Islamic banking in Iran

Seyed Hossein Mirjalili,PhD
Associate prof.,Institute
for Humanities,Tehran,Iran

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- Islamic Banking;
  A banking system that is based on the principles of Islamic law (Shariah).
- Two basic principles behind Islamic banking are the prohibition of payment and receiving of usury(interest) on loan and replacing by Islamic contracts.
- some Muslims dispute whether there is a consensus that interest is equivalent to riba.
- The realization of an usury or interest-free banking is a basis for the implementation of the Islamic banking which is a part of the Islamic economy as well.

- Wakalah has a central role in Islamic banking in Iran. The depositor (the principal or muwakkel) appoints a representative (the bank or wakil) to undertake transactions on his/her behalf. Because the principal does not have the time, knowledge or expertise to perform himself.(similar to a power of attorney agreement in conventional legal terms).

- The Islamic bank receive a Wakalah fee. The Wakalah services involve in Islamic products like Musharakah, Mudarabah, Murabaha, Salam and Ijarah etc.

- The bank invest on behalf of the investors (depositors).

- **Evolution of Islamic Banking in IRAN**:
- The government of Iran played a primary role in converting conventional banking into Islamic banking after 1979 Islamic revolution.
- After the Islamic revolution, the government nationalized domestic private banks. Banking law was changed under the new regulations.
- By 1982, the government reduced the number of banks to nine (six commercial and three development) and the number of branches to 6,581. Subsequently, the system expanded gradually.
- In 1983, the "law of usury-free banking" was passed by the Parliament, and in 1984, interest free banks started to implement Islamic banking law.
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- The banking system of Iran is being perceived as an effective tool and one step towards the Islamic economic objectives.

- The government began to privatize the banking activity in 2001 when licenses were issued to two new privately owned banks.
- **Types of financial institutions in Iran**:
- About 80% of the country's wealth was deposited with state banks and the remaining 20% with private banks. Iran's main finance institutions are:
- Banks
- Finance and credit institutions
- “gharzolhasana" Funds

- Resources Mobilization:
  There are two modes for mobilizing resources:
  1. Gharz Al-Hasanah Accounts:
  I. Gharz Al-Hasanah Current Accounts
  II. Gharz Al-Hasanah Savings Accounts

  2. Investment Deposit Accounts:
  I. Short-term Investment Deposit Accounts
  II. Long-term Investment Deposit Accounts

- For the utilization of investment deposits, in which the bank enjoys the power of attorney, the mode of financing are: Musharaka, Modharaba, Mosaqat, Modharaa, installment sale, Modhraba, direct investment, Istisna, Debt purchase, Salam(forward dealings), Ijara, and Joaalah transactions.
- Provisional profit rates are crucial in investment resource mobilization in Iran.
- For 2019, Term investment deposit provisional rate is 10% for short term deposits and 15% for one year investment deposits. Currently no rate assigned for more than one-year.
- For 2019, banks’expected lending rate for transaction contracts is 18%.

- **Musharakah** contract:(Joint venture) pillars includes: Partners- who must be capable of appointing agents and being appointed as agents. Capital- which must be asset valued in specific amount of money and not debt. Business- which must be permissible (halal) and all partners having right in managing it profit sharing- according to agreement in fraction or ratio or percentage but not in absolute amount . losses shared in proportion of shares.
- **Mudharabah**: is a contract where the owner of capital entrusts his funds to an entrepreneur who contributes skills in a business and the profits generated are shared between them while losses are entirely borne by the entrepreneur. In this mode of financing, the bank provide the cash capital and other party (the Amel or Agent) undertakes to use the capital for commercial purposes and divide the profit at a specified ratio between the two parties at the end of the term of the contract.
- musharakah and mudarabah also called profit-loss sharing (PLS) where financier and the user of finance share profits and losses. these have been called the "real and ideal" modes of Islamic finance.

- **Modharaa**: A contract wherein the bank (the Mozare) turns over a specified plot of land for a specified period of time to another party (the Amel or Agent) for the purpose of farming the land and dividing the harvest between the two parties at a specified ratio. (note: It has not the ground to implement except for a few)

- **Mosaqat**: A contract between the owner of a garden with another party (the Amel or Agent) for the purpose of gathering the harvest of the orchard or garden and dividing it, in a specified ratio, between the two parties. The harvest can be fruit, leaves, flowers, etc. of the plants in the orchard or garden.

