

Islamic Banking in Iran - Progress and challenges

DR. S.Husain Ashraf , Mr. Ali Alizadeh Giashi

Professor, Dept of Commerce, A.M.U (India)

Research scholar, Dept of Commerce, A.M.U (Iran)

Abstract

Islamic Banking an alternate to interest-based banking is not banking in the traditional sense of the word. It derives its inspiration and guidance from the religious edicts of Islam and has to conduct its operations strictly in accordance with the directives of Shariah. Islamic financial system employed the concept of participation in the enterprise, utilizing the funds at risk on a profit-and-loss-sharing basis. At present, there are more than 300 Islamic Banks and other financial institutions managing funds to the tune of \$300 billion, with deposits exceeding \$ 120 billion and operating in 48 countries. To avoid interest, Islamic Banks have developed profit-sharing schemes in tapping and mobilisation their resources. Both Islamic Banks lending policy and lending principles are excellent tools for creating and developing entrepreneurs. In relation to entrepreneurs, the status of the Islamic Bank is either of partner or investor, whereas, for conventional banks the relationship is more of creditor-debtor.

In this paper we have tried to trace out the growth of Islamic banking in Iran and the challenges faced by these banks in future. Islamic banking in Iran is currently facing tough time in the wake of dire economic sanctions against them. 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.

Keywords: Islamic Banking, usury-Riba, Islamization, Interest free, Qard al-Hasanah.

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.

From early twentieth century when the banks were institutionalized in economic systems, number of Muslim scholars attempted to solve the usury problem of traditional banks. Among the Muslim scholars, who investigated about this issue, are Shahid Seyyed Mohammadbaqr Sadr, Shahid Beheshti, Shahid Motahhari, Qureshi, Iqbal , Mohsen Khan and Arif. The practice of Islamic banking has become a fast growing and widespread phenomenon, not only in the Muslim countries of the Middle East, but also in countries such as Indonesia, Bangladesh, Morocco, Switzerland, etc. Beginning with the first Islamic bank established in Cairo, Egypt, in 1971, the movement towards banking practices based on Islamic Laws (Shariah) has proceeded at a phenomenal rate. Today, Islamic banks operate in over 45 countries, some of which (Iran and Pakistan) have completely changed their banking system to conform to Islamic Laws.

Although establishment of Islamic banking is new, yet it has been very successful. Wall Street Journal wrote: “American banking crisis is solvable if it tend to the Islamic banking system”. It also adds “in Islamic banking system, rather than banks paid loan based on a fixed interest rate to individual investors, the lender and borrower agree to a formal contract how to divide benefit (loss) of investing in projects between themselves.” Then he compares positive factors in the Islamic banking system with negative factors in western banking and writes: if the international banking affairs and domestic banks of America had been operating based on the Islamic banking system particularly in lending, international debt crisis and crisis of domestic banks in America, known as the savings and loan institutions crisis, didn't occur.”

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 Qu'ran following the Islamic Revolution.

In this paper we have tried to trace out the growth of Islamic banking in Iran and the challenges faced by these banks in future. Islamic banking in Iran is currently facing tough time in the wake of dire economic sanctions against them. 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.

Literature Review

During the past few years, Islamic banking practices have been at the center of many public policy debates, and numerous surveys of the extensive literature on Islamic banking have been written over the years. Among descriptive and empirical Papers that have been written international in relation to the impact of Islamic laws (sharia) on Banking system. We briefly review certain papers from international literature focusing mainly on material referring Islamic banking in Iran.

Mohammad Hassani (2010), in his article entitled “Islamic Banking and Monetary policy: Experience of Iran (1982-2006)”, addresses some of the issues and challenge that is islamic banking has been facing in Iran. It also seeks to exam modes of Islamic banking law, Hamid Zangeneh , in his paper entitled “Islamic Banking: Theory and Practice in Iran”, attempts to explain the theoretical as well as operational issues and problems of Islamic banking, Abdus Samad, Norman D. Gardner and Bradley J. cook(2005), in their paper entitled “ Islamic Banking and Finance in Theory and Practice : Experience of Malaysia and Bahrain”, primary objective is to identify the relative importance of various Islamic financial products, in theory and practice, by examining the financing records of the Bank Islamic Malaysia (Berhad) and the Bahrain Islamic bank, Humayon Dar(2010), in his article entitled “ Islamic banking in Iran and Sudan”, discusses Islamic banking in Iran and Sudan is currently and facing such a tough time in the wake of dire economic sanctions against them.

