How interest-free banking works

The case of JAK

by Ana Carrie

In 2001, Feasta's money group investigated the feasibility of establishing an interest-free bank in Ireland. The most promising way seemed to be to persuade the Swedish JAK Bank to establish an Irish branch. However, since JAK had no experience of running branches in Sweden, its directors turned the idea down. This is a report from a money group member who went to Sweden to study the bank.

Can a bank operate successfully if it does not charge interest on its loans? The Swedish JAK Medlemsbank (Members' Bank) certainly does – it has been called the safest bank in Sweden. This account of how it does so is based on two visits to its headquarters in Skövde and numerous conversations with JAK's enthusiastic staff and members, both in Sweden and in Ireland. I am indebted to the staff of JAK for their hospitality and assistance, and to Feasta for its financial support.

Savings Points

JAK's primary objective is to provide its members with interest-free loans. In order to accomplish this, it must attract interest-free savings. JAK uses a system of "Savings Points" in order to balance saving and borrowing.

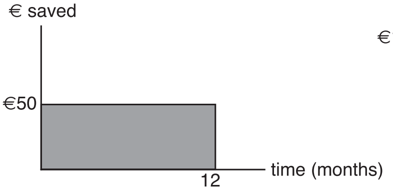
Given the choice of borrowing without interest or saving without interest, most of us would gladly choose borrowing. While people are generally willing to save temporary surpluses of money in current accounts that don't pay interest, few are willing or able to save more significant amounts over a long period of time with no compensation. JAK cannot, of course, lend money without having savings on deposit and so, using an imaginative system of Savings Points, each member who wishes to take out a loan must save money first and, over a lifetime with JAK, every member will have saved roughly as much money and for the same period of time as they will have borrowed. You could almost imagine JAK as allowing its members to borrow (interest-free) from their future selves.

For a new JAK member, the first step towards an interest-free loan is to save and thereby earn Savings Points. These are calculated as the amount saved, multiplied by the number of months for which it is saved, multiplied by a Savings Factor. This factor varies according to the type of savings account the member has selected and is lower (about 0.7) for a demand account from which savings can be withdrawn at any time. For example, assuming a Savings Factor of 0.9, we have[1]:

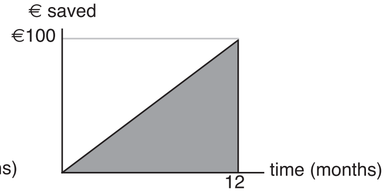
$$€100 \times 1 \text{ Month} \times 0.9 = 90 \text{ Savings Points}$$

The Savings Factor varies with the type of deposit account and is lowest for demand accounts where savings can be withdrawn at any time (about 0.7).

Example 1: Either of these scenarios would earn identical Savings Points.



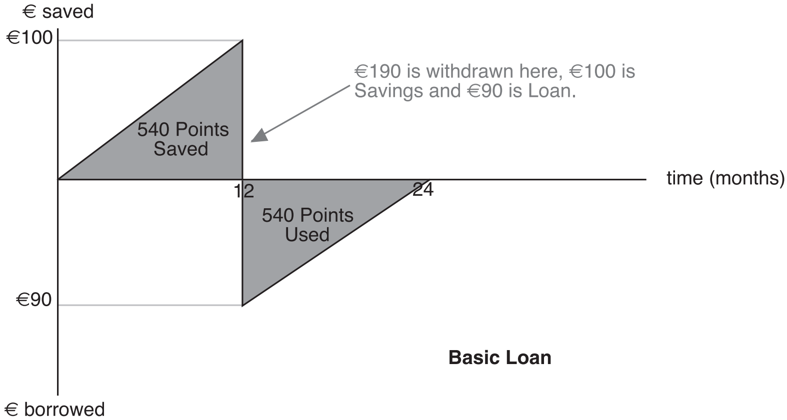
Term Savings



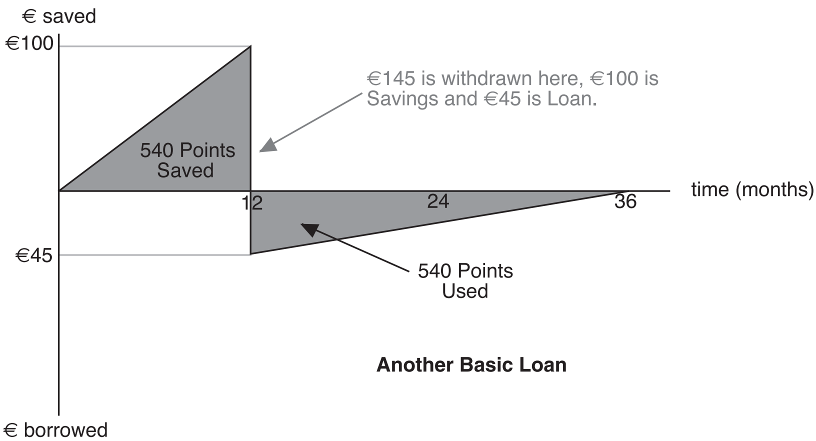
Instalment Savings

1 As a Swedish bank, JAK's business is denominated in Swedish Crowns but for convenience Euro will be used in this section.

