

**A Pathology of Usury-free Banking in Islamic Republic of Iran; Proposing New Approaches**

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**Abstract**

The main purpose of this paper is to review critically the twenty – five year experience of the usury – free banking in Islamic Republic of Iran. Empirical evidences and direct observations of the researcher indicate that there is a quick need to update the usury – free banking law of 1983 to catch up with the ever changing circumstances of domestic and international socio-economic environment. Government intervention and liabilities, insufficient training of employees and customers, unequal conditions of national and private banks competition, limited monetary policy tools, lack of a systematic relation between money and credit market and financial market, neglecting international linkages, low capital adequacy, low total factor productivity, conflicts between jurists and bankers on the legitimacy of contracts, skewness of contracts for the benefit of installment sales, low deposit attraction, weak customer services, etc. have made the prevailing situation in an unproductive position calling for a comprehensive revision of the law and its operational rules and regulations .The paper ends with a package of recommendations to revise the law and to facilitate the operational capability.

## **Introduction**

After the Islamic revolution in Iran (1979), several attempts were undertaken to convert the conventional banking system into an Islamic one. These attempts differentiated Iran from many Islamic countries which alongside their so called "Islamic banks" have parallel "Conventional banks operating in a competitive environment. By now there are at least three countries, which have committed themselves to the elimination of interest from their entire financial system. These include I.R. of Iran, Pakistan and Sudan.

Shortly after the revolution the banking system was nationalized. After some trial and errors the "law for Usury-Free Banking operations" was enacted in August 1983 to replace interest-based banking by interest-free banking.

As read in article 1 of the law, the objectives of Islamic banking system were:

(1) The establishment of a monetary and credit system based on rightness and Justice (as delineated by Islamic jurisprudence) for the purpose of regulating the sound circulation of money and credit to enhance the health and growth of the country's economy.

(2) Availing itself of monetary and credit mechanisms, to engage in activities conducive to the attainment of the economic goals, policies and plans of the Government of the Islamic Republic.

(3) Creation of necessary facilities for the extension of cooperation and Gharz-al-hasanch among the general public through the attraction and absorption of surplus funds, reserves, savings and deposits, and the mobilization thereof in provision of conditions and opportunities for gainful employment and investments, as stipulated in Clauses (2) and (9), Article (43) of the Constitution.

(4) Maintenance of the currency value and equilibrium in the balance of payments and facilitating the commercial exchanges.

(5) Facilitating payments and receipts, exchanges, transactions and other services to be performed by the banks, as determined by the Law.

This law allows the banks to accept three types of deposits, namely, qard hasan deposits, general term investment deposits and project-specific investment deposits, the qard hasan deposits can be comprised of current as well as savings accounts, which differ in their operational rules, The holders of current and savings accounts are guaranteed the safety of their principal amounts and are not entitled to any contractual return. However, banks are permitted to provide incentives to depositors through (i) the grant of prizes in cash or kind; (ii) a reduction in or exemption from service charges or agent's fees payable to banks, and (iii) according them priority in the uses of banking facilities, Holders of general term investment deposits are entitled to receive a variable return, depending on the profitability of the bank's investments, the Central Banks fixes the minimum and maximum rates permissible. At the beginning of the year, 'expected' rates of profit are declared.

However, the banks are required to calculate the 'actual' rates of return from their operations periodically and the difference between the two is adjusted post facto. The law allows the banks to undertake and/or ensure the repayment of the principal amounts of term investment deposits. The third type of deposits accounts are project specific in which banks mobilize savings for specific investment projects. In this type of account, the rate of return is calculated at the end of the project concerned. The bank charges only an administrative fee for its intermediation between the savers and the investors. The rest of the profit received by the bank is distributed among the deposit holders.