Noor Ahmed Memon(2007), in his paper entitled “Islamic Banking: Present and Future Challenges”, emphasizes the role of Islamic banks as financial intermediaries and the importance of financial intermediation for society. It argues that Islamic Banks entering directly into trade, industry and agriculture etc is not beneficial because it means leaving the role of financial intermediation for others. The basic principle of Islamic banking is the prohibition of Riba or interest, which has seldom been recognized as applicable beyond the Islamic world, but many of its guiding principles have, consciously or unconsciously, been accepted, M. Raquibuz Zaman and Hormoz Movassaghi (2001), in their article entitled “Islamic Banking A Performance Analysis”, study reviews the growth of Islamic banking since its inception nearly four decades ago. It examines the major products/services offered by various Islamic banking institutions (IB) as well as analyzing such institutions' financial performance based on the latest data available. The study concludes that some of the practices and the financial instruments used by the Islamic banks do not seem to conform to the traditional Islamic principles, and it offers suggestions for improvements.

History of Banking in Iran

Before establishment of the modern bank in Iran, banking operations had been carried out in traditional form, or in other words in the form of money changing. With the promotion of trade and business in the country, money changing are become a popular business in Iran. Exchanges of coins and hard currencies were also common in Iran. Before the advent of the Achaemenid Dynasty, banking operations had been carried out by temples and princes and seldom had ordinary people been engaged in this occupation.

Following a boost in trade and use of bank notes and coins in trade during the Parthian and Sassanian eras, exchange of coins and hard currencies began in the country. Bank notes and gold coins were first used in the country following the conquest of Lidi by Achaemenid king Darius the Great in 516 B.C. At that time, a gold coin called Derick was minted as the Iranian currency.

During the Parthian and Sassanids eras, both Iranian and foreign coins were used in trade in the country. However, with the advent of Islam in Iran, money changing and use of bank notes and coins in trade faced stagnation because the new religion forbade interest in dealing.

Before the printing of first bank notes by the Bank Shahanshahi (Imperial Bank), a kind of credit card called Bijak had been issued by money dealers. It was in fact a receipt of a sum of money taken by money dealers from the owners of Bijak. The credence of the Bijak depended on the creditability of the money dealer who had issued it.

Money changing continued until the establishment of New East Bank in 1850. With the establishment of the bank, money changing came to a standstill. The New East Bank in fact the first banking institute in its present form was established in Iran. It laid the foundation of banking operations in the country. It was a British bank whose headquarters was in London.

In order to compete with money dealers, the bank paid interest on the fixed deposits and current accounts to its clients. The head office of the bank in Tehran issued five 'qeran' bank notes in the form of drafts. These drafts were used by people in their everyday's dealings and could be changed into silver coins when offered at the bank. In 1885 Bank Shahanshahi (Imperial Bank) was established by Baron Julius De Reuter. This bank purchased the properties and assets of the New East Bank, thus putting an end to the banking operations of the former. The activities of Bank Shahanshahi ranged from trade transactions, printing bank notes, and serving as the treasurer of the Iranian government at home and abroad in return for piecework wage. The legal center of the bank was in London and it was subject to the British laws but its activities were centered in Tehran. Bank Shahanshahi continued its activities until 1948 when its name was changed to Bank of Britain in Iran and Middle East. The activities of the bank continued until 1952.

In 1856, a Russian national by the name of Jacquet Polyakov, had established Bank Esteqrazi for 75 year. The bank continued its activities under the name of Bank Iran until 1933 when it was incorporated into the Bank Keshavarzi (Agriculture Bank). Bank Sepah was the first bank to be established with Iranian capitals in 1925 under the name of Bank Pahlavi Qoshun, in order to handle the financial affairs of the military personnel and set up their retirement fund. With Bank Sepah opening its branches in major Iranian cities, the bank began carrying financial operations such as opening of current accounts and transfer of money across the country.

The proposal to establish a national Iranian bank was first offered by a big money dealer to Qajar king Naser-o-Din Shah before the Constitutional Revolution. But the Qajar king did not pay much attention to the proposal. However, with the establishment of constitutional rule in the country, the idea of setting up a national Iranian bank in order to reduce political and economic influence of foreigners gained strength and in December 1906 the establishment of the bank was announced and its articles of association compiled.

