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Evolution of Islamic Banking in IRAN: Prospects and Problems

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Abstract: *The government of Iran played a primary role in converting conventional banking into Islamic banking after 1979 revolution. In 1983, the law of usury-free banking was passed, and in 1984, interest free banks started to implement Islamic banking based on the 1983 law.The banking system of Iran is being perceived as an effective tool in pursuance of Islamic economic objectives. However, far from achieving the three-fold objectives of the 1983 banking act, the sector was plagued by slow growth, a large portfolio of non-performing assets and narrow range of products and services. Besides, most of people in charge of economic affairs regarded interest as an objective of non-omit able phenomenon and instead of probing into the real causes of interest entity and working out appropriate devices to eliminate it. Therefore, there is a need for introduction of new products and instruments for banking system in line with innovations in modern banking and compliance with financing new activities and with the development of modern banking system.Hencethe aim of this paper is to assess the development of Islamic banking financial institutions of this country through the review of past literatures. Most specifically the paper will highlight regulatory, products offered by Islamic banks in Iran, government support and performance of Islamic banking institutions in Iran. Furthermore, Problems, challenges, opportunities and prospects will be explained. Finally recommendations to further promote the Islamic banking financial institutions will be given which is expected to improve their performance and sustainability.*

I. Introduction

Islamic banking may not be a totally new concept, the widespread expansion of this form of banking is certainly a fairly recent phenomena. In recent years, several Muslim countries have made ambitious attempts to practice Islamic banking. There are more than 300 Islamic banking institutions and these institutions not only operate in Muslim countries, but have also gained footing in non-Muslim countries. Iran appears to be particularly active in transforming banking and financial sectors completely in line with the dictates of Shariah.

After the 1979 revolution the government of Iran played a primary role in converting conventional banking into Islamic banking. In 1983, the law of usury-free banking was passed, and in 1984, interest free banks started to implement Islamic banking based on the 1983 law. Most of the banks (28 out of 36) were nationalized. The government also managed to merge these nationalized banks. In contrast to most countries that have some degree of Islamic banking, has completely transformed it's banking activities to comply with the accepted Islamic principles in Iran.

All banks in Iran must follow the banking principles and practices described in the Islamic Banking (Sharia) law of Iran passed in 1983 by the Islamic Majlis of Iran. According to this law, banks can only engage in interest-free Islamic transactions (interest is considered as usury or riba and is forbidden by Islam and its holy book the Quran). The permitted commercial transactions involve exchange of goods and services in return for a share of the assumed profit. All such transactions are performed through Islamic contracts, such as mozarebe, foroush aghsati, joale, salaf, and gharzol-hassane. Details of these contracts and related practices are contained in the Iranian Interest-Free banking law and its guidelines.

Hencethe aim of this paper is to assess the development of Islamic banking financial institutions of this country. Most specifically the paper will highlight regulatory, products offered by Islamic banks in Iran, government support and performance of Islamic banking institutions in Iran. Furthermore, Problems, challenges, opportunities and prospects will be explained. Finally recommendations to further promote the Islamic banking financial institutions will be given.

Regulatory support

In 1960 (1339 solar year) The Central Bank of Iran (CBI) was established by Iranian Government and separated all central banking responsibilities from Bank Melli Iran and assigned it to the newly formed central bank (Central bank website). The Central Bank of Iran was renamed to "the Central Bank of the Islamic Republic of Iran" immediately after the Islamic revolution in 1979 and the overthrow of the king of Iran. Scope and responsibilities of the Central Bank of the Islamic Republic of Iran (CBI) have been defined in the Monetary and Banking Law of Iran. It is entirely government owned(Abdollah Riazi, 1972).

According to Monetary and Banking Act, the Central Bank is responsible for formulating the monetary and credit system of the country, formulating the regulations pertaining to outflow as well as repatriation of Iranian and foreign currency, foreign exchange transactions, commitments and guarantees with the approval of the Money and Credit Council; formulating the required regulations to control gold transactions with the approval of the Board of Ministers, determining the required regulations, approvals and circulars applicable to banks and credit institutions in the framework of the monetary and credit system of the country.