On the asset side, the Law provides for 13 contracts through which finance can be provided. These are: (i) qarad hasan; (ii) mudarabah; (iii) civil partnership (musharakah madani); (iv) legal partnership (musharakah haquai); (v) direct investment; (vi) instalment sales; (vii) hire-purchase; (viii) forward deals (salaf); (ix) ju'alah; (x) muzara'ah; (xi) musaqah; (xii) deb purchase, and (xiii) guarantee notes.

### **Review of some Empirical Works**

Despite the controversies over the efficiency of the Islamic banking system vs. the conventional one, there are empirical results reported in a paper by Darrat (2001) which suggest that practicing interest-free banking in Iran (and Pakistan) over the 1980s and 1990s has improved or at least has not hampered its overall macro-economic performance, also has led to a smoother behavior of money velocity, provided policy-makers with a more controllable monetary environment and strengthened the linkage between policy instruments and the main policy goal of price stability.

Yasserli (2001) examined the legal provisions of some of the most popular contracts of Iranian banking system and found that contracts are drawn in such a way as to close all legal loopholes that might possibly be used by the credit – applicant to his advantage, and to the detriment of the state-owned Iranian banks, also the contracts were one-sided, and in the favour of the banks.

Furthermore, the drafters of the contracts were determined to preserve an intermediary role for the banks and so relieving them of the responsibility, alien to their nature and being functionally unsuited for it, to engage in real, as against financial business. Iranian lawmakers have insured that Islamic banking contracts operate in a legally solid environment, free from ambiguous interpretations, and fully supported by legally binding measures. Moreover, the contracts are worded in such a way as to prevent the defaulting client-borrowers from claiming ignorance of the law and / or ignorance of the contract terms.

Sadr and Iqbal (2001) indicate that in a period of 15 years few partnership arrangements such as civil partnership or musharakah were used, however, installment sale, the best-known contract by the public played the dominant role in financing agricultural activities by Agricultural Bank of Iran. This bank doesn't monitor very closely the forward purchase agreement and as a result a lower recovery rate is observed for musharakah contract. An expert operating as a managing director of a private bank, believes that the main practical problems are:

- 1) Multiplicity/Variety of Contracts (o'quood),
- 2) Inadequate Training of the Users,
- 3) Inappropriate Selection of Contracts by Users and Inability to Counsel the Clients,
- 4) Inapplicability of certain Contracts to the Operation of some Banks,
- 5) Absence of Proper Supervision over the Use of Various Contracts,
- 6) High Cost of Proper Implementation of Contracts,
- 7) Divergence of Contracts from the Requirements/Wishes of some Clients.

There are many aspects to be covered as challenges of the UFBL in operation; however, in this study the main ones are elaborated.

### **The Main Challenges**

We can categorize the various shortcomings, disadvantages, complaints and critiques into three categories related to:

- 1- The Usury-Free Banking Law (UFBL)
- 2- The Mechanism and dynamism of implementing UFBL
- 3- The socio-economic environment

Problems have been encountered in moving away from traditional short-term trade financing operations and toward profit-sharing medium and long-term financing operations. It was expected that with the passage of time bank would increase their involvement in mudarabah and musharakah financing but this expectation has not been fulfilled. No attempt has been made so far to islamise the international banking and financial operations. Government continues to borrow from the banks on the basis of a fixed rate of return.

On the other hand in the early nineties, many Iranian technocrats at various official positions and particularly those at the Central Bank had concluded that state-owned banking could not support a higher rate of GDP growth deemed necessary to provide for the ever increasing number of youngsters entering into the work force. Their efforts resulted in the passing of the law allowing for the establishment of privately-owned banks. In the early days of this decade a number of private-banking licenses were issued.

These banks were, of course, required to operate under the same Non-Usury Banking Law.

In the prevailing conditions, the private banks which have a small share of the banking system have to compete with the state-owned banks that benefit from their economies of scale, inside information and authorized positions in various governmental positions. Of course these banks suffer from low efficiency and all of those shortcomings of public enterprises.

