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INTEREST ON INVESTMENTS, AND AMORTIZATION OF PREMIUMS PAID AND ACCUMULATION OF DISCOUNTS ALLOWED THEREON

The purpose of this thesis is to discuss the subject of interest as the income derived from investments in notes or bonds or similar obligations, and also to discuss the amortization of premiums paid and accumulation of discounts allowed upon such investments when purchased at a price other than par. Interest as now generally understood is the compensation allowed by law or fixed by the parties within legal limits for the use of money or credit, or compensation for the detention of a debt due.¹ Interest may be considered from the point of view of whether it be simple interest or compound interest; also whether it be lawful interest or unlawful interest; and legal interest, or the rate fixed by law in the absence of an agreed rate. In early times the words "interest" and "usury" were synonymous terms, and the word "usury" was generally used to express the idea of taking or receiving a profit for the use of money.² Among the ancient peoples of the world the taking of interest was considered unlawful.³ After the taking of reasonable interest became lawful, the word "interest" came to signify lawful compensation for the use of money, and the word "usury" unlawful compensation.⁴ The two words are now so understood, as will be seen by reference to the statutes of our various states. Unless there is a law which limits the rate of interest that may be charged, there can now be no usury.⁵ By universal custom interest is

1. 15 R. C. L., § 2; 22 Cyc., p. 1469.

2. 22 Cyc., p. 1471, ¶ A.

3. 22 Cyc., p. 1471, ¶ B.

4. *Juhan v. State* (Tex.), S. W. Rep. Vol. 216, No. 4.

5. *Whitworth v. Davey* (Mo.), S. W. Rep., Vol. 216, No. 4.

specified at a certain rate per cent per annum on the amount of the loan or debt, and is considered on that basis whether the period of the loan be less or more than a year, the amount of interest decreasing or increasing in the ratio as the time of the loan is less or more than a year. Unless otherwise agreed, interest becomes payable at maturity of principal of the debt.⁶ By agreement interest may be made payable in installments during the running of a debt, and on long time obligations is generally made payable periodically, as annually or semi-annually. Interest received in advance from a loan, at the time of making the loan, is designated as "discount."⁷ The privilege of receiving interest is not considered a natural right, but strictly a matter of law or contract.⁸

BRIEF HISTORY OF INTEREST

The custom of taking interest for the use of money is lost in antiquity. It was known from earliest historical times. In early times the taking of interest was prohibited and to take interest was punished. Usury was prohibited by the early laws of the Chinese and Hindus and by the Koran. Among the Romans interest charges were limited by the twelve tables (451 B. C.), but subsequently totally abolished. The Babylonians carried on business by loans at interest. Among the Athenians moderate interest charges were allowed. In the middle ages the people of England considered the taking of interest for the loan of money as a crime. In England, if, after death of a guilty party, it was shown that he had been an habitual receiver of interest, his estate was forfeited to the crown.⁹ The taking of interest was sanctioned in Prussia in 1385; in Marseilles in 1406; in Denmark in 1554. The practice of taking interest existed in England for generations before it was allowed by law. According to the law books, contracts for interest not exceeding 10% were expressly authorized in England in 1545, but repealed in 1555.¹⁰ In 1570 the statute was restored. In 1624 the highest rate allowed was fixed at 8%, and in 1651 at 6%. In 1714 the rate was fixed at 5%, but in 1833 and 1854 the restrictions were removed on certain short time obligations.

The right by legislation to regulate the amount of interest receivable for the use of money has been recognized in our various states. Each state by statute expressly regulates the rate of interest to be paid on contracts, where no rate is specified by the parties. All but four

6. *Koehring v. Muemminghall*, 61 Mo., 403.

7. *Youngblood v. Trust Co.*, 36 Ala., 245.

8. *Juhan v. State*, *supra*.

9. *Perley on Interest* (1893 ed.), p. 1.

