

# Iranian Islamic banking

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Published online: 2 August 2009  
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**Abstract** Islamic finance is an old concept but a very young discipline in the academic sense. It lacks the required extent and level of theories and models needed for expansion and implementation of the framework provided by Islam. In these circumstances, unawareness and confusion exist as to the form of the Islamic financial system and instruments. The main difference between the present economic system and the Islamic economic system is that the later is based on keeping in view certain social objectives for the benefit of human beings and society. Islam, through its various principles, guides human life and ensures free enterprise and trade. That is the reason why the conventional banker does not have to be concerned with the moral implications of the business venture for which money is lent.

**Keywords** Islamic banking · Iranian law · MUSHARIKA · MURABIHA · QARDE AL'HASANA · IJAREH · MUDARABA

**JEL Classification** E5 · E42 · E58 · G21 · K12

## 1 Introduction

Socio-economic justice is central to the Islamic way of life. Every religion has the same basic aim. In an Islamic environment, an individual not only lives for himself, but his scope of activities and responsibilities extend beyond him to the welfare and interests of society at large. The KORAN is very precise and clear on this issue. There are basically three components of an Islamic economic paradigm:

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1. That as vice-regent, man should seek the bounties of the land that God has bestowed on humanity. From the wealth thus obtained, he should enjoy his own share.
2. That he should be magnanimous to others and use a part of the wealth so obtained also for the benefit of his fellow-beings.
3. That his actions should not be willfully damaging to his fellow-beings.

Human society in Islam is based upon the validity of law, of life and the validity of mankind. All these are natural corollaries of the faith. Islamic laws promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity. God nurtures, nourishes, sustains, develops and leads humanity towards perfection. Even though an individual may be making a living because of his efforts, he is not the only one contributing towards that living. There are a number of divine inputs into this effort and therefore, the results of such an effort obviously cannot be construed as entirely proprietary (Mosavian 2002, pp. 23–25).

Where as the Islamic banker has a much greater responsibility. This leads us to a very fundamental concept of the Islamic financial system i.e. the relation of investors to the institution is that of partners whereas that of conventional banking is that of creditor-investor.

The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another. Those that swallow down usury cannot arise except as one whom SHAITAN (evil) has prostrated by (his) touch does rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it)—these are the inmates of the fire; they shall abide in it [SURAH 2:275].

Not that there was any ambiguity in the Command of Allah. Far be it from Him to give any order to His Servants, which they can not comprehend. The fact is that those who had surplus money and wanted to earn profit did so either by lending it through RIBA (usury) or by investing it in trade and hypocrites were not prepared to forgo the first option. Hence, they argued that since both were means of earning profit, they were alike and the prohibition of RIBA did not stand to reason.

The practice of RIBA i.e. usury was so deep-rooted in society and continuance of the practice was so undesirable, that Allah warned the believers that if they did not desist, they should be prepared for a war against Allah and His Apostle. This warning was heeded by the Muslim UMMAH and for more than a 1,000 years the economies of Muslim states were free from RIBA. With the ascendancy of Western influence and its suzerainty over Muslim states, the position changed and an interest-based economy became acceptable. Efforts in Muslim countries to revert to an interest-free economy were hampered by many obstacles.<sup>1</sup> This article divided into two parts:

<sup>1</sup> Free interest banking in convergence with international banking; 19 congress of Islamic banking articles; Iranian high educational complex of banking, Tehran, 2004.

1. General rules of Islamic finance and Banking
2. Islamic Banking in Iran

## 2 General rules of Islamic finance

### 2.1 The role of money

The traditional definition of the time value of money leads one to assume that profit maximization is the objective of investors irrespective of whether or not the earning of profit has made someone else worse off. Some economists have termed the maximization of profit as the sole objective of corporations. This view cannot be supported or defended since the profit maximization process may lead to perverse outcomes. When financial operations are removed of moralistic tone, competitive markets fail to achieve the efficient allocation of a country's resources (Totonchian 2006, p. 43).

In Islam money in itself is not considered, as actual capital only exists when money, along with other resources, is sunk into productive activities. Linking the use of money to productive purposes invariably brings into action the factor of labor, a process from which benefits pass on to society.

### 2.2 Types of Islamic financial instruments

Demand for monetary instruments is influenced by the variation and level in the market rate what is meant as the market rate of return. The demand for household monetary instruments is mainly for the purpose of circulation of income. Banks need these instruments for:

- A. Transaction purposes;
- B. Precautionary purposes, in that some unexpected payments have to be made while some expected inflows may not be forthcoming on their due date, and;
- C. not only to avoid loss but also to obtain gains in the capital value of financial assets under the expectation that the market rate of return may move in a certain direction.

