Two contexts, two models, two products: Interest-free solutions for a better world

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Abstract

Interest is forbidden in the three Semitic religions: Judaism, Christianity and Islam. However, we find proliferation of interest-based financial products in the societies where the followers of the three religions are living. Further, many critics challenge the structure of Islamic finance products as mere replica of the interest-based financial products. Instead of engaging in the continued debate in favor and against interest, some of the people of conviction chose to put forward a practical answer to this debate - interest-free financial products. This paper introduces the two products that were introduced in two different contexts and with two different objectives. First, Akhuwat that is providing *qarz-e-hassan* for poverty alleviation in Pakistan since 2001. Second, JAK Members Bank that has been operational since 1997 in Sweden and also operates in Denmark, Germany and Italy. JAK does not charge or pay interest on its loans. Akhuwat model bases itself on Islamic concept of '*akhuwat*' (brotherhood) and collects donations to provide interest-free micro finance to needy borrowers and transforms a borrower into a motivated donor overtime. With the high level of commitment and quality governance, Akhuwat model is seemingly sustainable to help achieve its poverty alleviation objective. The model of JAK, on the other hand, challenges interest on economic grounds to formulate its philosophy. The ultimate objective of JAK is to abolish interest as an economic instrument and to replace it with instruments that are in the best interests of the people. The JAK aims to provide its members with feasible financial instruments that are sustainable for the environment and serving the local economy. Financial and qualitative analyses of the two institutions suggest that the two institutions are not only achieving their policy objectives but are also financially viable.

1. Introduction

Interest is forbidden in the three Semitic religions: Judaism, Christianity and Islam. However, we find proliferation of interest-based financial products in the societies where the followers of the three religions are living. A plausible explanation may be the theoretical problem we are facing even today as highlighted in Quran (02:275), which is our inability to differentiate between 'riba' and 'bai' where former is strictly forbidden and latter is clearly permitted and encouraged.

Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein. (02:275)

Submitting to the Will of Allah (SWT) is at the core of Islam. However, selfishness and greed are instinctively in human nature. Islam addresses this issue at two levels. First, at individual level Islam advises the individuals to overcome these instincts to promote common good; and second, at society level Islam makes the government responsible for justice in all aspects of life. Consequently, the individual and the society achieve *'falah'* (success). The concept of *'falah'* is the progressive realization of worthy ideals for which the time horizon extends beyond this life to the life hereafter. We need to internalize the concept of *'falah'* to promote interest-free economic transactions in an Islamic economy.

At a conceptual level, the human capital and financial/physical capital are the factors of production that create economic value. The conventional economics considers financial/physical capital as the core. Such consideration initiates the multiplier mode of economic exchange that perpetuates the vicious cycle of capital accumulation and concentration. A recent report[1] of Oxfam claims that richest eight people own the same wealth as the 3.6 billion people or 50% of the world population (Oxfam, 2017). This clearly suggests that prevailing economic system promotes a society of the elite, and the state and market are mere instruments of exploitation and wealth accumulation and concentration for the owners of financial/physical capital (Hussain, 1997; Pedercini & Qureshi, 2010). As such, the report (Oxfam, 2017) calls for a fundamental change in the way our economic systems operate so that they work for all people and not just a fortunate few. Alternatively, interest-free economic transaction considers human capital as the core factor of production that creates economic value. Further, this system considers