- **Istisna**: It is a contract of exchange, whereby the funding party agrees to deliver a commodity or an asset at a pre-determined future time at an agreed price. It is widely used by Islamic banks and financial institutions to finance the construction of buildings, warehouses, residential, as well as manufacturing activity like aircrafts, ships, machines and equipments.

- **Murabaha**: (Cost-Plus Financing); Sale on profit. A contract of sale in which the seller declares his cost and profit. As a financing technique by Islamic banks, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is settled in advance.

- **Installment Sale:** A contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank. The contract involves the purchase of goods by the bank which then sells them to the client at an agreed mark-up. Repayment is in installments.

- **Salam**: a contract in which full payment is made in advance for specific goods (often agricultural products) to be delivered at a future date. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. It can also be used to finance the working capital needs to the business customer.

- **Ijara**:literally means "to give something on rent") is a leasing or renting contract. In traditional Islamic jurisprudence, it means a contract for the hiring of persons, services, or the “usufruct" of a property, generally for a fixed period and price.
- In the Iranian Islamic banking, Ijarah usually refers to a leasing contract that also includes and leads to the sale of the asset. Property such as plant, office automation, or motor vehicle, is leased to a client for stream of rental and purchase payments, so that the end of the leasing period coincides with completion of purchase payments and transfer of ownership to the lessee.

- **Joaalah:** The undertaking by one party to pay a specified amount of money (the Joal) to another party in return for rendering a specified service (i.e. repairing a house) in accordance with the terms of the contract. The party rendering the service shall be called "Amel" (the Agent or Contractor).
- **Gharz-al-hasaneh** Loan: An interest-free loan extended by a bank to a real or legal person for a definite period of time. This loan is a sort of microfinance lending. Islamic banking has a sense of duty towards the needy of the society and pursues to enrich them through microfinance, problem-solving as well as diminishing poverty in the communities as its objective.

- Mode of financing can be divided into four groups:
- 1. Partnership: includes Musharaka, Mudharaba, Mozaraeh, Mosaqat, and Isisna.

- 2. Trades and Transactions contracts: includes Installment sales, Morabaha, debt purchase, Salam.

  3. Services contracts: Letter of guarantee, letters of credit and Joalah.

4. Gharz Al-Hasanah;

- In Iran, six specific mode of financing are: civil partnership and legal partnership; direct investment; Joaale; Modharaa and Mosaghat for agricultural financing.

- Iran is a good example for the Islamic banking system.

- Sharia Board in the Central Bank of Iran:
- The compliance with Shariah law is necessary for Islamic banks that offer Islamic products and services. Shariah Supervisory Board (SSB) is in charge to advise the Central Bank of Iran on whether or not some proposed transactions or products follows the Sharia, and to ensure that the operations and activities of the banking system in Iran comply with Shariah principles.

- The borad composed of jurists specializing in fiqh al-muamlat i.e. Islamic commercial jurisprudence.

- **ARTICLE 4:**
- Banks are obliged to repay the principals of gharz-al-hasaneh (saving and current) deposits and may undertake and/or insure the principals of the term investment deposits.

- **ARTICLE6:**
- In order to attract and mobilize deposits, the banks may, through promotional methods, give the following rewards to the depositors:
- (A) Non-fixed bonuses in cash or in kind to gharz-al-hasaneh deposits.
- (B) Exempting the depositors from, or granting discounts thereto, in payment of commissions and/or fees.
- (C) According priority to depositors in the use of banking facilities.

- **ARTICLE8:**
- The banks may **directly invest** in productive and development projects or activities. Plans for such investments should be included in the State Annual Budget Bill to be approved by the Parliament and evaluation of the project should be indicative of no loss.
- **NOTE:** The banks are by no means entitled to invest in the production of luxury and non-essential consumer goods.
- **ARTICLE9:**
- In order to provide facilities required for the expansion of **commercial activities**, the banks may, within the framework of the commercial policies of the government, put the necessary financial resources at the disposal of the customers on the basis of **Modharebeh**, according priority to the legally-established cooperatives.