What differentiates a traditional financial market from others markets is that no tangible good or service is exchanged for any monetary consideration; only a "financial claim" changes hands in the form of a promissory note or a title to any future flow of income adjusted for any capital appreciation. Not all Islamic instruments are purely financial claims. Some of the instruments also represent ownership of the underlying assets together with a claim to underlying cash flows. Basically there are the following four types of Islamic financial instruments:

- A. Type "A" is a financial claim of monetary value with recourse to underlying durable assets and related cash flows. This type has a predictable future income stream, is marketable and can be discounted since with the changing of hands, the instrument passes title to the goods and not to the debt. It is basically lease-based.

- B. This instrument is partly backed by durable assets and its income is not predictable, but evaluated through an asset valuation process at the end of an agreed and declared duration. The underlying transactions can be a mix of IJARA, MODARABA, MUSHARAKA etc., contracts. This Type may be traded in the secondary market at its fair market price acceptable to the parties involved but not discounted.
- C. Type “C” is purely a monetary claim to an expected income stream forthcoming from underlying commercial transactions. Income is evaluated through an asset-valuation process at the end of an agreed and declared period. A transaction of this type may comprise MORABAHA, ISTASNA etc., contracts which are debt claims against third parties in respect to actual commercial transactions. The Type may be traded at its face value declared at the end of each accounting period but cannot be discounted.
- D. The Type “D” is purely a financial claim of monetary value but with recourse to certain precious metals such as gold, silver, platinum, etc., or commodities quoted on exchanges. The instrument entitles the holder to take delivery of the underlying asset but does not carry any attached revenue stream except that its price is pegged to the price of the underlying precious metal or commodity quoted at recognized international exchange rates. It can be traded but not discounted (Taheri 2006).

### 2.3 Risk mitigating features

The phenomenon of risk plays a pervasive role in economic life. Without it, financial and capital markets would consist of the exchange of a single instrument each period, the communications industry would cease to exist in so far as this market is concerned and the profession of investment banking would be reduced to that of accounting. Risk is further segregated from uncertainty. A situation is said to involve risk if the randomness facing an economic agent can be expressed in terms of specific numerical probabilities (these probabilities may either be objectively specified, as with lottery tickets or else reflect the individual’s own subjective beliefs). Situations where the agent cannot (or does not) assign actual probabilities to alternative possible occurrences are said to involve uncertainty (Rashidi 2008, p. 97).

While it is not always true that a riskier asset will pay a higher average rate of return, it is usually true. Risk is an opportunity in financial markets and also a problem. Risk-averse investors require additional return to be at additional risk and, in effect, in a competitive market higher return is accompanied by higher risk. An investor evaluates an asset in terms of its marginal contribution to his/her portfolio.

The fundamental principal of valuation is that the value of any financial asset is the present value of the cash expected. The process requires two steps:

- A. Estimating the cash flow;
- B. Determining the appropriate interest rate that should be used to calculate the present value;

The following are the SHARI'AH compliant risk mitigating features:

1. By prior arrangements in the instrument, the investing company, through its banker, would have a priori right in profit sharing up to an agreed upon ratio.
2. The profit will be paid on account on a monthly basis to the investing company as provided in the projected accounts.
3. The final accounting and settlement is accomplished at the end of the term of the instrument when the profit and loss accounts are finalized.
4. In order to mitigate the risk and as per the terms of the instrument, a TAKAFUL fund is established for the term of the instrument.
5. In this TAKAFUL fund where the invested company earmarks a part of their reserves for the TAKAFUL fund.
6. The investing company will contribute 1% of the invested amount.
7. This 1% contribution is made through an advance by the invested company on account of future profits.
8. In case of any loss during the tenancy of the instrument, it will be adjusted against the TAKAFUL fund.
9. The balance will be distributed between investor and at the end of the term of instrument.
10. Through a valuation, value of the investment would be established for the purpose of exercising the put option.
11. The investing company shall have the option to exercise its put option at the value price and the company shall buy this instrument.<sup>2</sup>

#### 2.4 Islamic leasing

But before describing leasing, as aforesaid, let me very briefly touch upon two of the basic or fundamental principles of Islamic finance in order to develop a premise for meaningful discussions on leasing.

*A. It has to be asset-based financing.* The first fundamental principle of SHARI'AH is that as opposed to conventional monetary dealing, profit is generated when something having intrinsic utility is sold or offered for use. Money has no intrinsic value. As such dealing in money (same currency) cannot generate profit but a RIBA unless converted into real assets to deal with.

*B. There has to be an element of risk.* The second basic element of SHARI'AH is that one cannot claim a profit or fee for a property/transaction, the risk of which was never borne by him.