[1] https://www.oxfam.org/en/pressroom/pressreleases/2017-01-16/just-8-men-own-same-wealth-half-world

financial/physical capital as a supplementary capital that facilitates economic transaction to achieve societal objectives. As such, access to financial/physical capital or financial inclusion is the policy tool to realize the economic potential of available human capital. Although it is quite late, yet conventional economics has also acknowledged that financial inclusion is linked to desirable economic outcomes (Naceur, Barajas, & Massara, 2015) notwithstanding the fact that high cost of financial inclusion especially in micro loans have resulted in human miseries in many parts of the world especially India[2] and Bangladesh (Ahmad, 2007). Further, the claim of poverty alleviation and its brand is used for corporate marketing for the very poor to promote and expand the corporate empire through its corporate offshoots in Bangladesh[3]. Instead, interest-free financial inclusion has resulted in many magnanimous stories around the globe. The followers of the three Semitic religions have provided interest-free financial inclusion to their *'have-nots'* to enable them to be *'haves'*. For example, 'Gemachs' in Israel (Rapaport, 2007) and JFLA[4] in USA are inspired by the principles of Judaism, and NILS[5] in Australia and Liberty Trust[6] in New Zealand follow the commandments of Christianity, and 'Akhuwat'[7] in Pakistan gets its inspiration from principles of Islam and example set by the historical event of *'muakhaa't-e-Madinah'* by Rasoolullah (SAW) and his Sahabah (RA). Moreover, there are others who do not promote the ideals of interest-free financing from religious perspective but from a pure economic perspective, for example, JAK Members Bank[8] in Sweden. There is need to initiate a platform where the followers of three Semitic religions can join hands to promote interest-free financing/investment alternatives for the humanity. For this suggestion, I seek inspiration from Quran (03:64)

Say: "O People of the Book! Come to common terms as between us and you……."

Apart from the introduction in this section, I will present Akhuwat and JAK Members Bank as the two case studies in section 2, and in section 3 I will put forward conclusions and policy recommendations. References are provided at the end.

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[2] http://www.businessinsider.com/hundreds-of-suicides-in-india-linked-to-microfinance-organizations-2012-2?r=US&IR=T&IR=T

[3] http://kathmandupost.ekantipur.com/printedition/news/2016-02-04/misery-and-microfinance.html

[4] https://www.jfla.org/

[5] http://nils.com.au/

[6] http://www.libertytrust.org.nz/better-way

[7] http://www.akhuwat.org.pk/index.asp

[8] https://www.jak.se/international#.WJw76lXhCpo

2. The case studies

2.1. Akhuwat

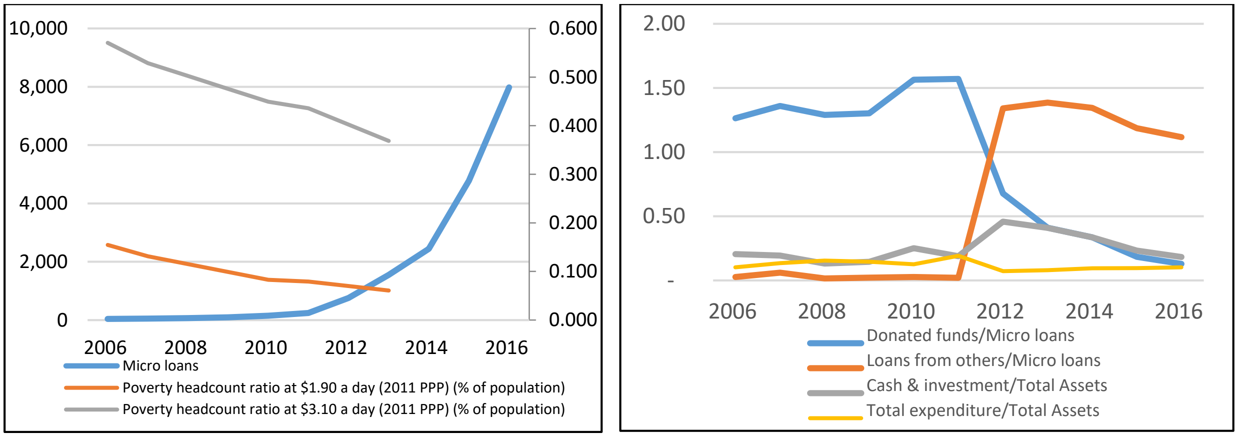
Inspired by the historical event of *'muakhaa't-e-Madinah'* and grounding on the principles of social justice, Akhuwat was established in 2001 with the objective to provide interest-free microfinance to the poor to enable them to enhance their standard of living. Consequently, Akhuwat expects to create a system based on mutual support and *'akhuwat'* (brotherhood) in the society that helps alleviate poverty. For this purpose, Akhuwat identifies the human capital found in the marginalized people and provides the supplementary microfinance as *qarz-e-hassan* to initiate value added economic exchange in the community to earn a reasonable living for their families. Further, the relationship between Akhuwat and its clients extends beyond the financial transactions as it also makes every effort to guide, support and empower its clients. While doing so, Akhuwat seeks to inspire and harness the spirit of volunteerism in society by not only operating through religious places (masjid, church, etc.) that attracts new donors to whom Akhuwat provides the platform to create brotherhood between *'haves'* and *'have-nots'* but it also motivates the borrowers to become donors over time. In other words, Akhuwat provides the opportunity to the *'takers'* to become *'givers'*.