10. *Perley on Interest*, p. 3, 22 Cyc., p. 1471, ¶ B.

states fix the highest rate that shall be permitted by contract; but California, Maine, Massachusetts and Rhode Island allow any contract rate, except on certain classes of small loans. Eleven states fix the highest rate allowed by contract at 12%; eleven states fix the highest rate so allowed at 6%, and in the other states the highest rates are usually fixed either at 7% or 8%. New York allows any rate on loans in amounts of \$5,000 or more secured by collateral. The penalties fixed by various state statutes for usurious charge of interest may be grouped as follows, to-wit: Forfeiture of usurious interest; forfeiture of double amount of usurious interest; forfeiture of three times amount of usurious interest; forfeiture of all interest; forfeiture of all interest and 10% of principal; forfeiture of all interest and principal; usurious charge declared to be a misdemeanor.

THE ETHICS OF INTEREST

In the days of barter, before commerce had developed, a strong prejudice existed against the taking of interest. Under the conditions of early times money as a medium of exchange was of little commercial value, and loans of money were generally confined to cases of necessity to relieve distress of the poor. There was no demand for the loan of money for use in commerce and for the purpose of gain. The masses of people had no remunerative employment for money and money was borrowed only in desperation or for self-indulgence. Borrowers of that day had little property or goods to pledge for the repayment of loans, and, as the pledge of the persons of debtors was permitted, the security was mostly the persons of borrowers, resulting in the practical enslavement of large numbers of the inhabitants of the nations. One can readily imagine that under such circumstances the taking of interest from poor debtors was regarded with abhorrence. Early economists regarded money as a mere medium of exchange and did not see money as the representative of value, and concluded that money could not be productive and its lending could not justify more than replacement of the principal; and they, therefore, regarded the taking of interest as immoral.

Under the term "usury" the taking of interest is frequently condemned in the old testament, and the early church, from its view of the various provisions of the old testament law, regarded the taking of interest as sinful and against the laws of God and morality. The Mosaic Law especially prohibited the Jews from taking interest from each other. The early Christian church accepted the prevailing prejudice against taking compensation for the use of money and for centuries forbade its members to take interest. Secular laws naturally

followed the convictions of the people of the times and prohibited the taking of interest. An Act of Edward VI (1537-1553) recited that "the charging of interest was a vice most odious and detestable and contrary to the word of God."

On examination of the various verses in the old testament on the question of usury, the following are noted as opposing the taking of interest from the poor, to-wit:

(1) If thou lend money to any of my people that is poor by thee, thou shalt not be to him a usurer, neither shalt thou lay upon him usury. Exodus xxii:25.

(2) If thy brother be waxen poor * * * 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. Leviticus xxv:35, 36, 37.

(3) He that by usury and unjust gain increaseth his substance, he shall gather it for him that will pity the poor. Proverbs xxviii:8.

The following references are quoted as opposing the practice of a member of the Jewish nation taking usury from another member, to-wit:

(1) Thou shalt not lend upon usury to thy brother; usury of money; usury of victuals; usury of anything that is loaned upon usury. Deut. xxiii:19.

(2) 'Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury. Deut. xxiii:20.

(3) I rebuked the nobles and rulers and said unto them, ye exact usury every one of his brother * * * I pray you let us leave off this usury. Nehemiah v:7-10.

The following references are quoted as opposing the practice of taking usury at all, to-wit:

(1) Lord, who shall abide in thy tabernacle: He that putteth not out his money to usury nor taketh reward against the innocent. Psalm xv:5.

(2) Behold the Lord maketh the earth empty and it shall be * * * as with the taker of usury, so with the giver of usury to him. Isaiah xxiv:2-3.

(3) Woe is me my-mother, that thou hast borne me * * * I have neither lent on usury, nor men have lent to me on usury. Jeremiah xv:10.

(4) He that hath not given forth upon usury * * * * he shall surely live, sayeth the Lord God. Ezekiel xviii:8.

(5) If he beget a son that * * * hath given forth upon usury and hath taken increase * * * he shall not live. Ezekiel xviii:13.

(6) * * * Lo if he beget a son that hath taken off his hand from the poor, that hath not received usury nor increase * * * he shall surely live. Ezekiel xviii:17.

(7) In thee (the city) have they taken gifts to shed blood; thou hast taken usury and increase, and thou hast greedily gained of thy neighbor by extortion. Ezekiel xxii.

From the foregoing references to the old testament, it will be seen that (a) the practice of taking interest from the poor was prohibited; (b) that the practice of a member of the Jewish nation taking interest from any other member of the nation was likewise prohibited; (c) that the practice of taking interest from any other person was also prohibited.