Based on the above fundamental principles, the most ideal mode or instrument of financing in SHARI'AH are MUSHARAKA and MUDARABA followed by SALAM and ISTINSA.

MORABAHA and leasing are not originally modes of finance. However, to meet certain specific needs where ideal modes like MUSHARAKA or MUDARABA are not workable for whatever reasons, they have been reshaped and allowed in SHARI'AH subject to certain conditions.

<sup>2</sup> Ibid, pp. 123–127.

1. Leasing described for leasing, IJARAH is an Arabic term with origins in Islamic FIQH, meaning to give something to rent. There are two types of IJAREH. One relates to employing or hiring the services of a person for wages whereas the second type relates to the hiring of any asset or property in order to reap its benefits without the transfer of ownership, or what is called in English “USUFUKT”. The price or consideration of this is the rent.

It is the second type of IJAREH which is the subject matter of the discussion here because it is generally used as a form of investment and also as a means of finance.

As described earlier, in the light of the two basic cornerstones of SHARIA’H, leasing is a contract whereby usufruct rights to an asset are transferred by the owner, known as the lessor, to another person, known as the lessee, at an agreed-upon price called the rent, and for an agreed-upon period of time called the term of lease.

2. Lease as a mode of financing Strictly speaking leasing is not a means of finance as originally envisaged. It is simply a transaction much as a sale/purchase. As described above, the leasing transaction simply denotes the transfer of the usufruct of a property from one person to another for an agreed-upon price called rent without transferring the corpus i.e. ownership of that asset. Accordingly, the rules of “leasing” closely resemble the rules governing “sale” because in both cases something is transferred to second person for valuable consideration.

Leasing differs from sale only in-so-much-as not transferring the corpus or ownership of the property which remains with the transferor. As such in SHARIA’H, a lease transaction is governed by a separate set of rules, which we shall outline in the following paragraphs.

Although leasing, as originally conceived, is not a means of finance, the financial institutions and the corporate world have adopted it as such. Due to several factors (including tax concessions, etc.), instead of providing an interest-bearing loan, certain financial institutions in the West started to provide requisite equipment to their customers. To arrive at the rent, the total cost of the asset is calculated plus interest or mark-up to be recovered during the period of lease on a monthly or quarterly basis. This type of lease in the West is known as a finance lease, to be distinguished from an operating lease, wherein various basic features of the leasing transaction are ignored which is tantamount to RIBA (Shabani and Farzinvash 2003, pp. 19–24).

Knowing that leasing is lawfully allowed under SHARIA’H, since it meets one of the basic criteria of asset-based finance, a number of Islamic financial institutions have adopted leasing on this model as carried out by conventional financial institutions without making the necessary modifications that really conform to the rules under SHARIA’H, particularly in regards to assuming the risk of ownership in the leased asset. Great care needs to be exercised to ensure various SHARIA’H requirements, as rendered below, based on the basic two principles of:

- A. Asset based finance, and;
- B. Assuming a risk element connected to the ownership of the asset.
- C. Basic Rules of Leasing

The description or definition given above, under part A, contains the following essential ingredients for outlining the basic rules under SHARIA'H:

1. That it is a contractual obligation.
2. That there has to be a valuable use of the asset and transferability of that usufruct.
3. That the ownership of the asset is retained by the transferor or lessor throughout the lease period. Consumable articles cannot be leased.
4. That the risk and liabilities of ownership lie with the lessor. The leased asset shall remain the risk of the lessor throughout the lease period. Any loss or harm caused by factors beyond the control of the lessee shall be borne by the lessor. However, the lessee is liable to compensate the lessor for any harm to the leased asset caused by any misuse or negligence on the part of the lessee.
5. That the risk and liabilities associated with the use of the asset shall be borne by the lessee. For instance, taxes and other government levies, utilities, etc. However, the contract must specify these items for clarity's sake.
6. That the term of the lease, period of the lease, its renewal or early termination must be stipulated.
7. Purpose of use. The lessee cannot use the leased assets other than for the purpose specified in the contract or agreed to by the lessor expressly.
8. Commencement of lease. The lease commences from the date of delivery of the asset to the lessee and not from the day of payment or lease agreement, with reference to the commencement of rentals.
9. Determination of rental. The rent for the entire period of the lease must be determined at the time of the contract. Different rates of rent for different phases during the lease period are permissible. This point will be elaborated in the following discussion of the issues.<sup>3</sup>

#### D. Issues

While operating a leasing business, a number of practical issues have cropped up which warrant discussion and interpretation under SHARIA'H. An exhaustive and conclusive list of such issues is impossible to make. However, certain important and salient issues need to be taken up in these discussions as follows:

1. Joint ownership (Lessors)/Joint Lessees—(permissible)
2. Insurance—Islamic TAKAFUL—(by the owner)
3. Renewal of or variation in the lease period—(permissible if mutually agreed-upon)
4. Future date. Agreement to commence lease on some future date is allowed. However, the rent has to commence from the date of delivery. If the lessee has paid the price and delivery of the asset is delayed by the supplier, then no rent is liable to be paid for the period of delay. It must be noted that future or forward sale in sale/purchase transaction is not permissible in SHARIA'H. This is another major point after ownership transfer which differentiates leasing from a sale/purchase transaction under SHARIA'H.

