Interest Free Banking in Iran: Challenges and Prospects

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Abstract

The revolution of Iran played a primary role in converting the conventional banking in Interest-free banking after 1979 in Islamic Republic of Iran. The government in 1983 passed the law of Interest-free banking, and in 1984 banks started Islamic banking based on the 1983 interest-free law. It is difficult to accept that a bank can be run without paying or receiving interest and without the involvement of interest banks will play any role in economic development.

The interest free banking system of Islamic Republic of Iran is perceived as an effective tool in achieving of the objectives of Islamic economics. This paper is an attempt to study Interest-free banking of Islamic Republic of Iran along with products offered. Furthermore, challenges and prospects will be focused. Finally, suggestions for the improvement of the performance of these banks will be mentioned.

Key Words: Interest, Islam, Islamic Banking, Law.

1. **Introduction**

Islamic Finance a recent phenomenon is not a new concept but as old as the Islamic state of Madina. Contemporary Interest free banking experimented on the land of Egypt in 70s has now reached to the non-Muslim countries too. Now more than 300 Islamic banking institutions have been established in the world.[2] The 1979 revolution of Iran played a primary role in converting the conventional banking in Islamic banking. The government in 1983 passed the law of Interest-free banking and in 1984, banks started to implement Islamic banking based on the 1983 interest-free law.[3] Most of the banks (28 out of 36) were nationalized and the merger of the banks took place. In comparison to other countries Islamic Republic of Iran has completely transformed banking activities to comply with the Islamic principles. All banks must follow the banking principles and practices described in the Islamic Banking (*Sharia*) law of Iran passed in 1983 by the *Majlis* of Iran. According to this law, banks can only involve in interest-free transactions. The permitted commercial transactions involve exchange of goods and services in return for a share of the

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[2] Islamic banking is practiced not limited to the following countries: Albania, Algeria, Australia, Bahamas, Bahrain, Bangladesh, British Virgin Islands, Brunei, Canada, Cayman Islands, North Cyprus, Djibouti, Egypt, France, Gambia, Germany, Guinea, Indonesia, Iran, Iraq, Italy, Jordan, Kazakhstan, Kuwait, Lebanon, Luxembourg, Malaysia, Mauritania, Morocco, Netherlands, Niger, Nigeria, Oman, Pakistan, Palestine, Philippines, Qatar, Saudi Arabia, Senegal, Singapore, South Africa, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, United Arab Emirates, United Kingdom, United States and Yemen.

[3] Ashraf, S. H. and Giashi, A. A. (2011), "Islamic Banking in Iran - Progress and Challenges." Kuwait *Chapter of Arabian Journal of Business and Management Review* Vol. 1, No.2.

assumed profit. All such transactions are performed through Islamic contracts, such as *Mozarebe*, *Joale*, *Salaf*, and *Gharzol-Hassane*. Details of these contracts and related practices are contained in the Iranian Interest-Free banking law and its guidelines.[4] Therefore, this paper is an attempt to study the Islamic banking along with the products offered in Iran. Furthermore, challenges and prospects will be focused. Finally, suggestions for the improvement in the performance of these banks will be mentioned.

2. Support at Regulatory Level

The Central Bank of Islamic Republic of Iran (CBI) was established in 1960 by Iranian Government and all central banking responsibilities from Bank Melli Iran assigned to the newly formed central bank (Central bank website). The Central Bank of Iran was entitled "the Central Bank of the Islamic Republic of Iran" immediately after the revolution in 1979. Scope and responsibilities of the Central Bank have been defined in the Monetary and Banking Law of Iran. 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 Islamic principles as the government mandates to follow the Islamic principles.[5] Therefore, running a conventional banking would be considered as against the fundamental teachings of Islam. It became compulsory for the Central Bank of Iran to set up an Islamic Banking law in tune with the instructions of Islam following the revolution.

3. The Islamization of the banking system in Iran

The Islamization of the banking system in Iran had gone through two phases. In the first phase (1979-82), the banking system was nationalized and in the second phase (1982-84), the law of interest-free banking was passed in 1983 and went into effect on March 20, 1984.[6] The law (Interest free law) described 14 types of operations applicable to assets and liabilities.

4. Characteristics of bank liabilities

According to the law of Interest– free banking liabilities incurred by the banks are of two kinds, as: *Gharz-al-Hassanh* deposits current and *Gharz-al- Gassanh* savings deposits. These are apparently similar to conventional banks except that they cannot earn any fixed return. Current *Gharz al-Gassanh* deposits are like 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 which, depositors are offered non-fixed prizes in cash or kind. Some other incentives are that the banks

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4 Central Bank of Iran, 2008, *The Law for Usury (Interest) Free Banking*.