In addition Iranian Banks are operated under strict Islamic principles as the country's government mandates to follow the strict Islamic principles. Therefore, running a traditional banking network would be considered as against the fundamental teachings of Qur'an. It became compulsory for the Central Bank of Iran to set up an Islamic Banking law in tune with the instructions of Qur'an following the Islamic revolution.

The process of Islamization of the banking system in Iran

The process of Islamization of the banking system in Iran had gone through two phases. In the first phase (1979-82), the banking system was nationalized, and reorganized. However, internal and external developments in this phase did not allow the policymakers to build an adequate plan for the Islamization of the banking system. The second phase began in 1982, and lasted until 1986. In this phase, the law of usury -free banking (i.e. no interest) was passed in 1983, which went into effect on March 20, 1984(Hassani, 2010). The law described 14 types of operations applicable to assets and liabilities. The banks were allowed to buy debt instruments, supported by real assets, for a period of one year. The Islamic banking system of Iran has the following features:

Characteristics of bank liabilities

According to the law of usury – free banking in Iran liabilities incurred by the banks are basically of two kinds, as follows: gharz- al- hassanh deposits current and savings deposits. These are similar to those of conventional banks except that they cannot earn any return. Current qharz al- hassanh deposits are like demand deposits or current account in conventional banks. This account from the point of view of customers is simply a means of making transactions and payments. The other type of gharz al- hassanh is saving account. In this account, depositors are offered non-fixed prizes and bonuses in cash or kind. Other incentives for this kind of account are that the banks exempt depositors from the payment of fees or commissions, and give priority in the use of banking facilities. qharz al- hassanh deposits are the main sources of gharz-al hassaneh loans.

Investment deposits, which banks are authorized to acquire are of two kinds: short term and long-term investment deposits. These deposits differ with respect to time. The minimum time limit for short term deposits is three months and long term deposits, 1, 2, 3, 4 and five years. No fixed amount, or rate of return, can be guaranteed to the depositors in advance. In practice banks pay the profit of depositors provisionally on a quarterly basis with a condition for final adjustment at the end of the financial year. Depositors can withdraw their money from long term investment deposits before the termination of agreement, if they give notice in advance. In this case, the basis for calculation of the profit will be the next lowest category of deposits, according to the time when the money has been deposited. Withdrawal from short-term deposits is possible at any time without notice.

Islamic banking product in Iran

Mudarabah: The law of usury –free banking in Iran provides various modes of operations for financing the contracts between banks and customers. The modes are as follows: Mudarabah (profit- sharing): banks provide initial capital to the commercial sector, both individual and traders who engage in trade and business. By previous agreement the profit from undertaking are divided at the end of the contract.

Musharakah (partnership)

The law recognizes two different form of partnership, namely civil and legal partnership. The first, i.e. civil partnership, is a project specific partnership for short and medium periods. It is defined as the mixing of capital from a bank with the capital from a partner or partners (in cash or kind) on a joint- ownership basis for performance of a specific job. The second form, i.e. legal partnership, is a joint venture for the long duration. In the case provides a portion of total equity of a newly established firm or purchases part of the shares of the existing companies.

Direct Investment

Banks can undertake to invest directly in any economic activity for a long period. The possibilities for direct investments by banks only exist in the public sector through the creation of companies where legal partnership is not possible, direct investment cannot be made in projects that lead to the production of luxury commodities. It must consider the priorities of the country economic development.

Murabahah : Banks are authorized to purchase raw materials, machinery, equipment, spare parts, and other needs of enterprises in industry, farming, mining and services and resell them by short term installments. Prices in these transactions cover cost, plus profit under specific regulations. Banks have been forbid to purchase items without the existence of a specific customer(Nurul Alam,1997).

Salaf (purchase with differed delivery)

Banks can purchase goods from productive enterprises in order to provide them with working capital. Thus, instead of lending money, the bank buys part of the future products at an agreed price which must not exceed the market price of the product at the time of the contract.