<sup>3</sup> Ibid, pp. 34–39.

5. Acquisition of an asset by the lessee. For various reasons, the asset subject to lease may be acquired by the lessee and payment may be disbursed? Through him by the lessor. This is permissible under SHARIA'H on the principles of agent and principal. Here there are two relationships separate from and independent of one and other. The first relationship is that before becoming a lessee, an individual acts as an agent for and behalf of the lessor to acquire the asset. This is an independent arrangement. Once the asset has been acquired with all the risk and reward of ownership to the lessor, then a second relationship is created i.e. the lessor and the lessee under the lease agreement. That cost of acquisition shall be borne by the lessor being owner and not by the lessee.<sup>4</sup>
6. Rentals.
  - A. Advance rentals are admissible subject to the condition of adjustment against the actual rental when due upon commencement of the lease as discussed before.
  - B. Unilateral increase by the lessor is not permissible even if stipulated in the contract.
  - C. Bench marks. The fixing of any bench mark for determining the amount of rent, as with an inflation index etc., is permissible provided that the lease agreement clearly stipulates the same e.g. if the inflation rate as declared by an authoritative body like the State Bank etc. is said to be 10% per annum, then the rent can be increased every year by that percentage.
7. Penalty for late payment of rentals. Penalty or compensation for late payment is not permissible. Rentals once due become a debt obligation or monetary asset which cannot generate profit under SHARIA'H. This situation has been exploited by unscrupulous lessees. In such circumstances, contemporary scholars have provided a solution whereby a penalty can be charged to the lessee for delayed payment though the amount recovered is only to be used for charitable purposes by the lessor. In other words, the late payment charges cannot be taken as income by the lessor. A suitable clause, therefore, is to be incorporated into the lease agreement to avoid any misunderstanding in this regard.
8. Premature termination of lease. Premature termination of lease is allowed provided that the lessee has violated or contravened the terms of the lease or it is by mutual consent of the lessee and the lessor. Any unilateral or unconditional termination of the lease either by the lessor or the lessee without prior notification is contrary to the principles of justice and equity, hence not allowed under SHARIA'H.
9. Repossession of an asset. In the event of early termination, or upon maturity of the term of lease, assets have to return to the lessor unless he voluntarily relinquishes his rights or makes a gift of the leased assets to the lessee. However, rent would be payable only up to the date of termination and not beyond. Entitlement or the right of the lessor to claim rent from any period

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<sup>4</sup> Articles presented to 18 congress of Islamic banking, Central Bank of Islamic republic of Iran publisher, Tehran, 2007, p. 134.



- after termination, even if expressly stipulated in the contract, is not valid under SHARIA'H.
10. **Residual value.** It is accepted under SHARIA'H that ownership of the asset belongs to the lessor and, therefore, assets should revert back to him upon expiry of the lease. Any stipulation to the contrary in the contract that the lessor can sell or transfer the asset to the lessee upon the expiry of the term of the lease at a pre-determined price called residual value is not considered valid from the point of view of SHARIA'H. However, this point is currently a subject matter of debate among contemporary scholars. They are of the view that if a lessor unilaterally undertakes or promises to transfer the ownership to the lessee as a gift or at a token price separate from the lease agreement, then this can be considered validly binding on the lessor at the option of the lessee.
  11. What is important is that under SHARIA'H the leasing and sale/purchase transactions are two separate things and should not be mixed up in one contract, as both are independent and governed by separate rules. Nothing, however, in SHARIA'H stops the lessor from giving away the ownership of his assets at his own discretion or good will toward the lessee at any mutually agreed-upon price or as a gift upon the expiry of the leasing contract.
  12. *Sale and lease back.* This is allowed, but only as two separate transactions. That in the first place there is a sale of assets to be purchased by the lessor. This is governed by SHARIA'H rules of sale/purchase at a fair market value. Once the ownership title is validly passed on to the lessee, a lease transaction can then be executed separately through a lease agreement.
  13. *Sub-lease.* Sub-lease by the lessee is permissible under SHARIA'H subject to the consent of the lessor and can be expressly outlined in the lease agreement. In SHARIA'H, however, there are divergent views if the rent arising from the sub-lease is higher than the rent payable on the original lease. Some scholars allow the differential to be retained by the lessee while others feel that the surplus received from the sub-lease should be passed on to the owner i.e. main lessor.
  14. *Assigning of the lease.* Also permissible under SHARIA'H, the lessor can sell the leased assets to a third party along with his rights and obligations. The relationship between lessor and lessee in this case will be determined between the new owner and the lessee. However, the lessor cannot assign the lease without transferring the ownership for monetary consideration. Here the basic SHARIA'H cornerstone of asset-back transaction is not there. Rent receivables are debt obligation which cannot therefore be transacted for a monetary price. Assignment of lease rentals without monetary consideration is, however, not prohibited in SHARIA'H.
  15. *Securing of the lease.* Leased assets can be secured along the same principles governing the assignment i.e. ownership of assets along with the rent. Rent alone without ownership of the assets cannot be secured for the reason of being a debt obligation as discussed before. Securing a lease can be made wholly or partly to one party or to a number of persons. Documentation has to be carefully prepared to ensure the securing instrument represents assets and not the debt or monetary obligation alone (Shabani and Farzinvasb 2003, pp. 59–65).