After saving for a minimum of six months, a member may apply for a loan. In order to borrow €1 for one month, one Savings Point must be redeemed. The amount borrowed and the time taken to repay are entirely up to the member, provided that the appropriate Savings Points are available. For example, borrowing €90 (or €9,000) over 1 year uses as many savings points as borrowing €45 (or €4,500) with repayments spread over 2 years.



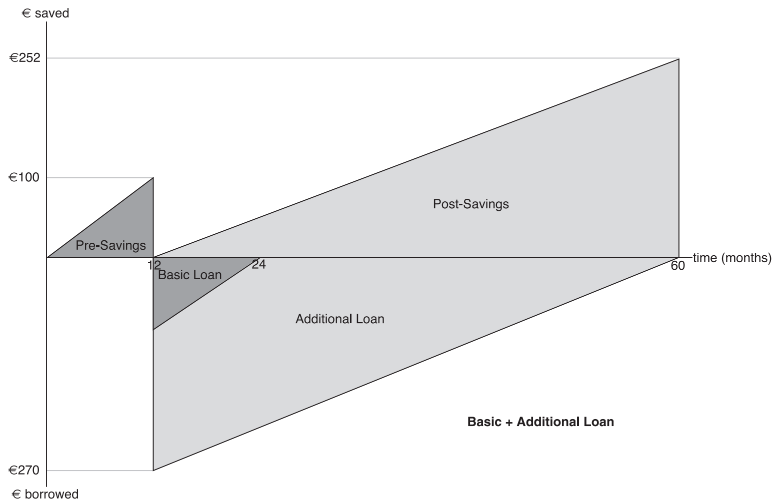
Example 2: A Basic Loan.



Example 3: An alternative basic loan, borrowing half as much but repaying it over a longer period.

In addition to a Basic Loan that uses Savings Points already earned, members may apply for an Additional Loan using Savings Points that will be earned in the future. An "Allocation Factor" (currently 14) is multiplied by the member's current Savings Points to determine the number of points available for an Additional Loan.

Each loan repayment includes a savings instalment, and the payments are structured so that when the loan is fully repaid, all necessary Savings Points have been earned. A consequence of this is that upon full repayment of an Additional Loan, the member has built up significant savings. Savings made during the course of repaying a loan are known as Post-Savings, while those that precede the loan are Pre-Savings. Once the loan has been repaid, the balance of the post-savings is available to the member to be withdrawn or, as frequently happens, to be used as the start of saving for a new loan.



Example 4: A Basic Loan with an Additional Loan

There is no interest charged on a loan, of course, but members must place 6% of the value of the loan on deposit for the duration of the loan, and additionally pay a loan fee to cover administration costs. Members also pay 200 SEK (about €22) when they first join JAK and 200 SEK per year as a membership fee.

JAK is a virtual bank in the sense that it has no branches and business cannot be transacted in person. A necessary and prudent decision since the membership of JAK is quite spread out over a large country, and also resulting in no bias against rural members who would have to travel much farther to their nearest branch. A result of this "virtual" status is that JAK members must have an account with another bank with which to conduct their day-to-day financial affairs. Members transfer money into or out of their JAK basic account via post giro, bank giro or Internet into their other accounts. With improvements in technology and the changing financial infrastructure, JAK hopes in the near future to offer direct deposit of paycheques and credit/debit card facilities to its members. For some members, this might negate the need to bank elsewhere.

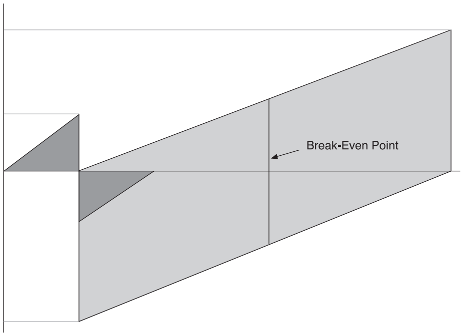
Credit control

Like any bank, JAK must ensure that loans can and will be repaid. Unlike most banks, however, JAK's system of saving and borrowing has several unique features that combine to give it an enviably low default rate.

