Debt and Interest—Rethinking the Pillars of Borrowing and Lending

AZZAD ASSET MANAGEMENT WHITE PAPER SERIES

ABSTRACT

Azzad Asset Management actively avoids profiting from interest-based lending and from the trading of debt. This is due to ethical and religious objections. Instead, it is preferable to support financiers like Islamic banks that structure their compensation based on mutual participation in the underlying asset or in the enterprise of the debtor. This is predicated on the notion that financiers who have a stake in a debtor's success are more likely to finance responsible endeavors. For individual investors, avoiding excessive debt and interest-based lending should be seen as a key component of responsible investing that makes both social and financial sense.

INTRODUCTION

The sub-prime mortgage crisis and subsequent financial turbulence that roiled markets starting in 2007 bluntly illustrated the effects that predatory lending and excessive debt accumulation can have on individuals, families, and communities. The irresponsible lending and borrowing that helped bring about the credit crisis has pushed the United States and Western nations to reassess what it means to extend credit in a manner that is safe and secure. Although terms of this reassessment are still being negotiated through international institutions, market participants have learned that fundamental questions need to asked about the way borrowing and lending is done in a modern, global financial system. This paper seeks to explore three key issue areas as they relate to debt and the giving and taking of interest:

1. Irresponsible borrowing and lending
2. Socially responsible banking
3. Values-based investing

It concludes with an overview of the Azzad Asset Management philosophy and offers a responsible way for investors to use their dollars to support worthy enterprises and, by doing so, to press for change.

THE HURDLE OF INTEREST-BASED LENDING

Why is interest-based lending an impediment to socially responsible investing? The primary reason relates to the potential for an exploitative relationship between lender and borrower. While lending to help someone in need is an important and noble role lenders play, profiting by interest may lead to exploitation of those in need of capital. Charging interest on borrowed money allows a lender to profit without participating in the risk of a borrower's underlying asset or enterprise. In order to more accurately align the interests of the two parties, it is in the interests of society that debt is based on fair terms whereby a financier can profit from a loan scenario by participating in the venture with their own capital.

The Islamic ban on interest is not new. For centuries banned by Christians and Jews, Islamic finance prohibits paying or earning interest, irrespective of whether a loan is personal or commercial.

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LEAVING ROOM FOR IRRESPONSIBLE BEHAVIOR

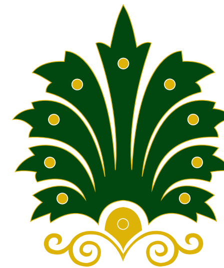
While responsible lending practices can undoubtedly empower and improve the lives of individuals and communities, interest-based lending lacks effective mechanisms to prevent borrowers, lenders and financial intermediaries from engaging in reckless and harmful behaviors.

Interest-based lending lacks a system to prevent a lender from exploiting the borrower. Most loan contracts allow debt to accrue interest due to the mere passage of time. If the debtor faces economic hardship, this can cause the debt to spiral far beyond the ability of the debtor to repay. For example, if the borrower took out a loan to finance a business that no longer produces the expected return, the loan may begin to eat away at the equity of the business. Ultimately, the business may be worth less than the original loan. Yet the borrower will continue to owe principal and growing interest payments. Although lenders have lien rights to collateral assets, the litigation process is costly and long, leaving borrowers to debt collectors in the interim.

Interest-based lending may also create opportunity for the borrower to abuse the lender. A borrower may delay or evade payment, behave recklessly with collateral, or undermine the enterprise. For example, during the sub-prime mortgage crisis, homeowners sometimes vandalized their own properties when they learned that mortgage companies would foreclose and take their houses. If homeowners had been able to participate in a partnership arrangement whereby their share of equity would not have vanished with the sale of the property, they would have likely acted more responsibly.

The central juristic principle in Islamic finance that informs the concept of risk-sharing states: "al ghunm bil ghurm," meaning "there is no return without risk."

Finally, in an interest-based lending system, lenders and borrowers alike are subject to potential abuse or unfair treatment by financial intermediaries. Since the compensation structure for intermediaries is based on how much lending they have arranged, there is a perverse incentive to help non-creditworthy borrowers obtain loans by reporting fraudulent information.



