

Islamic Banking In IRAN From Theory To Practice

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Abstract

The emergence of strong Islamic movements in recent years has enenerated a renewed interest in 'Islamic Economics', especially islamic (interest-free) banking. Iran has instituted Islamic banking systems, while many other countries have established 'mixed' systems which combine aspects of Western and Islamic banking practices. Iran began its interest-free banking system in 1979 when it nationalized its commercial banks. The process was accelerated in 1980 when the Money and Credit Council of Bank Markazi Jomhoori Eslamee Iran (the Central Bank of the Islamic Republic of Iran) reduced the interest rate charged by commercial banks against borrowers and those paid to depositors. In April 1983, the Iranian government submitted the Islamic banking bill to Majlis (the Iranian unicameral legislative body). Once approved by Majlis and subsequently by the Council of Guardians (a body that sanctions the compatibility of all laws with the Islamic tenets), the Islamic banking bill became law on 21 March 1984. This law banned the payment of interest on all lending and borrowing activities. A central tenet of an economic system based on Islamic principles is the absolute prohibition on the payment and receipt of interest .It is this prohibition that makes Islamic banks and financial institutions differ in a fundamental sense from their Western counterparts. In addition to the elimination of interest payments from all banking practices, new provisions were made for banks' acceptance of deposits. The extension of credit in a traditional sense was abandoned and new credit facilities, e.g. garz-ol-hassaneh (beneficence loans), were established. Recognizing that the abolition of interest on bank deposits would make regular saving and time deposits unattractive, the authors of the Islamic banking bill established a system whereby depositors would receive a return which would vary with the profitability of commercial banks. In practice, however, minimum rates of return were established on time deposits which depended on the maturity date of deposits. The theoretical as well as operational issues of Islamic banking in IRAN would be explained in this paper. Then, under the Law for interest –Free banking, credit operations and general regulations are analyzed. Sources of Funds of Islamic Banks are reviewed in this regard. In the following, developments of Islamic banking in IRAN would be described .

Key words: credit operations ,law of interest –free banking, shari'a, Funds of Islamic Banks, Bank liabilities and assets

Islam and the Shari'a

Comprising around 20 per cent of the world's population, Islam has established itself as the second largest religion in the world. Muslims are mainly spread over North Africa, the Middle East and South-East Asia. Although Islam originates from Saudi Arabia, non-Arab Muslims now outnumber Arab Muslims by a ratio of nearly three to one, which is also endorsed by the fact that the top four nations counting the largest number of Muslims in the world are all located outside the Middle East: Indonesia – 166 million, Pakistan – 111 million, Bangladesh – 97 million and India – 93 million. With the current reassertion of Islam the religion is of growing importance in an international context. In some countries there are clear tendencies towards an increasing use of Islamic law, also contributing to the mounting significance of the religion.

Sharia

An oddity compared with western legal systems is that in the more conservative appearance of Islam there is no separation between the church and the state. Governmental law and religion are sometimes one and the same. The religious law of Islam is called the Sharia and is a comprehensive discipline regulating all public and private behaviour. The word itself, Sharia, literally means 'the path leading to the water'. The widespread understanding of this expression implies that Sharia must be described as 'the path to be followed'. Islamic law (Sharia) can be divided into two aspects, Ibadat and Muamalat. The former involves practicalities related to worship and Muamalat deals with man-to-man issues including political and economical relationships as well as social activities. Accordingly, as Islamic banking is an economical matter, it is channelled through the Muamalat aspect of the Sharia. Another peculiar phenomenon in Islamic law is that besides classifying various actions or non-actions into forbidden and permitted behaviour there are two additional categories intended first of all for recommended conduct and secondly for reprehensive activities. These deeds are not necessarily deemed as forbidden behaviour, but the ambition should be to comply with the recommended conduct or non-conduct.