According to one of the CEOs of a private bank:

"The gist of the argument is that if we do not somehow use "fixed and pre-determined rate" in our banking system; whether it is called interest or profit, we would be depriving many potential investors (depositors) from safe and secure investment. Such investments would be "yielding a fixed return" somewhat higher than the inflation rate; and, without the fixed rate, we would be increasing the "cost of capital" to the users of funds (loan/investment recipients)."

Now we can elaborate the main categories as following:

**1) Problems with the Usury-Free Banking Law (UFBL)**

- a. The absence of a clear and practical definition of banking system and defining the range of inclusion of the law.
- b. The influence of the economic situation of the first years after revolution upon the law, specially the affect of governmental approach to the banks.
- c. Incapability of the law for designing models which suits different kinds of bank and non-bank credit institutions.
- d. Incomprehensiveness and insufficiency of the law about the goals and tastes of depositors.
- e. Incomprehensiveness and insufficiency of the law about the goals and tastes of demanders of facilities.
- f. Incomprehensiveness and insufficiency of the instruments of monetary policy used in the law.
- g. The absence of suitable solution for facing with delayed claims.
- h. The absence of a mechanism for the relation between banks and credit,

- i. The absence of a mechanism for religious and jurisprudential supervision upon the activity of banks and credit institutions.
- j. The absence of provisioned mechanism for research and development of interest-free banking.

**2) Problems with the Mechanism and Dynamism of implementing UFBL**

- a. Compulsory credits dictated to be paid to those mentioned by laws, bylaws and regulations
- b. lending much money to the government,
- c. low capital adequacy ratio,
- d. high fixed assets ratio,
- e. postponed and deferred loans,
- f. low quality of much of the assets,
- g. weak managerial skills to circulate liquidity, attract deposits and allocate them efficiently,
- h. Low information and communication technology use.
- i. Weak and non-diversified customer services, which results in informal transactions and increases the size of underground economy.
- j. Inactive supervision and low accountability, which leads to deficiency and corruption.
- k. high share of public banks in financing governmental projects as approved in 4th Five-Year plan (4th FYP)
- l. high role of central Bank in issuance of money to finance budget deficit,
- m. no significant linkage with the foreign banks,
- n. low risk management skills,

- o. high credit risks of partnership contracts,
- p. Dichotomized and complicated accounting, monopolized payment methods (no payment through credit in current account and credit cards).
- q. Ambiguous spread of expected profit rates of deposits and facilities because of fluctuating two-digit inflation rate.
- r. High operational costs, especially for partnership contracts.
- s. The ever changing regulations which makes the two parties indifferent of the main purposes of the law.
- t. Low and insufficient training of the employees and the customers, leading to deviation from the law and making formal transactions not the true ones.

A sum of 85 percent of the contracts is the transactional ones; however, the law didn't allow this situation. Musharaka and Mudharaba as the spirit of Islamic banking system which is based on profit-loss sharing (PLS) don't play an active role in Iranian banking system, Muzara'a and Musaqat are neglected.

### **3) The Socio-Economic Environment**

There are structural bottlenecks in infrastructures and institutional shortcomings which act as barriers to financial system efficiency and effectiveness. There are economists, CEOs of state-owned banks and official authorities in Central Bank that basically don't believe in the effectiveness of UFBL. So they don't accompany the jurists and scholars to implement the law perfectly and establish a feedback, reform and revision mechanism. On the other hand there is a wide range of government intervention in economic atmosphere.

The supreme leader of the I.R of Iran interpreted the article 44 of the constitution, so as to privatize 80 percent of public enterprises including most of the state-owned commercial banks. Two of them are being sold in this year at Tehran Stock Exchange. This is evaluated as a serious step to establish a fair competitive environment.

As in the case of monetary policy, Khataei and Seifipoor (2005) argue that expected profit on deposits and facilities is determined by the authorities (Money and Credit Council) rather than following the law of demand and supply in the financial market. Moreover the demand for banking facilities is more than financial sources available, therefore, decreasing the interest rate will not result an increase on the investment.