Ijarah be shart-e-tamlik (lease-purchase)

In this mode of financing banks buy real property or other assets needed by enterprises or individuals and lease the assets to them. The price of the asset is determined on a cost-plus basis. The ownership of the property is transferred to the lessees at the end of the contract.

Jualah (transaction based on commission)

This is a project undertaking by the bank (or customer) to pay a specific sum in return for a service as specified in the contarct. Jualah is one of the short term facilities which may be granted for the expansion of production, commercial and service activities. The service to be performed and the fee to be charged must be determined at the time of contract.

Gharz –al – hassaneh (benevolent loan)

This is a non-commercial facility without any expectation of profit. Gharz –al – hassaneh loans are usually made to small producers, farmers and small-scale businesses and the people who are unable to find financial sources for their personal needs. The ability of banks to grant this loan depends on the gharz –al – hassaneh saving deposits.

Number	Name	Year of Establishment	Note
Government Owned Banks			
	Commercial Banks		
1	Bank Meli Iran	1928	
2	Sepah Bank	1925	
3	Post Bank of Iran	1996	
	Specialized Bank		
4	Keshavarzi Bank		
5	Maskan Bank		
6	Industry and Mine Bank		
7	Export Development Bank of Iran	1991	
8	Toseye-Taavon Bank	2009	
	Private Banks		
9	Eghtesad Novin Bank	2001	
10	Karafarin Bank	2001	
11	Parsian Bank	2001	
12	Pasargad Bank	2005	
13	Sina Bank	1985	
14	Saman Bank Corp.	2001	
15	Sarmayeh Bank	2001	
16	Tat Bank	2009	
17	Day Bank	2010	
18	Cyrus Bank	2010	
19	Ansar Bank	2009	
20	Garzol – Hasaneye Mehr Iran Bank	2009	
21	Mellat Bank	1980	Privatized in 2008
22	Tejarat Bank	1978	Privatized in 2008
23	Sederat Bank of Iran	1952	Privatized in 2008

Table 1: Banks in Iran

The classification of Iranian bank: Banks of Iran can be categorized in two major groups: the government-owned banks and the private banks. All private banks are commercial banks but the government-owned banks are two types: commercial banks and specialized banks. Specialized banks are active in specialized fields like agriculture or housing. For example “Bank Keshavarzi” provides loan and financial services only for agricultural projects and “Bank Maskan” provides loan and financial services only for housing purposes. There are two important bank in iran which are listed below:

Bank Mellat

Bank Mellat was established on 1979/12/20 by virtue of the resolution dated 1979/9/29 adopted by the General Assembly of Banks and pursuant to the provision of article 17 of the Bill on administering the Banks, with a paid up capital of Rls 33.5 bn as a merger of ten pre-revolution private banks comprising: Tehran, Dariush, Pars, Etebarat Taavoni& Tozie, Iran& Arab, Bein-al-melalie-Iran, Omran, Bimeh Iran, Tejarat Khareji Iran and Farhangian.Currently, the bank's capital amounts to Rls 40000 bn and is one of the largest commercial banks in the Islamic Republic of Iran, ranking among the top 1000 banks of the world.

The most Significant Activities of Bank Mellat Bank is ready to supply financial resource required by the producers in the production sector, especially in the sector of converting industries. One of the most significant foreign activities of bank system is issuing variousguarantees which is done within the foreign currency policies of Central Bank of Iran in order to develop and facilitate the presence of economic activists in the foreign sector.

Bank Melli

Melli bank is the first national Iranian bank. The bank was established in 1927 by the order of the Majlis (the Iranian Parliament) and since then has consistently been one of the most influential Iranian banks.BMI acted as the central bank of Iran until Bank Markazi was established in 1960, after which all of its central banking responsibilities were transferred to the new central bank and bank Melli Iran is owned and operated by the government of Iran.

