Regulated and Regimented Interest in the Financial and Economy System: Issues and Challenges

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Keywords: Regulated interest, standardisation, banking, compliance reporting, three-tier relationship.

Abstract: The imposition of interest began with standardization of banking principles issued by the Bank of International Settlement (BIS). The main purpose of this paper is to provide a comprehensive review on the origin of interest applied in the economic and financial system. The study employs library research consist of core principles of Basel, policies imposed by BIS and local legislation of five countries. Based on an extensive reviews, the paper claims that the origin of interest in the economy and financial systems began with standardisation. The central banking contributes to the importation of the standards into the local financial system. The author characterize responses to standardization as obligatory on local banks or financial systems that creates the blooming of interest regime. The paper offers a holistic overview and proffer alternative solutions for free interest in the economy and financial system. Further research of interest on the economic system resulted from banking with interest can be analysed from the quantitative measures. Addressing the contextual root of interest which is legally regulated will help the financial and economic system towards a free interest economy.

1 INTRODUCTION

Regulated and legalised, these two words suffice to ensure something is to be followed. The link between interest rates and bank profitability are intactable in order to evaluate the effect of the monetary policy stance (BIS Working Papers No 514, 2015).

The earliest prohibition of interest was found in the Vedic Text of ancient India (2000-1400BC). *Vasishta*, a well known law maker of Hindu during that time, made a special law which forbade the higher castes of *Brahmanas* (priests) and *Kshatriyas* (warriors) from being usurers or lenders at interest. (V.Wayne, 1998) Among the Ancient Western philosophers who condemned usury can be named Plato, Aristotle, the two Catos, Cicero, Seneca and Plutarch (V.Wayne, 1998). Other religions of Jews and Islam prohibits any kind of interest or addition. Some of the earliest prohibitions of usury are to be found in the Old Testament, for example *Leviticus* 25:36–37: "Take thou no usury of him, or increase: but fear thy God, that thy brother may live with thee.… Thou shalt not give him thy money upon usury, nor lend him thy victuals for increase"; *Deuteronomy* 23:19: "Thou shalt not not lend upon usury to thy brother; usury of money, usury of victuals, usury of any thing that is lent upon usury"; *Deuteronomy* 23:20: "Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury; that the Lord thy God may bless thee in all that thou settest thine hand to in the land whither thou goest to possess it"; *Exodus* 22:25: "If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury" (Salin, 1971).

The prohibition of usury also can be found in the Holy Qur'an, for example, *al-Baqarah* 2:275-276: "Allah has permitted trading and forbidden usury. Therefore, he who receives this admonition (regarding the prohibition of usury) from his Lord, and then gives up (taking usury), may keep his previous gains (that he has taken before the prohibition of usury) and it is for Allah to judge him. But, those who revert to (taking usury), they shall be among the people of the Fire, and they shall abide in it forever. Allah deprives (the accumulation of wealth through) usury of all blessings"; *Ali 'Imran* 3:130: "O believers! Devour not usury, doubling and redoubling its rate many times, but remain conscious of Allah so that yu shall prosper"; *al-Rum* 30:39: "And (know that) what you give in usury, so that it may increase

Yaacob, H. and Rani, A.
Regulated and Regimented Interest in the Financial and Economy System: Issues and Challenges.
In *Proceedings of the 1st International Conference on Islamic Economics, Business, and Philanthropy (ICIEBP 2017) - Transforming Islamic Economy and Societies*, pages 10-16
ISBN: 978-989-758-315-5

in people’s property will not increase with Allah (does not bring any good)”;

But this paper does not intend to explain the prohibition of interest from religious nor philosophical perspectives. This paper analyses the imposition of interest in the banking system. We were thought on how interest is to be managed, monetary policy based on interest rate, discounted interest rate, compunding interest and etc. Traditional models emphasize the effects of monetary policy on the real interest rate. However, we were not thought on the origin of imposition of interest in the banking system. This is where the so called claim on the fractional reserve banking systems, money multiplication and money supply being connected to the banking system. What makes our banking system adopt the interest based system? Despite of being prohibited by most of the religion, interest still a good and viable option in the monetary banking system. This paper claims that the *reason detre* on the imposition of interest undeniably backed by certain regulations and standards (emphasise added).