The foregoing references furnished ample authority for the ancient believer to oppose the practice of taking interest, and were the foundations for his religious convictions on the question. No doubt the teachings referred to were mainly responsible for the views entertained by the ancient peoples in these matters, but, when, in addition, we consider that a majority of the ancient peoples eventually found themselves in a deplorable condition, almost slaves by reason of the burden of debt and its increase by interest, we can realize in a measure their fury against debts and the taking of interest. In Athens, in ancient Greece, the conditions became unbearable, and about 595 B. C., by the laws of Solon, the debts were cancelled, and the making of new debts upon the security of the debtor's person was forbidden, also a debt upon all of a debtor's property. The conditions in ancient Rome were similar, and about 500 B. C., a law was passed regulating the rate of interest, in the belief that the setting of a maximum rate would overcome the evil. That remedy did not prove sufficient. During the time of Julius Caesar (102-44 B. C.) the plan of Solon was adopted in Rome. Justinian (483-565 A. D.) established a rate not exceeding 8% interest on mercantile loans, and not exceeding 6% on other loans.

To give an idea of the attitude of ancient philosophers on the interest question, we mention two, to-wit: Xenophan (445-359 B. C.), a pupil of Socrates, is quoted as showing an appreciation of the value of trade and approving the payment of compensation for the use of money. Aristotle (384-322 B. C.) taught the sinfulness of interest, stating "As the natural riches of all mankind arise from fruits and

from animals, interest on money is detestable; that money should be born of money is contrary to nature."

From the teachings of the new testament it would appear that our Savior was not opposed to the taking of interest, and we may infer that at the time of Christ it was more or less customary to take interest or usury. There are two quotations from the Master in the new testament, indicating his assent to the practice of usury, to-wit:

(1) Thou oughtest therefore to have put my money to the exchangers, and then at my coming I should have received mine own with usury. Matthew xxv:27.

(2) I will judge thee, thou wicked servant: Wherefore then gavest not thou my money into the bank, that at my coming I might have required mine own with usury. Luke xix:23.

By slow change of public opinion, the prohibition against usury or interest became less severe, and loans for commercial purposes were approved between persons economically equal. This was a step forward from the strict prohibition, based upon loans from a rich man to a poor man. More modern philosophers agreed that the continued prohibition of interest was wrong. Calvin (1509-1564) declared that the prohibition of interest was not justified by authority of the Bible or by reason, and that other property, as well as land, was productive. As noted above, it was in the days of Calvin that the English statute of 1545 was enacted, permitting interest at not exceeding 10%. Grotius (1583-1645) declared, if the compensation for the use of money allowed by law does not exceed the proportion of the hazard run, its allowance is not repugnant to the revealed or natural law. If it exceeds these bounds, it is then oppressive usury and unjust, though sanctioned by state law. Even after the various countries had begun by law to allow interest, because of advanced thought on the subject, yet students of those times continued to oppose interest. Domat (1625-1696) declared that every agreement under which interest is taken for a loan is a crime, most piously condemned by the law of God and that of the church, no matter what pretext is made to color it.

The theoretical condemnation of interest was confirmed by many of the classical writers. Note scene from Shakespeare's (1564-1616) Merchant of Venice—enter Antonio—Shylock: "How like a fawning publican he looks! I hate him, for he is a Christian; but more, for that, in low simplicity, he lends money gratis and brings down the rate of usance here with us in Venice." * * * "He rails * * * on me, my bargains and my well won thrift, which he calls interest," etc.

As production beyond absolute necessities became universal, as means of transportation developed, and as economic goods produced in one section or country were needed for the well-being and happiness of man in others, trade developed. Such development necessarily required the use of money as a medium of exchange, and borrowing for commercial purposes naturally followed. Certainly there is no moral turpitude in a reasonable interest charge on loans made for carrying on business for profit. Taking human nature as it has been and is, there must be some inducement to a person who has accumulated money to incline him to allow the use of it by another, especially for the purpose of trade, with more or less hazard of loss. Also, as economic thought developed, it was found that coin was not only a representative of value, but had intrinsic value, and was not merely a token for use in exchange. It was discovered that coin was a valuable species of property, and that it was generally harmful to a community to prevent its use. It was found that hardship was not necessarily connected with all borrowing, and discrimination began to be made between loans. Laws permitting a reasonable charge for the use of money followed the change of public opinion; yet, not forgetting the past history of usury, such laws to protect the masses, usually regulate the highest rates that may be charged. Loans have been wonderful aids in the development of the world. Without compensation for commercial loans, most of such loans would not have been made and the progress of the world would have been retarded; thus interest has been and is a powerful agency in the development of commerce and civilization.