Considering Akhuwat from a sustainability perspective, there are three core areas of interest: First, number of potential borrowers over time; second, supply of the amount required to fulfill the required *qarz-e-hassan* need; and third, maintain a low cost service delivery system. I use micro loans extended as a proxy for potential borrowers along with the poverty headcount ratio[9]. I use three proxies for the supply of needed funds: Donated funds/Micro loans, Loans from others/Micro loans and Cash & investments/Total Assets. For the service delivery cost, I use the proxy of Total expenditure/Total Assets. The Figure 1a shows exponential growth in micro loans extended by Akhuwat. However, going through 'notes to the accounts' in their annual reports I observe that the exponential growth is an outcome of Akhuwat's collaboration with various initiatives wherein different provincial governments and NGOs provide non-interest bearing term loans to Akhuwat (Loans from others/micro loans in Figure 1b) to give *qarz-e-hassan* to finance the micro projects of the skilled but marginalized people to activate them at the local level and make a difference in their economic well-being. Moreover, these institutions also allow a reasonable percentage on the amount of credit as service charges to cover Akhuwat's operational costs on these amounts. Quite understandably, this enormous upsurge of micro loans is because

[9] The data is taken from WDI using winsorization for missing data points.

of outside loans provided for this purpose which is otherwise not possible to finance through donations. Nevertheless, this increased clientele base now will help increase future donors as the *'takers'* will become the *'givers'* over time. It is also relevant to note that with less than 0.2% default rate, Akhuwat is able to recover almost entire loan amount. A successful closure (full repayment and visible socio-economic impact) of the current term loans is likely to attract more funds from not only the current creditors but may also attract new creditors. Even though we observe an exponential growth in micro loans, but it will be relevant to note that fortunately Pakistan (a country of around 200 million people) has also witnessed a continuous decline in poverty head count ratio (please see Figure 1a) and as such the potential borrowers of Akhuwat are likely to decline in the long run. Apparently, one may consider it a threat to Akhuwat's sustainability. However, I consider it a step towards realization of their vision *"A poverty free society built on the principles of compassion and equity"*. Once that vision is achieved (seemingly a long journey ahead) they may reconsider their vision. The Total expenditure/Total Assets ratio (Figure 1b) clearly suggests that Akhuwat management is keen to keep the service delivery costs to as low as possible. Further, their annual reports also suggest that Akhuwat maintains a lean organizational structure to keep its operational costs low. A qualitative assessment of the success stories of borrowers of Akhuwat, the book by its founder detailing a decade (2001-2010) long journey of Akhuwat (Saqib, 2011), their webpage and annual reports, and many articles suggests a high level of motivation, commitment and inspirational brotherhood among the Akhuwat community. Further, the pervasive inequity in Pakistan suggests a dire need to outreach those areas and communities not served by Akhuwat so far. There are at least two plausible reasons for this recommendation. One, to attain sustainability where *'takers'* will become the *'givers'* over time; and two, to realize the worthy ideal of their vision[10] that will internalize the concept of *'falah'* to promote interest-free economic transactions in the economy to achieve *'falah'* of both the worlds.