The word interest and usury are interchangeably used and it has been a long history. In his Theory of Credit, Macleod describes: “A bank is therefore not an office for “borrowing” and “lending” money, but it is a Manufactory of Credit.”(Macleod,1905). According to encyclopedia Britannica: “In old English Law, the taking of any compensation whatsoever was termed usury. With the expansion of trade in the 13th century however, the demand for credit increased, necessitating a modification in the definition of the term. Usury then applied to exorbitant or unconscionable interest rate. In 1545 England fixed a legal maximum interest; any amount in excess of the maximum was usury. The practice of setting a legal maximum on interest rate was later followed by most states of the United States and most other Western nations.” (Britannica, 2001)

The international financial regulation and supervision have raised considerable scholarly interest. One has to understand that the the beginning of money standardisation began in 1944 resulted from the Brettown Woods System. The Bretton Woods Agreement remains an important part of world financial history. The creation of the International Monetary Fund (IMF) and valuation of gold and foreign exchange rates remain important to this day. The agreement also made currencies convertible for trade and other current account transactions. Since the collapse of the Bretton Woods System, IMF members have been free to choose any form of exchange arrangement they wish (except pegging their currency to gold) and allows the currency to float freely, pegging it to another currency or a basket of currencies, adopting the currency of another country, participating in a currency bloc, or forming part of a monetary union. The Bretton Woods Agreement resulted in the establishment of the IMF and the World Bank in July 1944. The goal of the agreement was to establish a framework for economic cooperation and development that would lead to a more stable and prosperous global economy. While this goal remains central to both institutions, their work is constantly evolving in response to new economic developments and challenges.(IMF Fact sheet, 2016) Unlike in the gold standard or Bretton Woods, ‘modern’ money is not backed by or redeemable for gold and hence the term fiat money. This brings the issue of seigniorage, which is the benefit one gets from the first use of fiat money, i.e. the free purchasing power which new money, not backed by gold or anything with intrinsic value, carries with.(Mydin, 2002).It is submitted that the authors are of the view that the usage of fiat money is not a problem in the financial system. Comparing fiat money with gold dinar is unjustifiable since fiat money is being regulated by the authority of each jurisdiction. People used gold and silver as main currency of exchange previously due to its precious values and unregulated. However, this statement need to be said in subtle. The usage of fiat money however, need to be free from any speculation and backed by financial stability. Isues and challenges of regulated and regimented interest is discussed in detail in below contents.

2 METHODS

The study employs library research. Data collected from the Standards and Policies of Bank of International Settlement and the Central banks.

3 RESULTS

The findings shows that interest in the financial and economic system originated from the standardisation. The standards issued in policies have supported by the Central Banks to materialise the implementation. In addition non-compliance with the policies and standards issued is subjected to non-compliance.

3.1 Evidences of the fractional reserve banking system

According to Werner. R, the sequential introduction of the incorrect fractional reserve and financial intermediation theories of banking – leading the student ever further away from the truth – was intentional or not requires further research. Such research should focus on the role of interested parties, especially that of internationally active banks, central banks and privately funded think tanks, in influencing academic discourse. It is worrying, for instance, that the topic of bank credit creation has been a virtual taboo for the thousands of researchers of the world's central banks during the past half century (International Review of Financial Analysis, 2016).

The collapse of Bank Heuss Herstatt in 1974 was a good bargaining factor to standardise the banking practices in the world. The Basel Committee initially named the Committee of Banking Regulations and Supervisory Practices.(BIS, 2016) It was established by the Central Bank Governors of the Group of Ten (G10) countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Herstatt in West Germany). The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.Since its inception, the Basel Committee has expanded its membership from the G10 to 45 institutions from 28 jurisdictions. Starting with the Basel Concordat, first issued in 1975 and revised several times since, the Committee has established a series of international standards for bank regulation, most notably its landmark publications of the accords on capital adequacy which are commonly known as Basel I, Basel II and, most recently, Basel III. The Core Principles for Effective Banking Supervision (Core Principles) are the *de facto* minimum standard for sound prudential regulation and supervision of banks and banking systems. The minimum standards originally issued by the Basel Committee on Banking Supervision in 1997, they are used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices. The Core Principles are also used by the IMF and the World Bank, in the context of the Financial Sector Assessment Programme (FSAP), to assess the effectiveness of countries' banking supervisory systems and practices.(bis,2016) The revised Core Principles define 29 principles that are needed for a supervisory system to be effective. Those principles are broadly categorised into two groups: the first group (Principles 1 to 13) focus on powers, responsibilities and functions of supervisors, while the second group (Principles 14 to 29) focus on prudential regulations and requirements for banks. The original Principle 1 has been divided into three separate principles, while new principles related to corporate governance, and disclosure and transparency, have been added. The Core increased from 25 to 29 Principles (BIS, 2016). Table 1 below shows the implementatation of fractional reserve system as required under the BCBS. Several jurisdictions were selected. The Central Banks Acts were analysed from five (5) jurisdictions. As shown in Table 1, the statutory reserve is required by the Central Banks Acts of these jurisdictions. The statutory reserve refers to the fractional reserve requirement to be applied in the banking system. Eventually, the "money multiplier" demonstrates that a sum of money introduced into the monetary system will increase the money supply by more than its notional value.