For example, in the Koran Muslims are discouraged from entering into any agreements or to close any deals Friday mornings since this is the foremost day for praying. However, an agreement entered into on this particular day is not null and void; also the contracting parties do not risk any reprisals due to the inappropriate choice of day. There are four fundamental sources of Sharia law, the most important being the holy Koran, which is said to be Allah's words presented to the Prophet. The Koran is the primary source; it is eternal and cannot be changed. The second element of Sharia law is the Sunna. The predominant meaning of the Sunna is that of the spoken and acted example of the Prophet. These examples have evolved into stories and anecdotes called Hadith, which were later, transmitted and put together. Simplified, these traditions can be said to constitute the Sunna. Just like the Koran the Sunna is everlasting and cannot be altered. As a third foundation the Ijma is a consensus of opinions, interpretations given by

religious scholars on a question of law. Qiyas is the last fundamental source of Sharia law and is a form of reasoning by analogy, a comparison with similar question already settled. Among the Shia Muslims Qiyas is not viewed upon as a legitimate source of Sharia law. In fact, the Jaferi school, the primary school of Shiites, totally rejects the usage. There are almost twenty nations that have acknowledged Islam in their constitutions. Some of them refer to Islam as the only tolerable judicial system, e.g. Iran, meanwhile others, for instance Malaysia, make use of a dual or even multi system of laws. This is also true on the topic of banking law structure, where Malaysia successfully applies a dual system with a complete range of choices. Utilising a dual or multi legal system means that, for instance, either British common law, Hindu law or Islamic law may be applied to an identical situation depending on circumstances such as religious beliefs. (Schéele,2002)

Islamic Banking Theories and Basis

Islamic banks are those banks that follow Islamic *Sharia* in their business transactions. Among other things, *Sharia* prohibits dealing in interest and undertaking transactions with unknown fate, while it requires transactions to be lawful (*halal*), and also requires Muslims to pay the religious tax *Zakah*. Abolishing interest from their dealings is the fundamental principle on which Islamic banks are based. Islam's strict ban on dealing with interest seems to have social roots. Use of *Riba* (usury) violates the principle of social justice, which is very important in Islam, because it leads to rewarding people without them making an effort. Those who lend money on interest do not make an effort, nor do they participate in the risks of the projects financed, and such behaviour is rejected by the teachings of Islam. Interest-based transactions allow lenders to receive the advantages associated with lending their money, while avoiding the risks and losses attached to ownership. The most apparent reason for the ban of *Riba* is to enforce the spirit of brotherhood between Muslims. (Bassam Maali,2003) In general, the *Shariah* legal maxim in relation to commercial transactions and contracts state, "they are permissible unless there is a clear prohibition."² In a nutshell, prohibited elements of a commercial transaction must first be removed for it to be *Shariah*-compliant. The major prohibited elements under *Shariah* are *riba* (interest), *gharar* (uncertainty), *maisir* (gambling), non-*halal* (prohibited) food and drinks and immoral activities. (THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS,2004)

From the viewpoint of Islamic *Shariah*, in order to be justified islamically the banking system has to avoid interest. Consequently, financial intermediation in Islamic banking between the bank and the client takes place as a partner rather than a debtor-creditor. The financial activities of modern conventional banks are based on a creditor-debtor relationship between depositors and bank on the one hand and between the borrower and the bank on the other. Interest is regarded by conventional banks as the price of credit reflecting the opportunity cost of money. As interest is prohibited in Islam, commercial banking in an Islamic framework could not be based on the creditor-debtor relationship. The other aspect of the theoretical basis of Islamic banking is that the interest free bank is not risk free. This principle is applicable to two main factors of production, i.e. labor and capital. According to this principle, as no payment is allowed to labor, unless it is applied to work, no reward for capital should be allowed, unless it is exposed to business risk.

From these two principles of the theoretical basis of Islamic banking, it may be said that Islamic financial relationships are of a participatory nature. Based on the theoretical background, business practices of Islamic bank, especially sources and uses of bank's funds, are characterized by the following modes or techniques.

Sources of Funds of Islamic Banks

Current Accounts

Islamic banks accept deposits from customers on current accounts as conventional banks do. This account is also known as 'Demand Deposit' as the deposited amount is payable to customers on demand without any notice. As banks use current account deposits on their own risk the depositors of this type of account are not entitled to any share in the profit earned by the bank.