[10] *"A poverty free society built on the principles of compassion and equity"*



1a 1b

Figure 1: Akhuwat sustainability indicators

2.2. JAK Members Bank

Interest free savings and loans system in Nordic region evolved over time. During the economic crisis in the 30's, some farmers in Denmark created their own currency and took loans from each other without interest using their own currency. The new system provided a respite in economic stagnation that attracted many new members. Consequent to this growth, the government got alerted and decided to prohibit the new currency. Accepting the government decision, the farmers replaced their currency with Danish Kroner but continued to save and loan interest-free from each other. The success story travelled to the neighboring country Sweden and in 1965 an organization named JAK (Jord Arbete Kapital - Land Labor Capital) was founded with the objective of human and economic liberation by spreading knowledge about the damaging effects of interest upon society and to promote economic cooperation among members by managing interest-free savings and financing system. The number of members of JAK did not exceed 3500 people by the end of 1980s clearly suggesting a slow but steady progress of JAK over the years. However, through its distinctive feature of educational courses JAK was able to spread knowledge about the interest-free economics creating a supportive ambience. Further, JAK has been resilient and robust to positively respond to state regulations and adapted to the new conditions in late 1990s without compromising the basic purpose. Consequently, JAK received full banking license in 1997 under the name JAK Medlemsbank (JAK Members Bank) that now has around 38000 members who all have one vote each in the democratic process of managing JAK. The liberation from interest burdens provides to JAK members much needed control over their own life situation.

There are three areas of potential interest to consider JAK Members Bank from a sustainability perspective. First, growth in number of members; second, supply and demand of interest-free deposits and loan; and third, maintain a low cost service delivery system. I use compound growth rate in members as a proxy for growth in number of members. From 3500 members by the end of 1980s to 38000 members now, JAK has witnessed an annual growth rate of 6.85% which is quite good when compared with 0.81% population growth rate of Sweden or 0.25% of Europe[11]. This clearly suggests the growing (more than the population growth rate) acceptability of the interest-free economic system. However, the presence of JAK in limited areas of only four countries may be a limiting factor for their members' growth rate. As such, I advocate that JAK needs to expand its operations first to Nordic countries and then to other European countries to capitalize on the growing awareness about the potential benefits of interest-free economic system. This will broaden and deepen their members' base to bring about the positive change they have envisioned. For the supply of interest free deposits, I use two ratios as the proxy: Deposits/Total Assets and Growth in deposits. For the demand of interest-free loans, I use two ratios as the proxy: Public loans/Total Assets and Growth in public loans. Further, I use a proxy of Deposits/Public loans ratio to estimate the supply-demand balance of the funds. On the income side, I use Cash and investment/Total Assets as a proxy for the income sustaining efforts of JAK. However, a higher value of this indicator means investment in interest-based products that will also suggest self-defeating policy of JAK wherein on one hand JAK presents an example of interest-free economic system and on the other hand helps nourish the interest-based economic system. For the service delivery cost, I use the proxy of Total expenditure/Total Assets. The Figure 2a shows that assets of JAK are almost 100% financed through deposits (Deposits/Total Assets). However, gradually the demand for public loans has decreased (Public loans/Total Assets) and the supply of deposits has increased (Deposits/Total Assets) resulting into surplus supply of funds (upward sloping Deposits/Public loans) that may have lead JAK to invest in interest bearing modes (upward sloping Cash & investment/Total Assets). We may interpret it as the confidence of the members in the JAK system but on other hand this also leads JAK to negate their philosophy by investing surplus funds in interest-bearing instruments. In my opinion, JAK might have either controlled the extra supply of deposits or should have kept them in some other non-interest bearing investment. It is also noteworthy that the default rate in JAK is either 0% or 0.1% during the period under study indicating effective loans management of JAK. JAK has a relatively higher service delivery cost with Total expenditure/Total Assets ratio at around 2.5% during the period under study suggesting a need to maintain a lean, low cost but effective service delivery system.