In April 1927, the Iranian Parliament gave final approval to the law allowing the establishment of Bank Melli of Iran. But, due to problems in raising 150 million rial capital needed by the bank, the Cabinet ministers and the parliament's financial commission approved the articles of association of the bank in the spring of 1928. The bank was established with a primary capital of 20 million rials, 40 percent of which was provided by the government. The bank was formally inaugurated in September 1928.

The Central Bank of Iran was established in 1928, tasked with trade activities and other operations (acting as the treasurer of the government, printing bank notes, enforcing monetary and financial policies and so on). The duties of the CBI included making transactions on behalf of the government, controlling trade banks, determining supply of money, foreign exchange protective measures (determining the value of hard currencies against rial) and so on.

In June 1979, Iranian banks were nationalized and banking regulations changed with the approval of the Islamic banking law (interest free), and the role of banks in accelerating trade deals, rendering services to clients, collecting deposits, offering credits to applicants on the basis of the CBI's policies.

In 1983 the Islamic Banking law of Iran was passed by the Islamic Majlis of Iran. According to this law, Iranian banks can only engage in interest-free Islamic transactions because interest is considered as usury and is forbidden

by Islam and the holy book of Qur'an. The banking system in Iran adheres to Islamic rules that prohibit earning or paying interest. Therefore, Iran banks execute commercial transactions that involve exchange of goods and services in return for a share of the assumed "profit". There are currently five types of banks operating in Iran: government-owned commercial banks, government-owned specialized banks, private banks, interest-free lending banks and near banks. In the additional to this, there is also a credit institution for development purposes. Islamic banking in Iran follows perhaps the most liberal interpretation of Islam-certainly more liberal than the Malaysian model that is already perceived more liberal than the middle eastern practice, especially in the countries belonging to the gulf cooperation council (GOC).

Theoretical Background (Theoretical Islamic banking)

O you who believe! Be afraid of Allah and give up what remain (due to you) from Riba (usury) (from now onward), if you are (really) believers (278). And if you do not do it, then take a notice of war from Allah and his messenger, but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums) (279). (Al-Baqarah 278-279)

The practice of collecting interest on loans (riba or reba; usury) is unambiguously condemned in the Qur'an (V:62; VI:161; 111:130-131; 11:275-75; 11:278-279). Unlike Judaism, where the practice of taking interest from non-Jews is allowed, Islam, like early Christianity, does not allow the practice of usury in any form.

Plato and Aristotle had also opposed the concept of interest in the era of before Christ. Interest was also prohibited in the preliminary teachings of Jews and Christians, and is also prohibited in the First Testament of the Holy Bible.

All Moslem scholars does not agree the absolute prohibition of usury. There are those who believe that the prohibition of usury (interest) is not applicable to loans made for industrial, trade, or other productive investments. They argue that, since borrowers use capital resources to produce goods and services, which are sold for a profit, the providers of the capital resources must benefit from the profits earned. Likewise, there are those who believe that indexation of debts to protect the real value of the principal is not strictly forbidden either.

Acceptance of one or the other view with regard to collection of interest is less a result of theoretical and empirical analysis, and more a reflection of religious beliefs, and the desire to attain justice by abolishing exploitation of one class by another. The attitude and feelings of Islamic scholars and religious leaders toward interest taking (riba) are best enunciated by Seyyad Mahmood Taleqani. "The greedy people, with the poison of money through usury, extracted the economic blood from the body of the producing classes, which are the active and progressive organs of society, and injected it into their fat bodies, which are the parasite of society...with all the complications, disorders, and injustices that usury and the concentration of money have brought about everywhere, it can accurately be said that they are the foundation and root of all or most social and economic problems."

What is Riba?

The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariat terminology, implies any excess compensation without due consideration (consideration does not include time value of money). This definition of Riba is derived from the Quran and is unanimously accepted by all the Islamic scholars. There are two types of Riba, identified to date by these scholars namely 'Riba An-Nasiyah' and 'Riba Al Fadl'. 'Riba An-Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principal (Ras ul Maal). 'Riba Al Fadl' is defined as the excess compensation without any consideration resulting from a sale of goods.

Islamization of banking practices requires two steps. Step one is the elimination of interest from banking practices; that is creating a "loan free" economy. The second step involves the adaptation of intermediation practices of the banking system to Islamic rules and principles.

The elimination of interest from bank lending and borrowing is most definitely not an inconsequential issue in a country that has previously operated in accordance with the directions given by the rate of interest. There are several authors who argue that the elimination of interest from banking would lead to disorder in the economy because saving, and therefore investment and aggregate demand, would collapse.