Amiri and Raissafari(2005) believe that the economical and political circumstances impose a lot of restrictions on banks. The presumed rules of the banking system in Iran cannot ensure rights for depositors. Therefore, it is necessary to give special attention to improving the rules of banking system and institutional conditions, which is part of the reforming process in the financial system in Iran.

### **New Proposals**

There are different viewpoints, based on the investigated aspects of the researchers:

Mirjalili (2004) suggests that the current banking system must undergo three changes. First, bank operations should be limited to handling current accounts, beneficiary loan deposits and other common banking services. Secondly, banks should not accept time investment deposits, this task will be handed over gradually to the related institutions. Thirdly, specialized banks should be transformed into commercial investment banks. In this model, the interest will be eliminated and the specialization of financial institutes will help decrease the informational asymmetry. As a result, direct investment will increase and the economic growth will accelerate.

Mousavian (2007) proposes a new UFBL:

- a) There will be three different types of banks: Commercial, Specialized, and Universal; and two sets of contracts: Mobadelei (Transactional) such as installment credit, and Mosharekatie (participatory) such as “mosharkate madani or participation in a certain project”.
- b) Our proposed “commercial bank”, while restricted to a limited number of “contracts” (only Mobadelei), will be able to offer almost all-above-the-line services offered by a typical commercial bank as defined in the international literature.
- c) The “specialized bank” will be able to offer what a typical “investment co.” or a “development bank” does.
- d) Our “universal bank” may offer what a commercial bank and/or a specialized bank do only if it has a sophisticated enough accounting system, capable of splitting various sources and uses of funds/contracts.
- e) Below the line activities: “derivative products”, as well as investment banking services are under consideration and development at present.

Heshmati molaei (2002) recommends deregulation and standardization to make a clear relationship between Islamic banks and international credit and financial institutes and focus on economic realistic approach and privatization in banking and financial institutes, to promote competition situation.

Rasoolof (2000) criticizing the deficiencies of state-owned banks provides a framework for future operation of banks as related to private banking, and tries to delineate the future trends in this respect. According to him banks are aware of the importance of customers' data to their continued existence. In future, their ability to provide innovative products and services to private clients will concentrate on the issue they are most interested in: privacy.

Khataei and Seifipoor (2005) using a VAR model conclude that liberalization of the financial market and creating a competitive atmosphere in the financial system and above all, the usage of appropriate monetary tools may have positive effect on investment.

Mirjalili (2002) focuses on the role of financial globalization as the integration of security markets, global insurances, floating exchange rate regimes, transnational banking, global finance, global intermediations of payment, liberalization of banking services, global standards, electronic banking and bank and proprietorship mergers that form the major aspects of banking sector. So the modernization of banking system improvement of capital adequacy ratio in commercial and specialized banks, reforming the regulations concerning the business of banking services and introducing structural organizational modifications are the urgent necessities of globalization of banking sector for Iranian banking system.

Toutounchian (1998) proposes a policy package of: a window for musharakah accounts, preferred and common deposit accounts, third-Party involvements, consultancy agents, shari'ah advisory board, urgent establishment of supervision and control bureaus and incentive schemes.

### **Summary and Conclusions**

The main intention of legislators of the UFBL was to Islamize the whole banking system of I.R. of Iran, however, after a period of 25 years of the implementation of the law, the circumstances have changed in so many aspects. Our knowledge of Islamic banking has developed, international dealings, linkages and interactions have risen, the economy has been developed, various instruments, contracts, and technologies are invented, etc. Therefore an urgent need to an efficient, effective and up-to date law is felt by many scholars, bankers, officials and economists. The new law is expected to cover all backward and forward linkages of banking system, simplify the contracts and facilitate the dealings, give a fair condition of competition, diversify the customer services, have a consistent body complying with the shari'a rules, be accountable to the stakeholders, be compatible with the ever changing international circumstances and finally pave the way for a balanced development of the Islamic ummah.

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