Savings Accounts

Islamic banks accept saving deposits from customers under Al-Wadia and Al-Mudaraba Sharia Principles. The word Al-Wadia means '*Trusteeship*'. In this case banks act as trustee for its customers. In Saving Accounts under the Al-Wadia principle the bank is given an authorization by depositors to use the fund at the bank's own risk. This type of deposit is almost similar to a 'Current account' or 'Demand Deposit' except that the bank guarantees its customer the full return of the deposited fund with any profit voluntarily. Under the Al-Mudaraba Shariah principle there are two different types of savings accounts, such as- savings under profit and loss sharing agreement and-savings under Investment Account. The word 'Al-Mudaraba' originates from the word 'Mudarib' and means '*The Manager*' of the fund. The bank in this case acts as a manager of customers' funds. The depositors on the other hand are known as 'Sahib-Al-Mal' meaning *the owner* of the fund. Deposits accepted on savings under the Profit and Loss sharing agreement is invested by the bank on its own risk. Customers give authorization to the bank to invest funds and share profit or loss on agreed proportions. Account holders of this type of account are required to maintain a minimum balance in the account. Further to the above, Islamic banks accept deposits from customers under the Investment Account on a Profit and Loss Sharing basis. The saving account of such a nature in an interest-free banking system is also known as a participatory account or a Profit or Loss Sharing (PLS) account. Depositors of this type of account receive share of profit to the agreed ratio from their funds invested by the bank. The profit and loss sharing also depends on the total amount deposited and the length of period the money is held by the bank. Depositors of an Investment Account are required to give prior notice to the bank if they withdraw their invested funds under any special circumstance. In such a case no share of profit is given for the amount withdrawn.

Saving Deposit as Quard E Hasan

Apart from the above Islamic banks accept savings from customers as Quard E hasan (benevolent loan) from the customers. Depositors of this sort of savings deposits receive financial or non-financial benefits from the bank.

Uses of Funds of Islamic Banks

Based on the theoretical viewpoint as discussed earlier two fundamental techniques or modes of investment advocated by the Islamic Shariah Principle is;

- Mudaraba (Capital Financing)
- Musharaka (Partnership)

Mudaraba (Capital Financing)

Capital Trust financing is a contract between at least two parties in which the bank as the investor supplies the entire capital of the business forming a relationship between the supplier of capital and the user of capital. These two parties work together and share profits and losses. Under 'Murabaha' financing the investor is known as 'Rab-Al-Mal' which means the owner of the property and the entrepreneur is called 'Mudarab', meaning the manager of capital. When the venture ends, the manager of capital i.e. the entrepreneur returns the entire capital to the bank, along with an agreed proportion of profit. If there is any loss, it is born by the bank. The main advantage with this type of partnership is that it combines the efforts of human beings and their skills with the capital, which contribute greatly towards the development activities in a society and also assists to solve unemployment problems by utilizing manpower resources in a productive way.

Musharaka (Partnership)

The word 'Musharaka' means a profit sharing joint venture, designed to limited production or commercial activities of long duration. In this case the bank and the customer contribute capital jointly. They also contribute managerial expertise and other essential services at agreed proportions. Profit or losses are shared according to the contract agreed upon. An individual partner does not become liable for the losses caused by others. In addition to the above two financial arrangements, Islamic Banks currently in existence are also engaging in or actively considering several other financial practices usually acceptable in Islamic Law. These are:

- Murabaha (Mark-up or Cost-Plus-based Financing)
- Ijara (Leasing) and
- Qard- E- Hasan (Interest-Free Loan)

Murabaha (Cost plus profit)

The word 'Murabaha' means a cost-plus Profit contract. In this system of financing the bank agrees to purchase for a client who will then reimburse the bank in a stated time period at an agreed upon profit margin. The mark-up price that the bank and the buyer agree to is mainly based on the market price of the commodity. Thus the bank earns a profit without bearing any risk. (*Nurul Alam,1997*)