In any case, whether or not one can show weak or strong causation between the interest rate and savings, elimination of the former should not cause alarm for numerous reasons. In an Islamic system one earns a share of the bank's profits (or losses, whichever the case might be) rather than a fixed interest. This potential for a share of the profits can be a potent motivation for saving. In addition to the profit potential, there are other reasons for positive savings,

such as the desire to accumulate wealth in anticipation of future consumption, and/or future retirement needs, and the desire to bequeath money to one's children. In other words, as long as people plan their consumption-saving behavior on the basis of a forward-looking expectation formula, their savings will be positive, regardless of whether a positive rate of interest exists. One could use the example of positive savings during an inflationary period, when the return on savings is usually not positive.

Another reason for positive savings, according to the Qur'an, is that by nature, human beings desire to save. Saving will take place as long as there are risk-averse people. There will always be those who will save for rainy days. Keynes touches upon this basic need in his discussion of the multiplier:

“The fundamental psychological law...is that men are disposed, as a rule and on average, to increase their consumption as their income increases, but not by as much as the increase in income.”

The theoretical issues arising in regard to Islamization of banking practices, there are operational questions, which relate to consumer loans, government borrowing, and international financial relationships. For consumer loans, there are no profits to be shared with the bank. So profit sharing schemes are not applicable. One possible solution for purely personal loans is the use of zokat money (wealth tax) to provide interest free loans to those who need financial assistance. As for consumer durable goods, one could suggest that banks should finance (or engage in a partnership of sorts) with the producer and share the profits earned by the producers. This will provide some income for the bank as well as financing for the customers who would be buying on installment directly from the producer, as in the case of the purchase of tools, inventories, etc.

With respect to international financial relations, there are several issues. One has to do with the feasibility and compatibility of free foreign exchange and free capital markets in a society that practices Islamic banking. There is a very plausible argument that in an interest-free environment, capital flight is inevitable. It is argued that capital will follow the highest return, wherever it might be. This issue can be addressed on two levels.

On one level are factors pertaining to religion. In compliance with Islamic teachings, Moslems cannot accept interest from anyone or any institution, foreign or domestic. There is one exception, however. "Charging interest is permissible for financial transactions with Dar Al Harb," i.e., for transactions with non-Moslems living beyond the rule of Islam. Therefore, based on religious beliefs, the lure of interest abroad should not be a significant problem in an Islamic society. On the other hand, investments in an Islamic bank will earn a share of the bank's profits. As a result, as long as the Islamic bank is profitable and competitive, there is no reason for an individual to shift his resources abroad. Following table shows the sharia principles adopted by different Islamic countries:

Table 1 : List of Sharia Principles Practiced in Selected Islamic Countries.

Category Countries	(A)	(B)	(C)	(D)
Bahrain	Musharaka	Morabaha Commission Service charges	Qard hassan	
Bangladesh	Al-mudaraba Musharaka	Bai-mua'zzal Bai-salam Hire-purchase Ijara Murabaha Commission Service charges	Qurd-e-hasana	Wadiah
Iran	Civil partnership Legal partnership Direct Investment Modarbah Mozaarah Mosaqat	Forward delivery Transaction Instalment sales Jo'alah Debt rading Hire-purchase	Qard Al-asanah	
Jordan	Mudaraba Musharaka	Morabaha Commission Service charges	Al-qird Al-hassan	Wadiah
Kuwait	Mudaraba	Morabaha	Qard-hassan	

	Musharaka	Commission Service charges Istisna Leasing		
Malaysia	Al-mudharabah Al-musyarakah	Al-murabahah Bai bithaman ajil Bai al-dayn Al-ijarah Al-ijarah thumma al-bai Al-wakalah Al-kafalah Al-hiwalah Al-ujr	Al-gardhul Hasan	Ar-rahn Al-wadiah yad dhamanah
Pakistan	Mushrika Equity participa-tion and purchase of share Participation term certificate(PTC) Modarabah Certificate Rent sharing	Mark-up Purchase of trade Bills Buy-back arrangement Leasing Hire-purchase Development charges Loan with service Charges	Qard-hasana	
Sudan	Mudaraba Musharaka	Morabaha Ijara Commission Service charges	Qard hassan	
Tunisia	Mudaraba Musharaka	Morabaha Taa-jir Commission Instalment sales	Interest free	
Turkey	Mudaraba Musharaka	Morabaha Ijara Irara wa-iktina Commission Service charges	Interest free	Trust
UAE	Mudaraba Musharaka	Morabahat Service charges	Qard hassan	

Notes:

- (A) Profit and loss sharing principles,
- (B) Fees or charges based principles,
- (C) Fees services principles,
- (D) Ancillary principles.