5 Curtis, G. E. and Hooglund, E., (2008), *Iran: A country study: Federal Research Division Library of Congress.* Washington D. C: Library of Congress.

6 Hassani, M. (2010). "Islamic Banking and Monetary policy: Experience of Iran." *International Review of Business Research Papers, 6(4),* Melbourne: Australia.

exempt depositors from the fees and give priority in the use of banking facilities. *Gharz al- Hassanh* deposits are the main sources of *Gharz-al Hassaneh* loans in the banking of Islamic Republic of Iran.[7]

Authorized Investment Deposits are of two kinds: short-term and long-term investment deposits which 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 and in practice, banks pay the profit to 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 and 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.[8]

5. Islamic banking product in Iran

Mudarabah

The law of interest–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.[9]

***Musharakah* (Partnership)**

The law recognizes two different forms 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 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.[10]

Murabahah

Banks are allowed to purchase materials, equipment, spare parts, and other goods of enterprises in industry, farming and mining and resell them by short-term installments. These transactions cover cost, plus profit under specific regulations but the Banks have been forbidden to purchase items without the existence of specific customers.

***Salaf* (purchase with differed delivery)**

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7 Mojtahed, A. and Hassanzadeh, A. (2009), *A Survey in Islamic Banking and Finance in Iran, Monetary and Banking Research Academy*, Tehran: Central Bank of Iran.

8 Mojtahed, A. and Hassanzadeh, A. (2009), *A Survey in Islamic Banking and Finance in Iran, Monetary and Banking Research Academy*, Tehran: Central Bank of Iran.

9 Khan, M. S., and Mirakhor, A. (1989). Islamic Banking: Experiences in the Islamic Republic of Iran and Pakistan. (IMF Working Paper No. wp/89/12). Washington DC: International Monetary Fund. (JEL Classification Nos. 3116; 3120; 314). p. 1.

10 Ashraf, S. H. and Giashi, A. A. (2011). Islamic Banking in Iran - Progress and Challenges.Kuwait Chapter of Arabian Journal of Business and Management Review Vol. 1, No.2.

Banks are authorized to 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 banks buy a real property or assets needed by enterprises or individuals and lease them. The price of the asset is determined on a cost-plus basis and ownership is transferred to the lessees at the completion of the contract.[11]

***Jualah* (transaction based on commission)**

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

***Gharz–al–Hassaneh* (benevolent loan)**

Gharz–al–Hassaneh is a non-commercial facility without any expectation of profit. These loans are made to small producers, farmers and small-scale businesses and the people who are unable to find financial sources for their personal needs.

6. The classification of Banks of Islamic Republic of Iran

The Banks can be divided in two groups: the government-owned and the private banks. All the private banks are commercial but the government-owned banks are of two types: commercial and specialized. Specialized banks are active in the specialized fields like agriculture or housing like, "Bank Keshavarzi" provides financial services for agricultural projects only and "Bank Maskan" provides financial services only for housing.[12] There are various banks in Islamic Republic of Iran:

S.No.	Name	Establishment	Remarks
1.	Bank Mili Iran	1928	Government Owned Banks
2.	Sepah Bank	1925	Government Owned Banks
3.	Post Bank of Iran	1996	Government Owned Banks
4.	Keshavarzi Bank	1933	Government Owned Banks
5.	Maskan Bank	1979	Government Owned Banks
6.	Industry and Mine Bank	1979	Government Owned Banks
7.	Export Development Bank of Iran	1991	Government Owned Banks
8.	Toseye-Taavon Bank	2009	Government Owned Banks
9	Eghtesad Novin Bank	2001	Private Banks
10	Karafarin Bank	2001	Private Banks

[11] Mojtahed, A. and Hassanzadeh, A. (2009). A Survey in Islamic Banking and Finance in Iran, Monetary and Banking Research Academy, Central Bank of Iran. Tehran: CBI.

[12] Mojtahed, A. and Hassanzadeh, A. (2009), *A Survey in Islamic Banking and Finance in Iran, Monetary and Banking Research Academy*, Tehran: Central Bank of Iran.

