banking system which started in 1892(Sanusi, 2010).

The BOFID allows the setting up of banks on the basis of profit and loss sharing modewith a minimum paid up share capital of N50 million. However, 20 years later, the NIB is yet to be fully operationalized. The framework for the NIB was provided in 2009 by the Central Bank of Nigeria. Though, a number of attempts such as Habib Nigerian Bank Limited (now Bank PHB PLC) were made to offer non-interest banking services on a “window basis” they actually commenced operations in 1999 (Fakiyesi 2011).

Jaiz International Bank PLC was licensed in 2004. The bank was granted approval in principle, but could not commence operation before the recapitalization of banks in 2005, which changed the required minimum capital base to N25.0 billion from N2 billion in 2004. Fakiyesi (2011)observes that the first full-fledged non-interestMicrofinance Bank is Al-BarakahMicrofinance Bank in Lagos established in 2010. As at 2012, only three banks, Jaiz , Standard Chartered and Stanbic IBTC Banks, have been given license to commence operation of NIB in the country.

**Non-Interest Bank(NIB) and Financial Inclusion**

Poldermans and Philippe (2008) observe that the ideal financial sector should display at least six core desirable features in line with World Trade Organization definition of financial sector. These are financial depth, financial breadth, financial efficiency, financial effectiveness, regulatory sophistication and financial life cycle for it to serve as a catalyst for growth and development. Collectively, these features represent the benchmark or the target. If the national (or regional) financial sector has all six pillars well developed and under control, it approximates an ideal financial sector. The financial depth connotes ability of the sector to mobilize financial resources from the economy. The financial breadth relates to the ability of the sector to offer several quality products and facilitates substantial choice. The willingness of the sector to provide affordable quality services is called financial efficiency indicator, the need for a good financial sector to be safe, stable and well regulated to meet the regulatory sophistication. A good system must have a defined progressive path known as financial life cycle.

The existence of NIB would possibly enhance financial depth by enhancing financial inclusion. It is good to note that financial Inclusion is a constitutional right of every citizen and must be respected. It is also a sensible public policy. The existence of NIB widens financial choice and enhances financial inclusion. NIB could increase financial resources mobilization and reduce capital flights as it could create avenues for a clement investment environment with low cost and adequate returns. The NIB would also enhance financial breadth of a country by providing several quality products, thereby improving financial choice available to customers.

When linked to various economic agents e.g. the household, business/firm and government, NIB also provide impetus for economic development. At the household level, it may provide an alternative portfolio of holding financial assets, broadens financial choice and inclusion. At the business/firm level, it may encourage emerging Small and Medium Enterprises (SMEs) through mutual risk sharing and promotion of entrepreneurship. For example, one of the financing modes of NIB (in Islamic Banking) is *Mudharabah*(a profit-sharing contract where one party contributes his entrepreneurial efforts while the other provides the capital).Profits are shared according to an agreed ratio as any loss is exclusively borne by the financier. At the government level, it could encourage real sector development. For instance, many of the government initiatives in the real sector can be financed at a low cost or zero interest, but on long term profit and loss sharing which would benefit both parties. A*Sukuk* bond (Islamic Bond)for example is being practiced in Malaysia,London and other countries to help in real sector development for fairly long period. The NIB through its *Sukuk* (Islamic Bond) can partner with the government to finance several other government initiatives in the real sector on a relatively long-term basis (Mobolaji, 2011).

**The Link between Non-Interest Bank and Islamic Banks**

Non-interest bank is a generic name for all financial institutions that operate without interest rate. However, non-imposition of interest rate is just one of the characteristics of Islamic banks, other conditions for Islamic banking includes profit and loss sharing, prohibition of unethical investment, speculative and uncertain transactions.

For effective operation of Islamic banking, the following instruments and economic agents meant for them are shown in Table 1.1.