- **Monetary Policy Instruments in Islamic banking of Iran**

- In implementing monetary policy, the Central Bank can directly resort to its regulating power or affect money market conditions indirectly as issuer of high-powered money (notes and coins in circulation and deposits held with Central Bank).

- On this basis, two different monetary policy instruments are being utilized: **direct instruments** (with no reliance on market conditions);

- and **indirect instruments** (market-oriented).

- **1. Direct Instruments**
- **1.1. Banking profit rates -** With the implementation of Usury-free Banking Law and the introduction of contracts with fixed return and partnership contracts, the regulations pertaining to determination of profit rate or expected rate of return on banking facilities and the minimum and maximum profit rate or expected rate of return, as is stipulated in the by-law of the Usury-free Banking Law, are determined by the Money and Credit Council (MCC).

- Moreover, the CBI can intervene in determining these rates both for investment projects or partnership and for other facilities extended by banks.

- **1.2. Credit ceiling** – According to Article 14 of the Monetary and Banking Law of Iran, the CBI can intervene in and supervise monetary and banking affairs through limiting banks, specifying the mechanisms for use of funds and determining the ceiling of loans and credits in each sector.

- **2. Indirect Instruments**
- **2.1. Reserve requirement ratio:** Reserve requirement ratio (RRR) is one of the CBI's indirect instruments of monetary policy. Banks are obliged to deposit part of their liabilities in the form of deposit with the CBI.

- Through increasing/decreasing this ratio, the CBI contracts/expands the broad money.

- According to Article 14 of the Monetary and Banking Law of Iran, the CBI is authorized to determine RRR within 10 to 30 percent depending on banks' liabilities' composition and field of activity.

- **2.2. CBI Participation Papers:** Appropriate implementation of monetary policies by the CBI is done through open market operations, which provide the required flexibility in liquidity management and intervention in the money market.
- Utilization of bonds, owing to its fixed interest rate nature, is prohibited according to Islamic Sharia, however, utilization of participation papers and investors' partnership in economic activities and payment of profit is encouraged.
- By using this instrument, the CBI could affect broad money (M 2) through monetary base, thereby controlling the rate of inflation.

- **2.3. Banks deposit account with the CBI:** One of the bold measures taken for the efficient utilization of indirect monetary instruments in the framework of the Usury-free Banking Law is to allow banks to open a special deposit account with the CBI.

- Regulation on ODA was approved by the MCC. The main objective was the adoption of appropriate monetary policies to control liquidity through absorption of banks' excess resources. The CBI pays profit to these deposits on the basis of specific rules.

- Iran's banking assets made up over a third of the estimated total of Islamic banking assets globally. They totaled more than US$523 billion at the free market exchange rate(using central bank data).
- The central bank authorized the creation of private credit institutions, and also authorized foreign banks(many of whom had already established representative offices in Tehran) to offer full banking services in Iran’s free trade zone.
- Electronic banking in Iran is developing rapidly. The needed $70 million initial capital for the opening of each electronic bank as approved by the Money and credit council compares with $200 million required to establish a private bank in the country.

- **5 Iranian development banks** include: Agriculture, Housing, Industry and mine,Export development, and cooperative.
- **Three of the leading banks are**; Bank Melli Iran, with assets of more than $50 billion, followed by Bank Mellat with more than $40 billion and with $39.3 . Bank Sepah would be the largest banks in Iran, when 6 banks and credit institutions merged.
- According to the Central Bank of Iran, the financial sector has about $260 billion of liquidity, or 65% of the GDP of Iran's economy.

- **Foreign banks;**
- According to CBI, five offices of foreign banks operate in Tehran and Kish free trade zone.
- There is no limitation for the activities of foreign banks in Iranian free economic zone.
- They may also open branches and representative offices in mainland or hold 40% shares of an independent unit.
- The minimum capitalization for establishing a foreign bank branch in Iran is euro 5m.
- Iran-Europe Commercial Bank, which is registered in Hamburg, Germany.
- Iranian-Venezuelan bank.