Ijara (Leasing)

The word 'Ijara' indicates leasing. The leasing purchase is another technique followed by Islamic banks in financing customers. This system is almost similar to the leasing activity provided in traditional banking. Leasing is a contract between the bank and the customer to use particular assets. In this case the bank is called lessor and the customer is called lessee who wants to use the assets and pays rent. in this regard argues as, " The leasing agreement is based on profit sharing in which the bank buys the movable or immovable property and lease it to one of its client for an agreed sum by installments and for a limited period of time into a saving account held with the same

bank. Different forms of leasing are permissible, including leases where a portion of the instalment payment goes toward the final purchase at the end of the leasing period whereby the ownership of the asset or equipment will be transferred to the lessee through a sale and purchase contract. It is considered as Islamic hire-purchase or Islamic finance leasing and also known as *ijarah thumma bai`* or *ijarah wa iqtina`* or *ijarah muntahiyah bi tamlik*. **(THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS,2004)**

jo`alah(service charge) This is a transaction in which one party undertakes to pay another a specified sum of money as a fee for rendering a specific service in accordance with the terms of the contract negotiated between the two parties.This mode facilitates consultation ,fund replacements, and trust activities.(Mirakhor &khan,1990)

Muzara`a.This contract is a device that allows a bank to lease agricultural land .The bank may provide for agricultural purposes and share the profits earned . In addition ,the bank may provide seed,fertilizer,water,pesticide,transportation,etc.(Zangeneh,2001)

Quard al Hasanneh (Interest free loan)

Quard E Hasan means an interest-free loan given by the Islamic bank to the needy people in a society. The practice of dealing with this sort of investment differs from bank to bank. Quard E Hasan is normally given to needy students, small producers, farmers, entrepreneurs and economically weaker sections of the society, who are not in a position to obtain loan or any financial assistance from any other institutional sources. The main aim of this loan is to help needy people in a society in order to, make them self-sufficient and to raise their income and standards of living. **(THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS,2004)**

Developments of Islamic banking in IRAN

Iran began its interest-free banking system in 1979 when it nationalized its commercial banks. The process was accelerated in 1980 when the Money and Credit Council of Bank Markazi Jomhoori Eslamee Iran (the Central Bank of the Islamic Republic of Iran) reduced the interest rate charged by commercial banks against borrowers and those paid to depositors. In April 1983, the Iranian government submitted the Islamic banking bill to Majlis (the Iranian unicameral legislative body). Once approved by Majlis and subsequently by the Council of Guardians (a body that sanctions the compatibility of all laws with the Islamic tenets), the Islamic banking bill became law on 21 March 1984. This law banned the payment of interest on all lending and borrowing activities. An exception was made for the ordinary transactions of the Central Bank with the government, government institutions, public enterprises, as well as banks, as long as these institutions use their own resources. A number of provisions of Islamic banking, two of which are listed here. First, in addition to the elimination of interest payments from all banking practices, new provisions were made for banks' acceptance of deposits. Second, the extension of credit in a traditional sense was abandoned and new credit facilities, e.g. *garz-ol-hassaneh* (beneficence loans), were established. Recognizing that the abolition of interest on bank deposits would make regular saving and time deposits unattractive, the authors of the Islamic banking bill

established a system whereby depositors would receive a return which would vary with the profitability of commercial banks. In practice, however, minimum rates of return were established on time deposits which depended on the maturity date of deposits.(YOUSEFI , ABIZADEH &MCCORMICK,1997)

Therefore the process of Islamization of Islamic banking in Iran has proceeded in three distinct phases. Nationalization, restructuring, and reorganization of the entire banking system characterized phase one taking place between 1979 and 1982. External and internal developments did not allow the policy makers to develop a coherent plan for Islamization of the banking system, although various piecemeal attempts were made towards this objective (Khan&Mirakhor,1989).