A member applying for a loan is given a range of options for the loan size and duration based upon their desired loan amount, desired repayments and available savings points. When they have made their selection, the loan department within JAK must assess the member's ability to repay the desired loan. The member's income and expenses are evaluated with the assistance of computer software that calculates average living expenses for individuals and families based upon age and gender.

Between 20 and 25 applications are processed per week, and 95% are approved. Most loans are secured, either against property or with a personal guarantor. Loans for up to 37,000 SEK (about €4,000) with 2-5 years' duration can be unsecured, but these are limited to 5% of JAK's turnover and so surplus applications must be held in a queue until funds are available. The most common reason for borrowing is to refinance a conventional bank loan obtained to buy a house followed by purchasing a car and making home improvements.

In general, people who can save regularly are good performers when it comes to loan repayments. The JAK system where saving must precede borrowing is therefore ideally suited to attracting these regular savers. In addition, around half-way through repayment of a loan there is a break-even point where the Post-Savings on deposit are equal to the balance outstanding on the loan, and from this point forward the loan is fully secured by the member's savings.



Very few JAK loans end in default. Borrowers are decidedly involved "members" as opposed to disinterested "customers". Many feel quite strongly about the idea of interest-free banking and this common bond goes a long way towards encouraging good behaviour. Personal guarantors rarely need to be asked to make good on their guarantee.

Liquidity

At the simplest level, a bank takes one person's savings and lends them to someone else. Ideological arguments aside, this presents some practical difficulties. Firstly, what if a saver wants their money back before the borrower has finished with it? Secondly, what if there are not enough or too many borrowers relative to savers?

The first point is generally dealt with in the banking system by having a reasonably large number of savers and making sure that enough money is set aside to cope with those who, on any given day, want some of their money back. While individuals might withdraw their savings in a random manner, a large group of savers will tend to be stable and predictable.

It is JAK's policy to keep a minimum of 20% of pre-savings available in either a bank account or in government bonds, either of which can be made available almost immediately. Too much liquidity means that money is lying idle rather than being lent out to members, so it is not seen as desirable to have much more than 20% on reserve. Post-savings do not need to have a component on reserve since these can only be withdrawn at specified times.

JAK also encourages stability from its savers by offering a higher Savings Factor in long-term deposit accounts. JAK members can choose from 6, 12 and 24-month deposit accounts which represent the advance notice required to make a withdrawal.

With regard to the second point, JAK has a more difficult balancing act between saving and borrowing than other banks, due to the fact that the two are intimately linked by Savings Points. Most people save with the intention of borrowing in the future. An excess of saving today could indicate too much demand for borrowing next year.

The Allocation Factor has a central role in the relationship between supply of savings and demand for loans. In general, the JAK board sets the Allocation Factor to reflect the current level of liquidity within the bank. The greater the pool of excess savings, the higher the Allocation Factor to encourage members to take out loans and reduce the excess. Unfortunately for JAK, the relationship between the Allocation Factor and the demand for loans is not as simple as this. In the short term, increasing the Allocation Factor can actually make things worse, as members decide to increase their Savings Points with a view to taking out a larger loan in the future. Excess demand for loans would be particularly problematic for JAK. Reducing the Allocation Factor would likely lead to an outcry from members who had made financial plans based on a higher factor. The alternatives, however, would be to refuse more loans or to introduce a waiting list. The dynamics of this saving/borrowing relationship are likely to be a constant challenge to JAK's management as the membership grows and the range of banking services offered by JAK expands.

JAK culture

A significant amount of JAK's energy is devoted to communicating with its 21,000-strong membership. JAK is a co-operative, fully owned by its members. In addition to a quarterly newsletter, 24 regional offices staffed by trained volunteers keep in touch with members through study groups and exhibitions. While JAK's primary function is to provide interest-free banking, it is also viewed by the membership as a vehicle for economic reform.

A recent innovation in support of economic reform is the Local Enterprise Bank. Community members save in a special JAK account and, rather than earning points themselves, their savings are used to provide an interest-free loan for a local enterprise. Savings are fully guaranteed, so members are not exposed to any financial risk. The first two projects to be funded in this way are an ecological slaughterhouse and a replica Viking village. It is an interesting experiment in local finance for local projects, and so far has been very warmly received by local media and participants. While savers don't, of course, receive any interest on their savings, they benefit both economically and otherwise from the improvements in their local economy and infrastructure as a result of the projects.

Conclusions

The JAK Members' Bank is unique in the commitment it inspires from its volunteers and staff. It provides affordable and responsible finance, and enables its members to have a say in where their money is invested. I have no doubt it will continue to be true to its purpose and values while exploring new frontiers in ethical finance.