Performance of Islamic Banking Institutions of Iran

Islamic banking in Iran is currently facing tough time in the wake of dire economic sanctions againstthem. Apart from these conditions Islamic Banks may face many problems in the future because they do not have unanimous rules in the realm of Islamic Banking all over the world. One of these problems is that banks want to get their profits without taking any risk, so they impose all the risks to the costumers. Some Islamic banks escape from executing the Islamic rules. They assume that if they run Banking System based on Islamic rules they would face with some problems.

This fear is baseless because they are accustomed to conventional Banking system and do not want to run the system based on other rules. This system does not cover a wide range of area. The amount of funding in these banks are less than in conventional Banks, this may weaken the Islamic Banking system in the future, but still the future of the global Islamic Banking industry offers continuing promise. The sheer size of the industry,running in billions of dollars cannot be over looked.

The banking system in Iran is regulated by the Central Bank of Iran (Bank Markazi). The Money and Credit Council (MCC) is the highest banking policy-making body of Bank Markazi. Its permanent members include the CBI Governor, the Finance and Economy Minister, two Ministers chosen by the Cabinet, The Head of the Chamber of Commerce, the General Prosecutor and two lawmakers. Each year, after approval of the government’s annual budget, the CBI presents a detailed monetary and credit policy to the MCC for approval.

Thereafter, major elements of these policies are incorporated in the five-year economic development plan (CBI, 2008). The functions of the central bank defined in the Money and Banking Law (1339/1960) is asfollows:

- Preserving value of the national currency inside the country and abroad.
- Issuing banknote and coins as legal tender.
- Formulating regulations that govern transactions in foreign exchange and Rial.
- Supervising gold transactions and formulating the related regulations.
- Formulating the monetary and credit system of the country.
- Balancing the volume of bank credits, harmonizing it with the country’s monetary needs.
- Keeping the accounts of ministries, government agencies, and agencies affiliated to the government.
- Taking custody of the country’s foreign exchange and gold reserves.
- Representing government in international and financial organizations.
- Possessing the right to take full charge of issuance of government bonds.

A new report shows the assets of Iranian banks increased by a whopping 40% in 2014. A report published in the Persian-speaking newspaper Iran which said that the total capital of Iranian banks reached the unprecedented figure of rials 13.3 quadrillion ($480 billion) over the past year. The figure was higher than the previous year by rials 3.8 quadrillion ($138 billion).Iran has quoted a report by the Business Monitor International (BMI) as saying that the total capital of Iran’s banks in 2013 stood at rials 9.4 quadrillion ($343 billion) showing a growth of 17 percent year on year.

The rise in the capital of Iranian banks, the report said, comes despite the fact that Iran's banking system is under strict US-led sanctions.It further added that the deposits in Iranian banks for 2014 had reached rials 5.9 quadrillion ($214 billion) and that the loans paid to the public totaled rials 5 quadrillion ($183 billion). The deposits indicated a growth of 34 percent while the loans were up 22 percent compared to the previous year, the report said.

Assets

The banks and financial institutions, total claims on the public sector (government and governmental institutions) amounted to 929 trillion IRR ($34.8 billion), and total claims on the non-public sector amounted to 5412 trillion IRR ($203 billion). The ratio of the claims on the public sector to the claims on the non-public sector was 17.2% in September 2014, 15.6% one year before, and 13.4% two years before. This trend suggests that the government is using more bank resources than it was previously, and that banks are getting more dependent on the government's solvency.

Liabilities

Deposits of the non-public sector amounted to 6245 trillion IRR ($234 billion) of which 78.4% is term deposits; this number was 74.5% one year before and 73% two years before. The trend is towards more term deposits and less sight deposits which could be a result of the higher cost of money, the downward trend in the inflation rate, and the stability in the economy.