## 2.5 Some difficulties

Major hurdles faced by Islamic finance houses are the absence of a necessary legal framework and the lack of adequate infrastructure in the banking and investment fields.

The modern banking system is based on the concept that money should be treated like any other factor of production and must earn some return over a period of time. It is argued that the establishment of large-scale enterprises, and hence material progress, is not possible unless there is an agency that can mobilize financial resources from the public by paying them some interest, while lending these resources to entrepreneurs. By charging these entrepreneurs a higher interest, these agencies were able to utilize the difference (called a spread) to meet their expenses and to make some profit for the owners of the agency (i.e. share-holders). Banks were established to fulfill this need and from the beginning were only authorized to perform this function. They were legally prohibited from entering into trade or industry. When the Government of IRAN decided to introduce an interest-free banking system, this prohibition was removed. After a lot of in-house the banks were told that they were allowed to deal in only 1–12 means of financing (only two were classified as “Financing by Lending”).

These two permitted lending without interest by charging the actual expense incurred by the banks to meet their cost of operation and QARDE AL’HASANA. All the rest were either trade-related or investment-type models. These included the purchase of goods by banks and their sale to clients at an appropriate mark-up price on a deferred payment basis, in case of default there being no further mark-up. This sale of goods on mark-up is known as MURABIHA. Other types of financing were hire-purchase, leasing, MUSHARIKA or profit- and-loss-sharing, equity participation and purchase of shares, etc.

Since MURABIHA was the type nearest to lending and since it did not require any expertise in buying and selling commodities, bankers limited most of their financing to this type. In order to eliminate the risk of prospective buyers refusing to accept goods purchased by the banks by reason of not being strictly in accordance with the specifications, banks were allowed to appoint the prospective buyer as their agent for the purchase of the goods and later for the sale of the goods to the buyer’s firm. Furthermore, to give as much leeway to the banks, as safeguards of public money, as possible, the ULAMA did not fix a waiting period between the two stages of buying and selling.

The banks did not assume the role of trader and MORABIHA degenerated into lending on mark-up. The banks rarely hired persons who knew even the basics of trading, nor did they train their existing staff to learn the art. They did not even bother to find out whether their agents had actually purchased the goods or not. The inability or reluctance of banks and financial institutions to change over their operations from lending to trading has been a serious impediment to the Islamisation of the economy.

The blame does not entirely fall on the bankers. Depositors have become so accustomed to their money remaining safe and yet earning profit that if a bank had really ventured to trade and incurred a slight loss, then the depositors would have

immediately demanded their money back causing the bank to go bankrupt. In the existing state of morality this was more likely to happen. It actually did happen to a few investment companies that had started with good intention, but could not go on giving away handsome profits to their depositors.

A lack of seriousness and dedication in those responsible for the implementation was also another great impediment to the achievement the goal of an interest-free economy. Many of these individuals thought that in the present world, there was no alternative to interest, yet something had to be done because of demands from the government. Some, who were more influenced by Western education and culture, thought that interest banking was not prohibited by Islam. Yet others thought that the efforts being made were only superficial and in reality the new system was no different from the existing system.