Why interest-free banking matters

Does it matter whether a bank charges interest or not? After all, every bank has to charge for its services or it won't stay in business. Interest is simply the way that banks calculate the charge they make for the service they render when they approve a loan and for the risk they take on by doing so. Why shouldn't the charge be based on the amount of money involved, the time for which it's being lent and the demand for money at the time? Doesn't that method of calculation seem fair?

As Ana Carrie shows in her article, even the JAK Bank charges an arrangement fee for approving a loan and then an annual fee every year for as long as that loan is on its books. If these charges were expressed as an interest rate, they would work out at about 3%. That seems cheap until you realize that JAK requires its borrowers to lend it the sum that they borrow for an equivalent length of time. This means that, while they are lending to the bank, customers lose roughly the same amount of interest that they would have paid, net of the 3% service charge, if the JAK had been an ordinary bank and had charged them interest when they were borrowing.

So if the JAK system merely involves people losing on the swings what they gain on the roundabouts, why are the bank's members so enthusiastic about it? One reason is that some believe that the charging of interest sets up a growth compulsion in the economy and that, as perpetual economic growth is unsustainable, the development of a no-interest banking system is a key step towards building a sustainable economy.

The roots of this type of thinking run back to the time when gold was used as currency. Since gold did not increase itself, and very little was being mined, where, people asked, was the extra bullion to come from to pay the interest when both principal and interest had to be handed over at the end of the year? Obviously, the borrower could only obtain more gold if someone else had less, so lending money at interest meant that either the borrower impoverished himself when he paid over the extra or he impoverished someone else. And, as neither outcome was socially desirable, usury, as all forms of moneylending were called no matter how low the interest rate, stood morally condemned by both the Roman Catholic Church and by Islam.

Even though we now use paper currencies, this source-of-interest problem has not gone away. Since almost all money in circulation is issued on loan, the money to cover interest payments can only be obtained by borrowers if other borrowers have borrowed sufficiently more. Moreover, the necessity to pay interest on these additional borrowings means that the economy needs to expand if the proportion of world income which is paid over in interest to the lenders is not to increase.

But let's look at this argument a little more closely. How much is 'sufficiently more'? Not all the interest paid over to the banks gets withdrawn from the stock of money in circulation. Some of it is returned to the stock right away by being paid as interest to the people from whom the banks themselves are borrowing money. Some returns by being paid to cover the banks' operating costs, such as their wages bill. And the amount paid in dividends to the banks' shareholders goes back into the stock too. So only the fraction of the interest paid that ends up as the banks' retained earnings has to be borrowed back into the system. This is not a serious problem. If inflation was allowed to run at about 2.5% a year, that would be enough to allow the ratio between the level of outstanding loans and national income to be held constant. So, if one has a fairly relaxed attitude to inflation, the charging of interest

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is not a serious component of the growth compulsion. If the JAK bank made a surplus one year and increased its reserves, it would be just as much a part of the problem as its commercial, interest-charging, competitors.

Other members of JAK have more sophisticated reasons for giving the bank their support. Oscar Kjellberg, the development director, is opposed to charging interest because it transfers wealth from the poor to the rich and from declining areas - often rural ones - to more prosperous parts. “That sort of transfer doesn’t happen with JAK,” he says. “People save with us because they either want to borrow interest-free themselves or because they want to assign the right to an interest-free loan to a relative, a son or daughter, perhaps or to an organization they support. This means that most money is lent out in the same area that it was collected, and, if it’s not, it’s only loaned in a place and for a purpose which the original saver has approved.”

In other words, perhaps the most important reason for backing JAK-style interest-free banking is that it limits a dangerous, destabilising positive feedback built into the present economic system. The feedback occurs because prosperous parts of the world get more investment because better returns can be had from projects there, which makes them still more prosperous, while poorer areas have what capital they possess taken away because no good projects can be found. As a result, the poorer areas fall further behind and people living in them are forced to leave to seek work wherever investment is going on. They take up residence in the expanding areas and add their spending to its rising income flow, generating further investment possibilities. And so the cycle goes on. A major cause of the emigration of young people from rural Ireland used to be that their parents had allowed their savings to be invested away from home. A JAK bank would help prevent a recurrence of that situation.

The JAK bank is a good example of a flourishing cooperative - the lenders and the borrowers and the owners of the bank are all the same people – engaged together in an independent enterprise which serves them all and accords with their beliefs. Although the services provided and the purposes for which loans are made are still fairly limited, these are expanding as Ana Carrie mentions at the end of her article. JAK is one of thousands of small cooperative banks around the world that confound the myth that financial services are best provided by the large capitalist institutions which dominate the mainstream financial services industry.

- Editors