Table 1: Banking Core Imposes the Fractional Reserve System in the Central Banks, sample of 5 jurisdictions. *(Author's own, 2017).*

Banking Core Principles	Singapore Law	Malaysian law	Brunei Law	Indonesian law	Thailand law
BCP18: Problem assets, provisions and reserves	Banking Act 1999 Maintenance of reserve fund Sec 22. maintain a reserve	Sec26(1) CBMA2009, Conduct of monetary	Sec 40 AMBD Order 2010	Art 10, Act 23/1999	Commercial Banking Act BE 2505 Section 11.

The above Table 1 may prove the Kamal Mydin Meera's theory that most all banks applies the fractional reserve banking system including Islamic banking (Mydin, 2016). This fractional Reserve is determined by the central bank and is known as the statutory reserve requirement (SRR). In Malaysia, as of October 1, 2006 the SRR ratio as set by the Bank Negara Malaysia was 4 percent of deposits. The reserve requirement is the proportion of deposits which the banking sector must keep as reserves to fulfill withdrawal needs. Based on the above, it is submitted that there is nothing wrong with the reserve. We do not oppose to any idea of reservation at the central banks for financial stability purposes. However, we do object on taking and loaning it out but at the same time, amount loaned is still considered as assets and liabilty which is double entry. *Ceteris paribus* this is interest. In most countries, Islamic Banking and Finance too operates under this principle (Mydin, 2009).

3.2 The Three Tier relationship

The relationship of how banking system works is best demonstrated in below Figure 1. The incorporation of standards issued by the international organisations will be distributed to the Central banks. Central banks will act as an agent to disseminate information, standards, guidelines and any written directives from the international organisations. Standardisation is meant to create a harmonised practices in the financial system. Undeniably standardisation is needed towards globalisation.

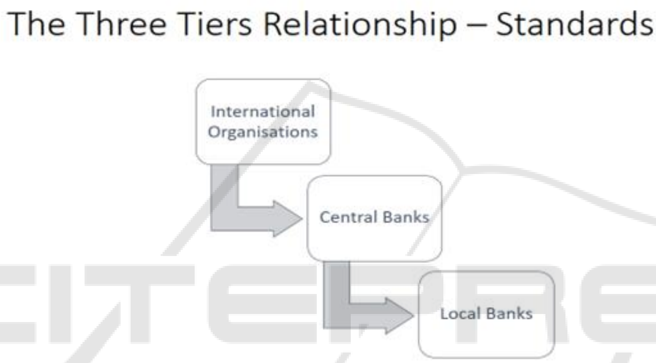

Figure 1: The Three Tiers Relationship. Source: Author's own (2017).

As can be seen from the Figure 1 above, the three tiers relationship appears to have coherent effects of standardisation and practices. Eventually all the local institutions embed the same standards. By incorporating the standards into the local jurisdictions or local institutions, the monitoring and reviewing processes requires compliance. These compliance requirements demand large compliance towards the standards.