One weakness in the implementation of the proposals to eliminate interest from the system was that people were not sufficiently motivated to kill a part of their financial interests for the sake of carrying out the commands of Allah (SWT), and the Prophet (SAW). Anyone attempting to change a well-established practice must be prepared to make some kill for this, as arguably no noble cause has been achieved without any kill. The prevailing level of public morality within the existing legal and taxation system of the state made it an up-hill struggle to rid the banking system of interest. And it remains so. Beyond this, there are many avenues of making profit that would have to be forgone and many types of modern banking services which also could not be provided by a bank working strictly on Islamic principles. For example, they could not keep their surplus cash in fixed or saving deposits. In spite of these difficulties, those who were engaged in the task of Islamisation took it upon themselves to portray as successful the reforms, while those who pointed out the difficulties were labeled as either a cynic or an opponent of the new system. Anyone who uttered a word of caution was regarded as someone who did not want the experiment of Islamisation to succeed. As a matter of fact, reward in the Hereafter (AAKHIRAT) should have been the main purpose of Islamisation. It might not have attracted many people, but the foundation would have been firm.

One great obstacle in the realisation of the goal of an interest-free economy has been absence of a proper environment. Unfortunately nothing has been done to produce an ideal or a near ideal Islamic environment by government or public leaders. The most important pre-requisite for the enforcement of SHARIA'H is A'DL [translation!!!!!!]. Establishment of the rule of law and ensuring justice to aggrieved persons should be the first task of an Islamic state, yet nothing have been done to achieve this end (Khavari 2004, pp. 97–103).

One very important requirement of an ideal environment is an inflation-free economy. Inflation erodes the real value of money, meaning that when a person gives a sum of money on loan and receives the same amount back after 1 year, he has made a net loss. A major source of inflation is deficit financing. The printing of notes to meet budgetary deficit is in fact an injustice to the public, since the real value of their money is consequently eroded. In this respect too, the government's performance is very discouraging. Government borrowings at high interest rates and the quantum of the government's domestic and foreign debts has reached a level

which cannot be sustained. There has also been no effort to change the taxation structure so as to bring it to conform to SHARIA'H.

### 3 Islamic banking in Iran

In Iran, after the revolution of 1979, the banking system was nationalized. Shortly thereafter, in 1983, the Law of Usury-Free Banking was passed, and on March 21, 1984, interest free banks started to implement Islamic banking based on the 1983 law.

There are several questions regarding the feasibility of the practice of Islamic banking which involve, among other things, bank activities, the process of money (deposit) creation, international banking relations, government lending and borrowing from financial institutions, the monetary policy of the Central Bank, etc.

In an Islamic banking environment, commercial banks are allowed to accept demand deposits the same way that their counterparts in the United States were permitted to do under "Regulation Q". That is, they accept deposits without paying any interest on them. Using Islamic terminology, this is called Qard al-Hasanah (Qarz ol-Hasaneh). However, banks are not prohibited from offering prizes or other incentives of various forms to attract funds to the bank. For example, in its routine banking practice, the bank might give priority to those who have a deposit account, e.g. those depositors might be given priority over others in their loan applications. Besides the interest-free demand deposits, people could choose to deposit their money in interest-free savings deposits as well. These are also classified as Qarz ol-Hasaneh.

For those people, however, who wish to earn some form of compensation for their deposits, other types of savings accounts are available. These alternative accounts may set minimum limits on the amount of deposit and the length of time required for the deposit. There are short-term investment deposits which require depositors to leave their resources in the bank for a minimum of 3 months and which require a minimum deposit of RIs; 2,000. For those people who have a greater amount of money available for deposit, at least RIs. 50,000, and who are willing to part with their money for at least 1 year, there are long-term investment accounts. Depositors of these accounts are not compensated on the basis of a predetermined interest rate. They are paid, however, a share of the bank's profits, whatever those profits might be.

On the asset side of their balance sheet, commercial banks or other specialized financial institutions<sup>5</sup> can have interest free loans (Qarz ol-Hasaneh), or income-earning assets. Every bank is required to provide a portion of its deposits, almost free of charge to the industrious and the needy. Most of these loans go toward productive small businesses and toward personal expenditures such as weddings, medical, needs, etc. There is a 1.5% per year handling fee charge for "industrial" or a 1% per year handling fee charge for personal Qarz Ol-Hasaneh. Industrial Qarz Ol-Hasaneh must be paid back in no more than 5 years and personal ones in no

<sup>5</sup> First Iranian financial institution (After Islamic revolution) established in 1994.

more than 1 year. Other types of assets that banks can acquire can be divided into several categories: (Mudarabah, or Qirad), Mosharekat, Installment Sale, Lease = Purchase contracts, Mozareh, Mosaqat, Jo'aleh, and Direct Investment.