11	Parsian Bank	2001	Private Banks
12	Pasargad Bank	2005	Private Banks
13	Sina Bank	1985	Private Banks
14	Saman Bank Corp.	2001	Private Banks
15	Sarmayeh Bank	2001	Private Banks
16	Tat Bank	2009	Private Banks
17	Day Bank	2010	Private Banks
18	Cyrus Bank	2010	Private Banks
19	Ansar Bank	2009	Private Banks
20	Garzol-Hasaneye Mehr Iran Bank	2009	Private Banks
21	Mellat Bank	1980	Privatized in 2008
22	Tejarat Bank	1978	Privatized in 2008
23	Sederat Bank of Iran	1952	Privatized in 2008

7. Performance of Interest free Banking of Islamic Republic of Iran

Interest free banking in Iran is currently facing tough time in the wake of dire economic sanctions. The amount in these banks is less than in conventional Banks, but still the global Islamic Banking industry offers continuing promise. The 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.[13] The functions of the central bank defined in the Money and Banking Law (1339/1960) is as:

- Preserving and maintaining value of the national currency inside and outside the country.
- Issuing banknotes and coins as legal tenders.
- Formulate regulations which govern transactions in foreign exchange and Rial.
- Supervising transactions of gold.
- Formulate the monetary and credit system of Islamic republic of Iran.
- Managing the volume of bank credits, harmonizing it with the monetary needs of the Country.
- Keeping the accounts of ministries and agencies affiliated to the government.
- Taking custody of the foreign exchange and gold reserves of the Country.
- Representing government in international financial organizations.
- Possessing the right to take charge of issuance of government bonds.

[13] Central Bank of Iran, (2008)., *The Law for usury (Interest) Free Banking*.

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 earlier 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.[14]

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.[15]

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%.[16]

8. The challenges and prospects of Interest Free Banking of Iran

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

1. The basic 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 including the alleviation of poverty and attainment of national self-sufficiency of the country.

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14 "Islamic Banking Growth, Efficiency and Stability," DCBIF Annual Report 2014

15 "Islamic Banking Growth, Efficiency and Stability," DCBIF Annual Report 2014

16 "Islamic Banking Growth, Efficiency and Stability," DCBIF Annual Report 2014

3. The preservation and the maintenance of the currency value of the country and promotion of balance of payments stability.[17]

Most of people regarded interest as a non-omitable phenomenon. For instance, in *Mozarebeh* contract, the bank and agent agree to engage in a commercial activity to earn a profit which will be shared between the bank and the agent (customer). Therefore, there is a need for introduction of new products and instruments in line with innovations in modern banking. The policy makers about the transmission mechanism through which the adoption of policies leads to outcomes was complicated. There were steps in the 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 for introduction of new products and instruments for banking system in line with innovations in modern banking.[18]

Another criticism is that the Iranian Interest-Free banking law has simply created the context for legitimizing interest or *Riba*. Banks are charging their borrowers a fixed pre-set amount at a rate of interest that is approved by the Bank Markazi. No goods or services are exchanged as part of these contracts and banks hardly ever 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.[19]

9. Suggestions and Recommendation

- The banking system needs to address the problem of interest by designing appropriate alternate tools and techniques.
- It needs to increase the products and services.
- Some of the contracts need to be redesigned to bring them in accordance with the spirit of Islamic principles as well as in line with the financial requirements but not just following the juridical requirements.
- Policy makers need to come up with a well-defined mechanism to recognize the policy and mission of Islamization.
- With the potential and experience, Iranian banking system can be redesigned to become more inclusive and participatory.
- The Interest free law needs to be updated keeping in view Shariah as well as financial requirements.
- The banking system needs to be redesigned to respond the internal challenges at national level as well as at international level.

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17 Hassani, M. (2010)., "Islamic Banking and Monetary policy: Experience of Iran." *International Review of Business Research Papers, 6(4),* Melbourne: Australia

18 Hassani, M. (2010)., "Islamic Banking and Monetary policy: Experience of Iran." *International Review of Business Research Papers, 6(4),* Melbourne: Australia.

19 Mojtahed, A. and Hassanzadeh, A. (2009)., *A Survey in Islamic Banking and Finance in Iran, Monetary and Banking Research Academy,* Tehran: Central Bank of Iran..

10. **Conclusion**

Islamic Banking industry has shown tremendous potential for growth hence Iran has completely transformed banking activities to comply with the Islamic principles. This system of banking is being perceived as an effective tool in pursuance of the objectives of Islamic economics. There is growth by the assets and the range of products and services but not up to satisfactory level. There is a need of new products and instruments for banking system in line with Islamic principles and financial requirements. Further the law of Interest free Banking needs to be updated keeping in view at the one hand the maintenance of *Shariah* standards and on the other hand the financial requirements of Islamic Republic of Iran. With efficient governance and a healthier interaction with relevant institutions, Interest free banking of Iran needs to contribute to the welfare of their Country as well as to the welfare of the mankind as a whole.

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