The second phase began in 1982 and lasted until 1986. It was a phase primarily characterized by adoption of legislative and administrative steps in order to implement a clearly articulated model of Islamic banking (Iqbal & Mirakhor 1987). The law for *Riba*-free banking was passed in August 1983, giving a very short deadline of one year to the banks to convert their deposits in line with Islamic law and their total operations within three years from the date of the passage of the law.

The third phase, which continues till now, began in 1986. This phase defines the role of the Islamic banking system differently from the earlier phases. The system is now expected to be an integral part of the Islamic government, and thus, a direct instrument of its policies. This development is a direct result of the political debate within Iran surrounding the proper role of the government in an Islamic economy. This debate culminated in a ruling by Imam Khomeini, which confirmed a highly activist role for the central government in shaping the structure of the Iranian economy and legitimized a trend in the interventionist posture of the government vis-à-vis the economy. The ruling also indirectly affirmed the use of the banking system as an instrument for promoting social and economic development.

The banking sector has been used as an instrument to restructure the Iranian economy. The restructuring was essentially directed towards the shifting of financial resources from services and consumption to the production sector in four ways. First, credit to the service sector, which constituted some 55 percent of the GDP (1984-85), has been drastically reduced to halt its expansion in the short-run and curtail its size in the mid-term. Second, using all available modes of Islamic finance to help farmers to improve and expand production has used bank credit to encourage the growth of the agricultural sector. Coupled with substantial government subsidies for seed, fertilizer, machinery, and crop insurance, the credit policy of the banking system is aimed at reviving the agricultural sector. Third, Islamic banking has been used to create incentives for the development of a co-operative sector spanning agriculture, industry, and trade. Fourth, the banking system, in partnership with the government, undertakes to finance large industrial projects and investment in social overhead capital (Mirakhor & Zaidi ,1988).

Bank liabilities and assets under Interest -free banking Law

The structure of the Islamic banking system was put in place in 1983 by issuing the Interest-Free banking Law of 1983. This law was implemented in March 1984,

and banks were given 18 months to complete transformation to Islamic banking principles.

The Interest-Free Banking Law contains several features that are peculiar to the Iranian circumstances. These features could be elaborated as follow:

Al Qard al-Hasan

This type of lending receives a very high profile in the 1983 law. The giving of loans and credits without interest is laid down as one of the functions of the banking system. Banks are allowed to recover expenses associated with granting *al qard al-hasan* finance. Fees of 1.5 per cent for institutions and 1 per cent for individuals have prevailed. The maximum tenor for institutions is usually five years and for individuals three years.

Remuneration of deposits

The 1983 law does not provide a fixed system for paying depositors . Demand deposits may not receive a fixed return, but a bank may offer 'unfixed reward in cash or in kind'. Banking fees may also be waived and special services offered. The 1983 law is scarcely more specific on the remuneration of long-term investment deposits. Article 20 of the law gives the central bank the power to fix maximum and minimum percentages of profits that may be distributed to depositors. These powers cover remuneration of all types of deposits, short and long-term.

Types of long-term deposits

The developmental role of the banking system also becomes clear in the note attached to article three of the law, dealing with types of deposits. The note specifies eight forms of investment deposit in which a bank has a partnership on. These are: *musharaka*, *mudaraba*, *ijara bi shart al-tamlik*, *muamalat bil taqsit*, *muzara'a*, *musaqat*, *muamalat bay al-salaf*, and *joala*.

These types of financing are fairly standard forms of Islamic finance. The central Bank of Iran has specified which types of financing are appropriate to certain types of transactions. For example, installment sales and *al qard al-hasan* are appropriate to finance personal consumption, while *mudaraba*, *musharaka*, and *joala* may be used for commercial finance. (Ahmad,2006)