Modarabah is one way that a bank can provide financial resources to an individual or a firm for a particular project. In this type of transaction, the bank and an agent (customer) agree to engage in some commercial activity and earn, hopefully, a profit, which will be shared between the bank and the agent (customer). The expected rate of profit is not known in advance (Shabani and Farzinvasht 2003, pp. 74–108). However, the Central Bank (Bank Markazi Iran) sets the minimum expected rate of profits for policy and resource allocation purposes. This type of agreement is used for any short term commercial activity except importation which is currently prohibited. The expected rates of profit set by the Bank Markazi Iran for such activities are 12% for domestic commerce and imports (when legal), and 8% for export agreements. Setting the expected profit rates for imports and exports allows the use of Modarabah agreements for imports and exports activities in the future, whenever the government decides to relax the prohibition mentioned before. The maximum amount for a contract between a bank and an individual engaging in commercial activities is Rls. 50 million; for banking contract with an incorporated the maximum is Rls. 500 million (Hassan and Nasrin 2003, pp. 42–46; Zangeneh 2004, p. 127).

Musharakah (Mosharekat) is a partnership arrangement between the bank and an individual or a firm to start a new line of business. In this case, assets of the business entity belong to all partners and profits will be shared according to each Mosharekat agreement. Bank Markazi Iran sets the minimum expected profit rates for Mosharekat. Currently the rates are 6% for agricultural projects; 8% for mining and industrial projects; 10% for housing and construction; 12% for commerce and services. Besides the minimum required profit rates that can be manipulated by the Central Bank for policy purposes (setting the country's priorities), the maximum amount of the bank's share in a project can also be used as a policy variable. Currently, the maximum share for a bank entering into a civil Mosharekat agreement in agriculture is 90%; in mining and industry it is 85%; in housing, commerce, and services the rate is 80%. Even though the bank is providing a given share of the capital, this does not necessarily mean that the profits are to be shared in the same proportions. That is, the ability to manipulate how the profits are to be shared is another tool available to the policy makers for setting the economic priorities of the country. It is very possible that, for instance, in an agricultural project, 90% of the capital may be provided by the bank, yet only 50% of the profits are agreed to be paid to the bank. This is another way of encouraging expansion of investment in agriculture. The maximum amounts that a bank can invest in a Mosharekat agreement are set by the Bank Markazi Iran. Currently, the maximum amounts are one billion rials for agriculture, one billion rials for mining, 500 million rials for services, and 500 million rials for commerce.

Installment sales constitute another type of service that a bank can provide its customers. On an installment basis, a bank can buy and resell tools, raw materials, machinery, houses, or any business inventory, thus earning a profit. Currently, banks are not allowed to finance consumer durable goods on installment.

The sale price of goods sold on an installment basis will be based on a cost-plus scheme. In the case of raw materials and spare parts, the sale price must be paid back in 1 year. In special cases the repayment period can be postponed one additional year. In the case of machinery, the repayment period cannot be more than the useful life of the machine. Currently, the rate of profit on installment sale of tools and spare parts is 4% and the rate of profits on machinery is 8% in agriculture and mining and industry, respectively. The maximum amount of installment loans is Rls. 50 million and Rls. 3 billion, for individuals and corporations, respectively. The rate of profits for machinery bought on an installment basis in the service sector is 10%. The maximum amount of an installment loan made to an individual for machinery is Rls. 100 million, while the maximum amount loaned to a corporation is Rls. 3 billion, the bank may require a down payment from a corporation. Currently, Iranian banks require a 10% down payment for agricultural machinery, 15% for mining and industrial machinery, and 20% down payment for machinery used in the service sector (Makiyan 2003, pp. 39–41).

Home financing is more involved than other types of installment sales. In regard to housing construction, the applicant can borrow up to 80% of the project's cost to complete a construction project. After the completion of the project, which should not be more than 1 year after the time the contract was signed, the bank will add a maximum of 10% profit, on an annual basis, to the money borrowed during the construction period. At that time the builder can pay the entire amount and the bank would release the mortgaged project. If the borrower should decide to repay over a long period of time, i.e. on an installment basis, the bank will add 6 or 10% profit per year (6% for those with a savings account and 10% for others) to the borrowed money, and the property will remain mortgaged until all the debt is completely repaid.

The Lease-Purchase (Hire Purchase) contract is a device that allows a bank to buy and lease buildings, machinery, and equipment. At the end of the lease period, the lessor (the bank) transfers the property (movable or immovable property) to the lessee. Currently, the profit rate is in the range of 6–8% for agriculture, 8–10% for mining and industry, and 10–12% in the service sector. The maximum amount of a contract in industry is Rls. 100 million and Rls. 50 million for the service sector. The maximum contracted amounts are Rls. 500 million for the service sector and Rls. 3 billion for the industrial sector. There is a 20% down payment requirement for these contracts.