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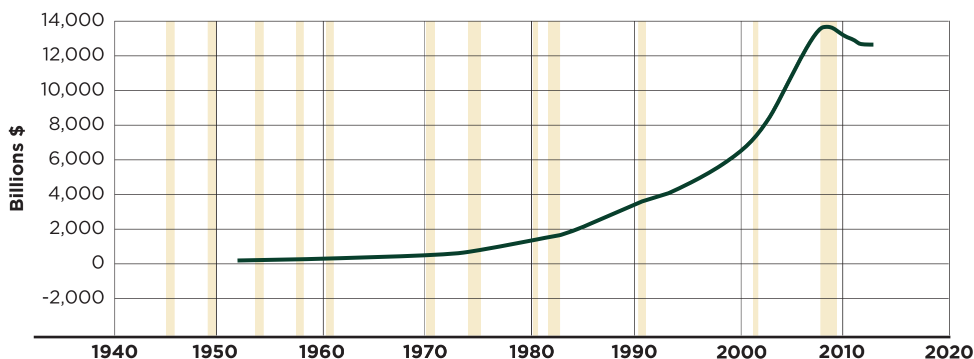
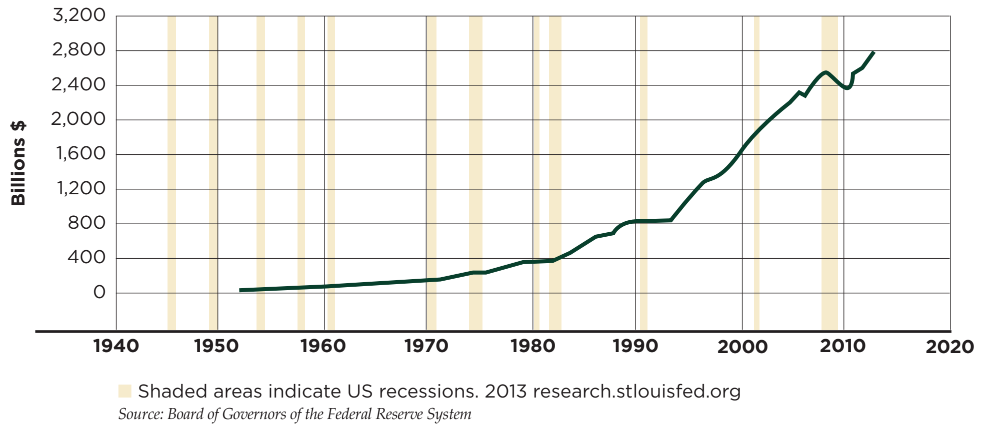
LIABILITY LEVEL OF CREDIT MARKET INSTRUMENTS— HOUSEHOLDS AND NONPROFIT ORGANIZATIONS



Shaded areas indicate US recessions. 2013 research.stlouisfed.org
Source: Board of Governors of the Federal Reserve System

SOCIALLY RESPONSIBLE INVESTING AND DEBT

In addition to the issue of interest, common practices at certain financial institutions pose other conundrums to the socially responsible impact (SRI) investor. For one, these institutions observe few limitations on where they can invest depositor funds or use shareholder money. They may invest in industries irrespective of SRI screens or prey on vulnerable consumers with too-good-to-be-true loan offers. Conventional banks, especially larger multinationals, may have little interest in whether loaned monies create a tangible benefit in communities. These banks may also be solely interested in the collateral and the ability of the borrower to repay principal and interest. Unlike Islamic banks, they do not typically offer support services to borrowers to help them succeed in their enterprise.



Shaded areas indicate US recessions. 2013 research.stlouisfed.org
Source: Board of Governors of the Federal Reserve System

During the 2008 credit crisis, mortgage brokers and loan officers were paid excessive fees by lenders to put unsuspecting borrowers into expensive loans. The Department of Housing and Urban Development estimates that this practice cost borrowers $16 billion in 2007 alone…"

BEST PRACTICES TO AVOID INVESTING IN DEBT AND DEBT-BASED INSTITUTIONS

When evaluating the landscape of investable securities, it is often best to avoid institutions that offer interest-based lending, as well as those heavily in debt. This is because excessive debt on corporate balance sheets can negatively affect the financial health of the institution, especially during difficult economic times.

High debt decreases a company's ability to take risk. With significant debt to repay, a company no longer has the risk capacity to engage in innovative ventures, research and development, charitable donations, or increased hiring. Furthermore, companies may be hindered from pursuing opportunities that will give them a competitive advantage. While leverage may be a tool companies use to expand, excessive debt can in fact inhibit this goal. Significant debt can also cause companies to become more vulnerable to takeovers and external control. It can also shift efforts away from a company's number one task: working on behalf of shareholders. If a company is forced into bankruptcy, equity shareholders are the last to be paid in the liquidation, if at all.

In their September 2011 research paper, "The real effects of debt," economists Stephen G. Cecchetti, M.S. Mohanty and Fabrizio Zampolli, say "Our examination of debt and economic activity in industrial countries leads us to conclude that there is a clear linkage: high debt is bad for growth." The research team found that when debt is in a range of 90% of GDP, further increases may begin to have a significant impact on growth.[1]

CONCLUSION

Azzad Asset Management seeks to avoid the exploitation of human weaknesses and temptations. While this includes screening out industries such as alcohol, tobacco and gambling from our investments, we also extend this to industries involved in or profiting from excessive debt and interest-based lending. Learn more about our socially responsible screens at azzad.net

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[1] http://www.bis.org/publ/othp16.pdf Cecchetti is Economic Adviser at the Bank for International Settlements (BIS) and Head of its Monetary and Economic Department; Mohanty is Head of the Macroeconomic Analysis Unit at the BIS; and Zampolli is Senior Economist at the BIS. This paper was prepared for the "Achieving Maximum Long-Run Growth" symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 25–27 August 2011.

ABOUT AZZAD ASSET MANAGEMENT

Since 1997, the mission of Azzad Asset Management, advisor to the Azzad Mutual Funds and sponsor of the Ethical Wrap Program, has been to provide investment services designed to help clients enjoy optimum performance without compromising their values.

Azzad is proud to serve as investment advisor to the Azzad Wise Capital Fund, the first Halal, socially responsible fixed-income fund investing in:

- Sukuk
- Islamic Bank Deposits
- Ethical Dividend-Paying Stocks

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