If it be conceded that it is ethical to receive reasonable rent for land used in production of husbandry, subject to the hazard of agriculture, why is it not ethical to receive reasonable interest for the use of money to be used in commerce, subject to the hazard of trade? If it be ethical to receive reasonable interest for the use of actual money, why not for the use of credit, a modern substitute for money?

THE ECONOMICS OF INTEREST

From the economic point of view, interest may be regarded as composed of two elements: (a) Insurance against risk of loss of principal, and (b) pure compensation for the use of money. Lenders are perhaps not conscious of these two elements, in asking a certain rate per cent for the use of money, but they are involved nevertheless. Occasional losses are bound to occur with the greatest care possible, and these losses must be covered in any volume of business. In a carefully conducted banking business, these losses are very, very small indeed, considering total loans made. However, these losses

must be considered. They are the basis of the provisions of our national banking laws, limiting the largest amount to be loaned to any one borrower to not exceeding 10% of the capital and surplus of the lending banks respectively. Similar provisions will be found in the modern banking laws of our various states. These provisions are a great protection to the various institutions. The excess of interest received, over the losses sustained, is the actual compensation received for the use of the volume of money borrowed, and represents profit; not net profit, because from the actual compensation must be deducted the expenses of doing business.

Before commerce developed to the point where it was profitable to borrow money to facilitate trade, the economists regarded money as having no value and as being merely an unnecessary instrument in making exchanges of goods. Economic thought has advanced to the point of recognizing that coins have real value and are a valuable species of property, and that any owner permitting the use of such property is entitled to compensation, the same as the owner of other property used in the production of economic goods or the transportation or distribution thereof, or the well-being of the people of the community. It is now general and universal for those engaged in commerce to borrow money for use in business. What a contrast to the original economic theory in that regard! As the money is borrowed by the respective obligors for use in business, and as they themselves make a greater profit from the use of the money, they are glad to pay reasonable rates of interest for the use of the funds, and economically the community is benefited by the increase in trade thereby permitted. Ancient economic principles and ancient laws on the question of interest cannot be comprehended by the modern student, unless he inquire into the conditions of ancient times, as already briefly reviewed above. Aristotle said in effect that money was barren; that one piece of coin could not beget another. His philosophy did not contemplate modern conditions. While a coin cannot be increased by planting in the ground as seed, it can in these days be put to work and render a useful service to mankind and aid in economic development.

The question of the rate of interest, to be paid for the use of money in the different communities, varies largely according to local supply and demand, but also in a marked degree according to the use to be made of the amounts borrowed, and according to the length of time for which borrowed. In ancient times it was thought that setting the highest rate to be allowed would be sufficient to overcome abuse in interest charges, but experience taught otherwise, and the law

was repealed. It is now recognized, as already stated, that owners of funds cannot be expected to make loans without reasonable interest; that there must be an inducement to let another use the funds, instead of having the owner himself do so. By lending his funds, the owner passes the responsibility for its use upon another, and the owner himself avoids the care and worry incident to the actual employment of funds in some process of commerce or business. The relief is some consideration and makes for the establishment of a supply of funds in the community, and thus affects the rate of interest. Rates of interest in a financial center are always much lower than in an undeveloped and sparsely settled community, this inclusive of loans where the element of insurance of principal may be considered equal. Under such circumstances, the law of supply and demand will control the rates, and in the center the rate, because of increased supply, will always and inevitably be less than in the sparsely settled community.

The credit, or recognized ability to pay, behind an obligation has a material effect on the rate of interest; persons of highest credit rating receiving the benefit of the lowest prevailing rate of interest for money. If funds borrowed are invested in readily convertible economic goods, and borrowed for a short time only, so that the paper representing the loan comes in the class considered liquid, then the borrowers also receive the benefit of the lowest prevailing rate of interest. Borrowing for investment in fixed and not readily convertible assets, and for long periods of time, must be absorbed by funds held for permanent investment and necessarily must pay higher rates than liquid paper. Income taxes upon income and property taxes upon securities affect interest rates in a direct way, and lenders seek an increase in rates to make up in part at least the amount of taxes to be considered. Of course, government securities have the highest credit, and are negotiated at the lowest prevailing rate of interest; next come securities of states; next political subdivisions of states; then individual and corporate securities.