Sources: Bahrain: IBB's 1994 Annual Report; Bangladesh: IBBL's CAD letter dated 21 March 1994, Iran: The Law for Usury-Free Banking 1983; Jordan JIB's 1993 Annual Report; Kuwait: KFH's 1993 Annual Report; Malaysia: Money and Banking, Bank Negara Malaysia 1994; Pakistan: State Bank of Pakistan's BCD Circular no 13, 20 t h June 1984; Sudan: Ahmed, 1990; Tunisia: B.E.S.T Bank's 1992 Annual Report; Turkey: FFI's 1993 Annual Report; United Arab Emirates: DIB's 1992 Annual Report.

A second major aspect of international financial relations pertains to the dealings between Islamic and non-Islamic banks in the rest of the world. Various questions arise when one considers such dealings: Would an Islamic bank receive interest on its deposits in the Eurodollar market? Would an Islamic bank refuse to pay interest on its overdraft or borrowing from foreign banks? It seems that, in practice, as long as there are no international or multinational Islamic banks operating on Islamic principles, countries with Islamic banks must adhere to the laws,

rules, regulations and Customs of the countries with which they are dealing if they want to be a part of the international community. Therefore, they must accept and pay whatever charges, including interest, may occur.

A final debate has to do with the question of government debt and deficits in an Islamic system. Can a government borrow from the private sector to finance its deficits? The answer seems to depend on the use of funds. If the borrowed funds are to be used for a profit making government project, then there is no problem. The government enterprise is treated as any other private business. Therefore, if a government-owned and operated project is efficient and profitable, it can be financed by banks. If not, there is no financing available. As for not-for-profit government projects and expenditures such as justice and defense, borrowing from the private sector to finance the deficit is not feasible. In regard to government borrowing from the state-owned banking system (i.e., state-owned commercial banks and the central bank) any charges, interest and/or fee are of no consequence. This position is a direct result of the attitude of the Islamic scholars about usury, and is particularly true in Iran. The argument against usury is that people, particularly poor people, negotiate with the usurers (banks) from a weak position. They have no choice but to agree to pay a part of their production (income) to those people who have hoarded part of their income in the past. This is not just. However, if one organ of the government pays interest or a fee for borrowing from another organ of the same government, no injustice has taken place. Money is taken from one pocket and is put in another pocket. As a result, it is argued that government can borrow from state-owned banks, including the Central Bank, and pay whatever is needed for that purpose.

Table 2: Deposit Facilities Available at Islamic Banks in Selected Countries

Bahrain	Current accounts Inv. accounts Saving accounts Fixed term
Bangladesh	Current accounts PLS accounts : Saving Term deposit Short notice Inter-bank deposits
Iran	QH Current accounts QH Savings accounts Time or investment deposits Inter-bank deposits
Jordan	Trust accounts : Current Demand Joint inv. account : Saving accounts Notice accounts Specific inv. accounts Inter-bank deposits
Kuwait	Current accounts Inv. accounts Saving accounts Limited period Unlimited period
Malaysia	Current accounts Saving accounts Investment deposits Other deposits Inter-bank deposits
Pakistan	Current accounts Savings deposits Fixed deposits

	Other deposits
Sudan	Current accounts Saving accounts Inv. deposits
Tunisia	Account at call Inv. accounts : PDA Saving (<i>tawfir</i>) Time deposits CPD
Turkey	Special current account PLS " <i>Modaraba</i> " accounts
UAE	Current accounts Saving accounts Inv. deposits : <i>Muddharabah</i> Specified

Notes:

Inv.: Profit and loss sharing principles,
QH: Fees or charges based principles,
PLS: Fees services principles,
PDA: Ancillary principles.
CPD: Committed participating deposit.

Sources: Bahrain: IBB's 1994 Annual Report; Bangladesh: IBBL's 1993 Annual Report, Iran: BMI's 1992 Annual Report & Hedayati (1993); Jordan JIB's 1993 Annual Report; Kuwait: KFH's 1993 Annual Report; Malaysia: BIMB's 1994 Annual Report; Pakistan: MCB's 1993 Annual Report; Sudan: El Gharb's 1993 Annual Report; Tunisia: BEST's 1992 Annual Report; Turkey: FFI's 1993 Annual Report; United Arab Emirates: DIB's 1992 Annual Report.