The breakdown of term deposits shows that 44 percent of term deposits are short-term and the rest are long-term. In line with these changes, taking a look at the yield curve for the last 5 years shows that the right side of the curve has moved upward significantly and the left side has become steeper, making long-term deposits more attractive. According to the Dubai Centre for Islamic Banking and Finance (DCIBF) report 2014:Iranian Islamic Banks hold total asset is $482.4 billion, total equity $ 34.9 billion and net income $5.1 billion. Apart from this gross financing $257.9 billion, customer deposit $273.3 billion and gross loans 94.4% (DCIBF report 2014)

The problems, challenges, opportunities and prospects of IBI of Iran

The banking system of Iran is being perceived as an effective tool in pursuance of Islamic economic objectives such as:

1. The proper issue of money and credit for the creation of a just, healthy and progressive economy.
2. The use of monetary tools to promote the national objectives of the country including the elimination of poverty and attainment of national self-sufficiency.
3. The preservation of the national currency value and promotion of balance of payments stability.

However, far from achieving the three-fold objectives of the 1983 banking act, the sector was plagued by slow growth, a large portfolio of non-performing assets and narrow range of products and services. Besides, most of people in charge of economic affairs regarded interest as an objective of non-omit able phenomenon and instead of probing into the real causes of interest entity and working out appropriate devices to eliminate it. For instance, in mozarebeh contract, the bank and an agent agree to engage in some commercial activity and earn, a profit, which will be shared between the bank and the agent (customer).

The bank has received interest from the agent of mozarebeh contract and both parties treat the amount excess to the principal as a certain sort of interest. Of the nine most often used modes of finance by commercial banks in two decades, about on average 40.6 percent has been under the installment sale category which is the closest form to interest- bearing conventional banking. Since interest free loans are the only kind of loan acceptable for personal and consumption needs according to this law and banks have very limited resources for this purpose, in reality, most of the loans demand are fake and the loan itself is financed using other kinds of Islamic contract; besides pushing the bank resources from productive sectors to consumer sector. Therefore, there is a need for introduction of new products and instruments for banking system in line with innovations in modern banking and compliance with financing new activities and with the development of modern banking system.

The advocates of Islamic banking had exaggerated expectations of the benefits from proposed law. Even if there was agreement among policy makers about the elements of a program of policies, the transmission mechanism through which the adoption of policies leads to outcomes was complicated. There were steps in that process of Islamization which was subject to uncertainty and delay with probability of adverse results. The adverse implications of poorly conceived policies exacerbated economic distortions.There is a need forintroduction of new products and instruments for banking system in line with innovations in modernbanking (Hassani, 2010).

Another major criticism is that the Iranian Interest-Free banking law has simply created the context for legitimizing usury or riba. In reality all banks are charging their borrowers a fixed pre-set amount at a rate of interest that is approved by the Bank Markazi at least once a year. No goods or services are exchanged as part of these contracts and banks rarely assume any commercial risk. High value collateral items such as real estate, commercial paper, bank guarantees and machinery eliminate any risk of loss. In case of defaults or bankruptcies, the principal amount, the expected interest and the late fees are collected through possession and or sale of secured collaterals (Mojtahed and Hassenzadeh, 2009).

II. Recommendation

- The banking system needs to address the issue of interest and not just circumvent it. Appropriate alternate tools need to be designed to address this issue.
- It needs to widen the base of products and services offered.
- Most of the contracts need to be redesigned to bring them in accordance with the spirit of Islamic principles and not just juridical requirements.
- Policy makers need to come up with well-defined transfer mechanism to realize the Islamization policies.
- With the experience at its disposal, Iranian banking system can be redesigned to be more inclusive and participatory in nature rather than just intermediary as the conventional banks are.

III. Conclusion

According to our discussion we can conclude that Islamic Banking industry has shown tremendous potential for growth. Iran has completely transformed its banking activities to comply with the accepted Islamic principles. The banking system of Iran is being perceived as an effective tool in pursuance of Islamic economic objectives. But the sector was plagued by slow growth, a large portfolio of non-performing assets and narrow range of products and services. There is a need forintroduction of new products and instruments for banking system in line with innovations in modernbanking. With effective corporate governance and a better interaction with relevant international, regional and national institution, Islamic banking of Iran will definitely contribute to the welfare of their community as well as to the welfare of the world as a whole.

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