There are a number of theories as to the philosophical conception of interest, concerning which economists are not in agreement. The theories referred to are (1) the monopolistic theory (2) the abstinence theory, (3) the productivity theory. (A) Economists of the monopolistic school hold that those who have or control accumulated funds enjoy a monopoly over those who need money, and, therefore, have power to levy upon the needy the equivalent of a tax, more or less severe, for the use of the funds; that accumulated capital may control means of production and must not be allowed to oppress the people by

what is equivalent to an assessment on the producer and thus to the consumer; that, therefore, the use of capital is a matter for the state, and should be controlled for the protection of all. (B) Economists of the abstinence school hold that interest is a reward to those who produce more than they consume, the amount not consumed being represented by the amount of money saved; that thrift benefits not only the one who saves, but the people also, and, therefore, should be rewarded; that one who abstains from using up all of his production should be encouraged to use his surplus for the benefit of others and earn a profit, or allow others to borrow for commercial use and be paid a reasonable profit; also that the present use of money has a value greater than the right to the use later, and, if loaned for present use to another, that reasonable profit may be required (C) Economists of the productivity school hold that interest is a return for production of capital, on the same basis that wages are a production of labor; that money invested in commercial facilities or goods is not dead, but active; that working capital invested in business, the same as other capital, is active; that in such forms capital is indispensable to production or transportation or distribution in commerce, and entitled to its fair reward.

SOME GENERAL LEGAL RULES AFFECTING INTEREST

1. Interest is allowed by law only on the ground of a contract, express or implied, or as damages for a breach of duty.¹¹ After an agreement has been duly made for the payment of a lawful rate of interest, the charging of a higher rate in the particular transaction is illegal.

2. On a contract for a payment of a debt, where no interest rate is specified, or where the law imposes an interest penalty for delay in payment, the interest allowed is at the legal rate.¹² This rate varies in the different states, according to the laws of the respective states, and reference must be had to the laws of the states as to what are legal rates in the respective states. These rates vary from 5% to 8% per annum.

3. When a loan is made for a lawful rate of interest between the original parties, the holder of the paper thereafter may sell the same at any rate per cent, and (although such sale may be made at a rate higher than is allowed by law against usury between the original parties) the second transaction is not tainted by the question of usury.¹³

4. If an instrument is made payable at a future date with interest,

11. *Harmanson v. Wilson*, 11 Fed. Cas., No. 6074.

12. *Williams v. Williams*, 67 Mo., 661.

13. *Powell v. Waters* (N. Y.), 8 Conn., 669.

and nothing is said in it as to the commencement of the interest period, interest is to be computed from the date of the instrument.¹⁴ Where interest is allowed as damages for the breach of a contract, interest ordinarily would run from the date of the breach;¹⁵ but in many cases demand is essential to fix the time of default.¹⁶

5. A general deposit in a banking institution does not bear interest, unless there is an agreement or usage to the contrary. The undertaking of such institution on a general deposit is only to repay on demand amounts deposited.¹⁷ Interest is properly allowed upon a check, the payment of which has been wrongfully refused by the institution, from date of presentation of the check for payment.¹⁸

6. Interest obligations, such as interest notes or interest coupons, that provide for the payment of a definite sum at a definite time, and having no provision for interest after maturity generally bear interest from maturity.¹⁹ A few cases hold that interest on coupons will run only from demand.²⁰ In this connection one must bear in mind that the law does not favor compound interest, and, where compound interest is prohibited or limited, then the law will prevail.²¹

7. A mistake in the calculation of the amount of interest due is regarded as a mistake of fact.²² Where a mistake has been made as to the proper rule to apply in the calculation of interest in a given case, such mistake will be regarded as a mistake of law.²³ This distinction is important, because the law always allows the correction of a mistake of fact, where correction is requested within a reasonable time, while the law does not allow correction where the mistake is one of law.²⁴