The Muzara'a (Mozare'a) contract is a device that allows a bank to lease agricultural land. The bank may provide a piece of land, for a specified period of time, to a farmer for agricultural purposes and share the profits earned. In addition, the bank may provide seed, fertilizer, water, pesticide, transportation, etc. Currently, banks have the authority to set the terms of Mozare'a contracts, which are usually for 1 year.<sup>6</sup>

Musaqat (Mosaqat) is the same as Mozare'a except the contract is for trees. The bank may provide an orchard to a farmer for a period of time (1 year or until its fruits are harvested) for a share of the profits.

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<sup>6</sup> Ibid, p. 46.

**Table 1** Methods for providing financial resources to individuals and businesses

Methods	In percent
Lease-purchase	9.5
Installment sale	18.4
Civil partnership	17.5
Mudarabah	19
Jo'alah	6.6
Legal partnership	8.7
Debt purchasing	11.2
Others	9.1
Total	100

Source: Iranian central bank report (Tehran, 2006)

Jo'aleh is a service contract according to which one party (Ja'el) purchases another party's (Amel or contractor) services for a specified commission (Jo'al). The bank may function as either Ja'el or Amel depending on the situation and the need of the customer.

Direct Investment is another way that a bank can engage in whatever activities it deems desirable for the purpose of economic development, or in response to a social concern. Direct investment, however, occurs only as long as the project is not designed to produce luxury and/or unnecessary goods and services. Obviously the definition of socially and economically desirable goods and services is subject to the discretion of the authorities. The minimum profit rate required to justify direct investment is set by the Currency and Credit Council of Iran.

Because Islam is not just a religion but a total way of life, the resurgence of Islamic fundamentalism has had far-reaching effects, even to the point of influencing economic systems. One of the most recent manifestations of the Islamic way of life has been in banking. In many countries, business persons, in cooperation with governments, have established Islamic Banks either to compete with an existing interest-based banking system or to completely replace it. This has happened despite misgivings and uncertainty that exist on theoretical as well as theological grounds (Karimi et al. 2003, p. 53).

Iran, in contrast to all other countries that have some degree of Islamic banking, has completely transformed its banking activities to comply with the accepted Islamic principles. Some of the transformation of the liabilities of the banking system is evident in Table 1. Interest-oriented savings accounts were discontinued in 1362 (1983). Starting in 1363 (1984), new types of deposit accounts, e.g. qarz ol-Hassaneh; short and long-term investment deposits were created.

As far as the feasibility of Islamic banking, the banking system has been operating over the last few years in Iran without many publicized problems. There are a variety of methods for providing financial resources to individuals and businesses to promote flexibility within the system. For example, one could use Hire Purchase agreements for industrial projects, commercial, or housing projects.<sup>7</sup>

<sup>7</sup> Ibid, p. 79.



As far as monetary policy is concerned, the Bank Markazi Iran is not any less able to manage the monetary policy now than before the implementation of Islamic banking. As was discussed before, there are several new tools available to the central bank to manage the monetary policy. These new tools include the establishment of maximum and minimum amounts of loans that the bank can provide for a particular project; the expected rate of profit from a project; and the bank's share of the profit. Each of these could be changed to achieve an economic objective and/or direct the scarce resources toward a particular sector of the economy.<sup>8</sup>

#### 4 Conclusions

To outline the broad features of a strategy which holds the promise of successfully implementing an Islamic system of finance are as follows:

1. The process has to be guided by basic legislative efforts covering all the essential elements of the proposed programmed.
2. The legislation would define RIBA and prohibit transactions connected with RIBA.
3. The application of the law would be unqualified and without exception, thus the entire financial sector, covering banking government finance and foreign transactions would be covered in its ambit.
4. Given the unqualified and non-exceptional nature of the proposed law, even existing relations will have to be converted into permissible forms, for which a suitable time frame, within a phasing-in period, will be allowed.
5. The law should also provide for the Constitution of a SHARIA'H Board which would assist the SBP to formulate permissible means of financing. Such means, specified with the prior approval of the Board, will only be illustrative and no restrictions will be placed on banks and financial institutions to design means of financing which are free of RIBA.
6. A major portion of the law will have to be devoted to a plan of restructuring the fiscal policy which comprises a scheme for the privatization of public sector assets and the use of its proceeds for the settlement of the outstanding stock of public debt.

The proposed strategy is based on the clear recognition of the scope implied by the prohibition of RIBA. This is critical, for otherwise the solution will continue to elude us.

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<sup>8</sup> Ibid, p. 64.



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