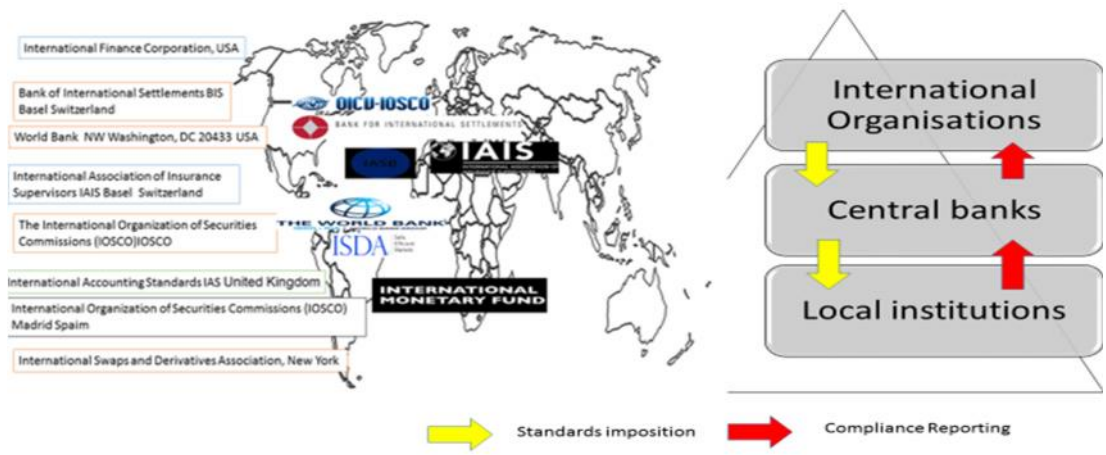

Figure 2: Flow in Standards Imposition and Flow out Compliance Reporting. Source: Author's own (2017).

Based on Figure 2 above, the Standards Basel Core Principles states the Central Bank has to impose enalty for non compliance of the Basel requirement. It is monitoreed through the Financial Assesmenet Programme. The assessment methodology can be used in multiple contexts: (i) self-assessment performed by banking supervisors themselves (ii) IMF and World Bank assessments of the quality of supervisory systems, for example in the context of FSAP; (iii) reviews conducted by private third parties such as consulting firms; or (iv) peer review conducted, for instance, within regional groupings of banking supervisors. So far the assessment involving 150 countries. The Basel Committee on Banking Supervision has issued guidelines for performing self-assessments: Conducting a supervisory selfassessment– practical application, Basel, April 2001. The regular reports by the IMF and the World Bank on the lessons drawn from assessment experiences as part of FSAP exercises constitute a useful source of information which has been used as an input to improve the Principles.

In order to achieve full objectivity, compliance with the Core Principles is best assessed by suitably qualified external parties consisting of two individuals with strong supervisory backgrounds who bring varied perspectives so as to provide checks and balances; however, experience has shown that a recent selfassessment is a highly useful input to an outside party assessment.

a) A fair assessment of the banking supervisory process cannot be performed without the genuine cooperation of all relevant authorities.
b) The process of assessing each of the 29 Core Principles requires a judgmental weighing of numerous elements that only qualified assessors with practical, relevant experience can provide.
c) The assessment requires some legal and accounting expertise in the interpretation of compliance with the Core Principles; these legal and accounting interpretations must be in relation to the legislative and accounting structure of the relevant country.They may also require the advice of additional legal and accounting experts, which can be sought subsequent to the on-site assessment.
d) The assessment must be comprehensive and in sufficient depth to allow a judgment on whether criteria are fulfilled in practice, not just in theory. Laws and regulations need to be sufficient in scope and depth, and be effectively enforced and complied with. Their existence alone does not provide enough indication that the criteria are met (BIS,2016)

3.3 The problems in Islamic banking operations

According to the World Bank Working Paper, in dual financial systems with fairly developed conventional money markets, Islamic banks evolve in an interest rate dominant environment. Due to arbitrage between conventional and Islamic financial systems, there tends to be spillovers from conventional interest rates to Islamic banks funding costs, to returns of Profit-Sharing Investment Accounts (PSIAs) as well as to costs of Islamic credit (Methodology of Assessment on BCBS, www.bis.com, 2017). In most jurisdictions that applies dual banking systems, there is often no Islamic finance equivalent to money market or government securities yield curves that can serve as references to price Islamic banks credit. As a result, some Islamic banks tend to rely on conventional interest rates to price their Murabahah and Ijarah contracts.(Mariam El Hamiani Khatat IMF Working Paper, 2016).