Financing and credit operations and Interest-free banking Law

The Law provide various modes of operation upon which the financing transactions of the banks must be based. The banks can acquire profit-sharing assets via two principle modes of transactions: *Mudarabah* and *Musharakah*. Under the provisions of the first mode, surplus funds are made available to the entrepreneur to be invested in a productive enterprise in return for a predetermined share of the profits earned. Financial losses are borne exclusively by the lender. The borrower, as such, loses only the time and effort invested in the venture. This arrangement, therefore, effectively places human capital on par with financial capital. In *Musharakah*, on the other hand, there is more than a single contributor of funds. All parties invest in varying proportions, and the profits (or losses) are shared strictly in relation to their respective capital contribution. This financing method corresponds to an equity market in which shares can be acquired by the public, banks, and even the central bank and the government. Traditionally, *Mudarabah* has been

employed in investment projects with short gestation periods and in trade and commerce, whereas *Musharakah* is used in long-term investment projects. These two modes have their historical counterparts in farming (*Muzar'ah*) and in orchard keeping (*Musaqat*), where the harvest is shared between and among the partners based on prespecified shares. In transactions where profit sharing is not applicable other modes of financing can be employed, which include the following.

Qard al-Hasanah (beneficence loans). These are zero-return loans that the Quran exhorts Muslims to make available to those who need them. Financial organizations that provide these loans are permitted to charge the borrower a service charge to cover administrative costs of handling the loan so long as the charge is not related to the amount or the time period of the loan, and represents solely the cost of administering the loan.

Bai' Mua'jjal (deferred-payment sales). This mode allows the sale of a product on the basis of deferred payment in installments or in a lump-sum payment. The price of the product is agreed on between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

Bai' Salam or Bai' Salaf (purchase with deferred delivery). In this transaction the buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made, that is, agricultural and manufactured products.

Ijara (leasing). In this transaction, a person leases a particular product for a specific sum and a specific period of time. He can also negotiate for lease-purchase of the product, where each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.

Jo'alah (service charge). This is a transaction in which one party specifies a sum of money as a fee for rendering a specific service in accordance with the terms of the contract. The party who undertakes to pay another a fee for the contract negotiated between the two parties. This mode facilitates consultation, fund placements, and trust activities. (khan&mirakhor,1990)

Other Regulations and supervisions in interest-free banking Law

The Law for interest-free banking not only provides regulations to cover specific modes of transactions but also specifies additional regulations that govern asset acquisition by the banks. The most important of these regulations are the following: (i) Banks are responsible for the control and supervision of the activity to which their own resources are contractually committed. (ii) While banks may engage in joint venture projects with other banks, one specific bank must assume the responsibility of supervision and control of the project undertaken. The Law has placed the responsibility of the supervision of the banking system of the country with

Bank Markazi. Bank Markazi is required to determine minimum and maximum profit shares for banks in their Mudarabah and Musharakah activities. Moreover, Bank Markazi is authorized to audit and inspect banks 'accounts and documents (Iqbal & Mirakhor, 1987).

conclusions

Islamic banking in Iran was shaped by the overall reorganization of the economy after the 1979 revolution. The structure of the Islamic banking system was put in place in 1983 by issuing the Interest-Free banking Law of 1983. This law was implemented in March 1984, and banks were given 18 months to complete transformation to Islamic banking principles. The Law required the banks to convert their deposits in line with the shari'a within one year, and their total operations within three years, from the date of the passage of the Law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The Interest-Free Banking Law contains several features that are peculiar to the Iranian circumstances.

In Iran the banking system is looked on as an instrument for achieving the goals and objectives of the Islamic revolution. Three distinct phases of this progress have been identified. Each phase has meant a significant jump in utilization of the banking system to achieve the economic goals of the revolution and each phase has been prompted by impatience of the government authorities with the pace of Islamization. Thus, in the third phase the line of demarcation establishing the previous status for the banking system has become quite blurred, and the banking system is being rapidly integrated with the rest of the government. Thus, the banking system is perceived not only as the major source of financial resources to underwrite the government's fiscal deficits but also as an effective tool for pursuance of Islamic economic objectives, such as the modifications and shifts in the pattern of consumption, investment, and production behavior in the economy as well as restructuring of the economy and income redistribution. The general conclusion that can be derived from this study of Iran is that the adoption of Islamic banking has not led to the collapse of the financial system as some had feared. There has been a rapid growth of private-sector deposits in Islamic modes in the country, demonstrating that the system can be effective in mobilizing resources.

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