Table 1.1: NIB Financing Instruments and Economic Agents

|  |  |  |
| --- | --- | --- |
| Economic Agent | Term | Meaning |
| Households and Firms | Musharakah | A partnership contract between two or more parties each contributing capital. Any profit or loss is shared according to agreed ratio. |
| Households and Firms | Mudarabah | A profit-sharing contract where one party contributes his entrepreneurial efforts while the other provides the capital. Profits are shared according to an agreed ratio, while any loss is exclusively borne by the financier after necessary due diligence has been observed by the entrepreneur |
| Household Empowerment | Murabahah | A sale contract involving the bank selling an asset to a customer at a cost-plus margin |
| Firm/Industrial sector Development | Ijara | Sale and lease-back of asset, generally for long term financing |
| Firm/Industrial sector Development |  | A purchase order contract of assets whereby a buyer places an order to purchase an asset to be delivered in the future. This is useful for manufacturing/ industrial financing |
| Firm/ Agricultural sector |  | Very useful for agricultural product financing |
| Government | Sukuk | Islamic Bond used for long term government finances and development projects |

Source: (Mobolaji 2011) with some modifications

**Non-Interest Banking: Some Challenging Issues in Nigeria’s Financial System**

For the NIB to fully realize its potentials and impact more on the economy, some of the following challenges have to be attended to. These include well structured regulatory framework on NIB to guide against abuses and ensure uniformity in practices. The framework should equally spell out clearly the relationship between these banks and other conventional banks. The money market has to be restructured to accommodate transactions of assets in a non-interest bearing modes. In the same vein, the capital market may be rearranged to allow the NIBs to seek for long term and medium term funds. Also, non-interest bonds should be allowed in order to facilitate further financial intermediation. Other challenges include dearth of specialists, competition with other conventional banks, poor public awareness, unstable macroeconomic environment, standardization of accounting procedures, etc. All these challenges are however, surmountable, considering the relative importance of this sector.

**Summary**

Given the challenges that come with interest banking system, the non-interest banking system provides an alternative financial intermediary for mobilizing and allocating resources. Through its operational modalities, it enhances financial inclusion, financial depth and breadth. It is capable of improving financial effectiveness and efficiency which are needed for national economic development, since such NIBs are asset backed. It is more stable and less fragile unlike the conventional banks that are asset based. NIBs are ethical investment banking outlets that enhance mutual risk sharing between investor and banks. This reduces asymmetry and facilitates entrepreneurship and innovation. In NIBs, more market restraints and discipline are likely to operate.

Although NIB is relatively new in Nigeria, it has gained a momentum across the globe. It is in operation in more than fifty countries in the world, including the Middle East and some other countries like the United Kingdom, the United States of America, Switzerland, South Africa, Morocco, Libya, etc.The recent global financial crises have made several countries in the world to reconsider the practice of non-interest banking alongside the conventional banks.

The existence of NIB will put Nigeria among countries that offer dual banking system, (combining the ethical features of the NIB and the financial innovation of the conventional banking system). The existence of the two systems would further enhance the potential impact of the financial sector in facilitating economic development as they are meant to be complementary and not substitute.

Finally, NIB is an ethical system based on religious values with a fundamental requirement that financial transactions are linked to real economic activity or real sector development. This system has to be embraced in its entirety if NIB would contribute towards economic development.

**Self-Assessment Questions**

(i) explain the concept of non-interest banking (NIB)

(ii) discuss the evolution of non-interest banking

(iii) mention five (5) financial instruments of noninterest banking

(iv) mention five (5) economic agents of non interest banking

1. mention four (4) challenges of non-interest rate in the economy.

**Tutor-Marked Assignment**

(i) Explain the various types of financial instruments and their economic agents of non -interest banking

(ii) Discuss the challenges facing non interest banking in Nigeria

(iii) Explain the link between non-interest banking and financial inclusion.

(iv) Explain the relationship between non-interest banking and Islamic banking; and

**Reading List**

Enhancing Financial Innovation and Access (EFInA) (2010) *Access to Financial Services in Nigeria.* www.efina.org.ng

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Schumpeter, J. A. (1934). *The Theory of Economic Development*. Cambridge MA: HarvardUniversity Press.

Siddiqi, M. N. (1983): *Banking without Interest*. The Islamic Foundation, Leicester, UK.

1. The results of the EFInA(2010) Access to Financial Services in Nigeria showed that 39.2 million Nigerians representing 46.3 percent of the adult population are financially excluded. Only 25.4 million Nigerians are banked representing 30.0 percent of the adult population.  The main barriers for financial exclusion includes unemployment and distance to bank branches, someMuslims are also excluded from accessing conventional interest-based banking institutions in observance of the prohibition against Riba. [↑](#footnote-ref-2)
2. For a detailed analysis on the metamorphosis of interest rates, (see Persky, 2007). [↑](#footnote-ref-3)