8. Interest is generally to be computed so as to avoid the payment of compound interest. Courts oppose the allowance of compound interest, unless the law expressly permit and there be a definite contract to pay interest upon interest, or to pay interest with stated periodical rests.²⁵ To quote Chancellor Kent: "Interest upon interest * * * would as a general rule become harsh and oppressive. Debt would accumulate with a rapidity beyond all ordinary calculation and endurance. Common business cannot sustain such overwhelming accumulation. It

14. *Pittman v. Barret*, 34 Mo., 84.
 15. *Dobbins v. Higgins*, 78 Ill., 440.
 16. 15 R. C. L., § 25.
 17. *Atlanta N. Bank v. Burke*, 81 Ga. 597.
 18. *Niblock v. Park N. Bank*, 169 Ill., 517.
 19. 22 Cyc., p. 1508.
 20. 22 Cyc., p. 1549, ¶ f.
 21. *Stover v. Evans*, 36 Mo., 461.
 22. *Boon v. Miller's Ex.*, 16 Mo., 457.
 23. *Page on Contracts* (2d ed.) § 966.
 24. *Hethcock v. Crawford*, 200 Mo. 170.
 25. *Perley on Interest*, p. 158.

would tend also to inflame the avarice and harden the heart of the creditor. Some allowance must be made for indolence of mankind and the casualties and delays incident to the best regulated industry; and the law is reasonable and humane which gives, to the debtor's infirmity or want of precise punctuality, some release from the same infirmity of the creditor. If the one does not pay his interest to the uttermost farthing, at the very moment it falls due, the other will quickly avail to demand it with punctuality. He can demand it and turn it into principal when he pleases; and we may safely leave this benefit to rest upon his own vigilance or his own indulgence." The great evil referred to by Chancellor Kent will be more fully realized when the growth of compound interest is taken into consideration. For instance, \$1 at 6% simple interest in one hundred years will amount to \$7; while \$1 at 6% annual compound interest in that period will amount to \$339.30.

9. The general rule is to the effect that compound interest is not recoverable, unless there has been a settlement between the parties, or a judgment, whereby the correct amount of principal and interest is turned into a new principal.²⁶

10. An agreement making interest payable annually, and if not paid when due to bear the same rate as the principal, in a majority of the states is held invalid, as contrary to public policy;²⁷ but if interest has actually become due, and payment has been extended, then a new agreement to pay interest upon such interest is permissible.²⁸

11. As to whether a contract is usurious, the law in force at the time the contract was made determines the matter.²⁹

12. Interest is an incident to a debt, and cannot exist without it. When the debt is extinguished, interest is also.³⁰

13. Special Missouri rules: (a) A contract to pay more than the legal rate of interest must be in writing.³¹ (b) Where interest is due, it may be added to the principal, and a new agreement to pay interest upon such increased sum will be valid.³² (c) Though by the terms of a note the interest is to be paid annually, yet the interest will not be compounded, unless the note express on its face that the interest is to bear interest.³³ (d) The legal rate is 6%.³⁴ (e) The highest rate allowed

26. 15 R. C. L., § 33.

27. 15 R. C. L., § 34.

28. 15 R. C. L., § 35; Perley on Interest, p. 159.

29. Seymour v. Continental L. I. Co., 44 Conn., 300.

30. McCreery v. Day, 119 N. Y., 1; 15 R. C. L., § 11.

31. Balz v. Nelson, 171 Mo., 682.

32. Gunn v. Head, 21 Mo. 432.

33. Stoner v. Evans, 38 Mo., 461.

34. Mo. R. S. 1909, § 7179.

is not to exceed 8%.³⁵ (f) In case of liens upon personal property pledged or mortgaged * * * * proof that party holding lien has received usurious interest will render the mortgage or pledge invalid.³⁶ (g) Parties may contract in writing for payment of interest upon interest, but the interest shall not be compounded more than once in a year.³⁷ (h) In case of partial payments, interest is to be calculated according to rule known as U. S. Court Rule, hereinafter explained.³⁸

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(To Be Continued)

35. Mo. R. S. 1909, § 7180.
36. Mo. R. S. 1909, § 7184.
37. Mo. R. S. 1909, § 7185.
38. Pullis v. Somerville, 218 Mo., 624.