3.4 Banking Models

As pointed by Werner (2014), there are three banking models currently being adopted. The Fractional reserve banking system establishes money creation and multiplier that evantualy leads to interest. The Keynes' theory in his Treaty mentions as follows; "*A banker is in possession of resources which he can lend or invest equal to a large proportion (nearly 90%) of the deposits standing to the credit of his depositors. In so far as his deposits are Savings deposits, he is acting merely as an intermediary for the transfer of loan-capital. In so far as they are Cash deposits, he is acting both as a provider of money for his depositors, and also as a provider of resources for his borrowing-customers. Thus the modern banker performs two distinct sets of services. He supplies a substitute for State Money by acting as a clearing-house and transferring current payments backwards and forwards between his different customers by means of book-entries on the credit and debit sides. But he is also acting as a middleman in respect of a particular type of lending, receiving deposits from the public which he employs in purchasing securities, or in making loans to industry and trade mainly to meet demands for working capital. This duality of function is the clue to many difficulties in the modern theory of money and credit and the source of some serious confusions of thought*." (Keynes, John Maynard, 1930). The financial intermediation theory includes the 'credit view' in macroeconomics, proposing a 'bank lending channel' of monetary transmission and according to Goodhart (1989):

"*'Intermediation' generally refers to the interposition of a financial institution in the process of transferring funds between ultimate savers and ultimate borrowers. … Disintermediation is then said to occur when some intervention, usually by government agencies for the purpose of controlling, or regulating, the growth of financial intermediaries, lessens their advantages in the provision of financial services, and drives financial transfers and business into other channels. … An example of this is to be found when onerous reserve requirements on banks lead them to raise the margin (the spread) between deposit and lending rates, in order to maintain their profitability, so much that the more credit-worthy borrowers are induced to raise short-term funds directly from savers, for example, in the commercial paper market*" (p. 144)(Goddhart,1989)

The three banking models as suggested by Werner associated with interest. Surviving in this conundrum, this may cause furore to Islamc banking system. As opposed to the nature of Islamic banking being the proprietor in every transaction, financial intermediary is a big no for Islamic banking. Riding on the fractional reserve banking system for long time may defeat the upholding principles of shariah. As a corollary, the three models promotes interest which is not viable for islamic banking models.

3.5 The accounting standards

Charging interest on a loan principal is anathema in Islamic banking. AAOIFI appears to agree that recognition of profit is related to the repayment period, and under its Financial Accounting Standard (FAS) No. 2, Murabaha and Murabaha to the Purchase Orderer. Under IAS 18, Revenue, when there is a difference between the fair value and the nominal amount of consideration the difference (i.e. is recognised as interest revenue using the effective interest method under IAS 39, Financial Instruments: Recognition & Measurement. The effective interest method amortises the cost of the financial asset and allocates the interest income over the relevant period based on the effective interest rate. The financial reporting and accounting standards being regulated under the International Acounting Standards Board imposes interest calculation on reporting side. The accounting standards of AAIOFI which prohibits interest is claim to be incompatible with the current sale based transaction. The problems not only in sale based contract but also other contract such as ijarah, wakalah, musharakah and mudharabah. There will be extended consequences in the taxation system as well. By adopting the International Accounting Standards, the system of reporting and accounting are still *ceteris paribus* interest.

4 FINDINGS AND CONCLUSION

Based on the above, interest was regulated and regimented through standardisation. Indeed the monitoring on compliance requires strict adherence to the policy established. In a dual banking system, it is proposed that the Central Banks provides pure alternatives models for Islamic banking to detach from the fractional reserves or the full reserves. To adopt the financial intermediary models seems to strayed from the real economic activities of Islamic banking. Islamic banking acts as proprietor in every transaction. Impossible for them to adopt the financial intermediary models. A true banking model for Islamic banks that free from multiplier, money begets money, imposition of interest, compounding interest, etc. this looks like easier said than done.

However, based on the above observation it is not impossible for the banking system to be detached from the interest based system. In dealing with monetary policy, it is submitted that the increase and decrease of interest rate will act as pain killer to the grave desease. Infact more harm will be caused to the public and not the main financial players. The increase of interest rate may only harm the public. Extended consequences will cause damage to the societal values, the money created and multiplied from the financial players. The control of money supply should involve the financial players not merely increasing the Statutory Reserve. The *non-desciscendum* from the current avalanche may cause difficulties for Islamic banking. However, continue living in the current conundrum, may brings harm. It is timely for Islamic banking to be detached from the fractional reserve system, full reserve nor financial intermediary models. To achieve this objective, a concerted effort from the central banks are pivotal. Being regulated under the regimented interest rulings may cause harm to Islamic banking in future.

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