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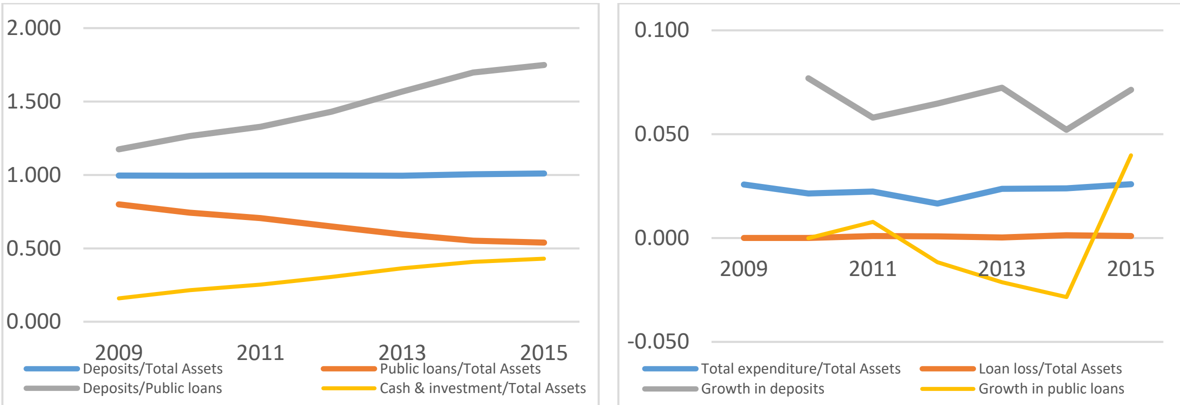
[11] https://en.wikipedia.org/wiki/List_of_European_countries_by_population_growth_rate



2a 2b

Figure 1: JAK sustainability indicators

3. Conclusion and policy recommendations

Many people around the globe believe in the economic sense of the theory of interest-free financing. However, some of the staunch believers and courageous practitioners took initiative to put that theory into practice in their communities to demonstrate the socio-economic utility of the interest-free financing in order to facilitate the replication of their case in other communities to result in a global interest-free financing system. I have presented two different case studies; Akhuwat and JAK Members Bank; that are inspired by two different value-laden philosophies to provide interest-free financing to two different set of communities. Both organizations are seemingly building their members' base on the positive feedback loop '*snow-ball-effect*'. However, keeping this growth momentum is a monumental challenge for both the organizations. This challenge is already visible from their data. Akhuwat owes its exponential growth of micro loans to its institutional collaboration especially with provincial government of Punjab. Not being endogenous, such collaboration may not be sustainable. However, the large number of current borrowers ('*takers*') may generate endogenous source of future contributors ('*givers*'). On the other hand, JAK has witnessed 6.85% growth in their members' base. To sustain this growth rate, they need to outreach other areas and communities. Otherwise, this may be a restraint in their growth rate that is quite visible in the declining trend of public loans/total assets ratio.

The two organizations face a different set of challenges in the demand-supply of the funds. Akhuwat faces a challenge in raising endogenous supply of funds to fulfill higher demand of funds for which currently it largely depends on governmental support for supply of funds. Whereas JAK has surplus supply of funds from the members and as such has to extend its operations to more avenues/regions to diligently invest their surplus funds in interest-free modes. Finally, Akhuwat is operating with a very lean organizational structure that has resulted in low cost and effective service delivery system. However, JAK has effective but relatively high cost service delivery system. This might be a challenge for JAK's future development.

Overall the two organizations are quite unique and effective. They have demonstrated the robustness of their models. These models are seemingly portable to other countries for a successful replication.

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