Practice of Islamic Banking in Iran

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

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

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

For those people, however, who wish to earn some form of compensation for their deposits, other types of savings accounts are available. These alternative accounts may set minimum limits on the amount of deposit and the length of time required for the deposit. There are short-term investment deposits which require depositors to leave their resources in the bank for a minimum of three months and which require a minimum deposit of Rls. For those people who have a greater amount of money available for deposit, at least Rls., and who are willing to part with their money for at least one year, there are long-term investment accounts. Depositors of these accounts are

not compensated on the basis of a predetermined interest rate. They are paid, however, a share of the bank's profits, whatever those profits might be.

On the asset side of their balance sheet, commercial banks or other specialized financial institutions can have interest free loans (Qarz ol-Hasaneh), or income-earning assets. Every bank is required to provide a portion of its deposits, almost free of charge to the industrious and the needy. Most of these loans go toward productive small businesses and toward personal expenditures such as weddings, medical, needs, etc. There is a 1.5 percent per year handling fee charge for "industrial" or a 1 percent per year handling fee charge for personal Qarz Ol-Hasaneh. Industrial Qarz Ol-Hasaneh must be paid back in no more than five years and personal ones in no more than one year. Other types of assets that banks can acquire can be divided into several categories: (Mudarabah, or Qirad), Mosharekat, Installment Sale, Lease=Purchase contracts, Mozareh, Mosaqat, Jo'aleh, and Direct Investment.

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

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

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

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

Home financing is more involved than other types of installment sales. In regard to housing construction, the applicant can borrow up to 80 percent of the project's cost to complete a construction project. After the completion of the project, which should not be more than one year after the time the contract was signed, the bank will add a maximum of 10 percent profit, on an annual basis, to the money borrowed during the construction period.

At that time the builder can pay the entire amount and the bank would release the mortgaged project. If the borrower should decide to repay over a long period of time, i.e., on an installment basis, the bank will add 6 or 10 percent profit per year (6 percent for those with a savings account and 10 percent for others) to the borrowed money, and the property will remain mortgaged until all the debt is completely repaid.

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

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

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

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

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

Table 3 - Profitability of some Iranian banks for last five years

Milion Rial

Year Name of bank	2006-07 (1385)*	2007-08 (1386)*	% increase/decrease	2008-09 (1387)*	% increase/decrease	2009-10 (1388)*	% increase/decrease	2010-11 (1389)*	% increase/decrease
	melat	1,065,492	2,664,306	150	3,725,327	250	4,730,490	344	4,538,481
tejart	1,386,671	3,152,804	127	3,930,251	183	4,462,516	222	5,880,162	324
toseh sadrat	689,030	1,015,073	47	1,586,333	130	1,017,375	48	1,431,561	108
sadrat	1,241,357	1,623,631	31	3,103,916	150	3,860,822	211	8,210,130	561
karafarin	529,949	819,626	55	1,450,217	174	1,905,660	260	2,033,281	284
parsian	2,151,154	3,313,342	54	3,937,079	83	4,549,042	111	5,918,492	175
pasargad	857,000	1,679,670	96	2,446,123	185	3,560,355	315	6,517,814	661

saman	258,580	490,374	90	465,579	80	833,011	222	1,509,444	484
-------	---------	---------	----	---------	----	---------	-----	-----------	-----

* The Persian year is from 21 march of this year to 20 march of next year. For example the year of 1385 started from 21 March 2006 and ended to 20 March 2007.

Table 3 shows profitability of some Iranian banks for last 5 years from 2006-07(1385) to 2010-11 (1389). There are four government-owned banks namely bank Mellat, bank Tejart, bank Toseh sadrat, bank Saderat and bank Sanat va madan and also four private banks namely bank Karafarin, bank Parsian, bank Pasargad and bank Saman. The private banks were established under Decree No. 948-1379/09/20(2000) of The Money and Credit Council (MCC). As it is shown in the above table profitability of banks in 2010-11(1389) compared with 2006-07(1385) are increased upto 561% in the government-owned sector and upto 661% in the private sector. Profitability of these banks on average increased by 358% in the government-owned sector and 321% in the private sector in 2010-11(1389) compared with 2006-07(1385). However, in some years we rarely see a reduction in profitability compared to the previous year, for example bank Toseh sadrat in 2009-10 and bank Saman in 2008-09, but generally the banks which mentioned above have had soaring profitability. Although at the beginning of Islamic banking in Iran, some experts were opposed to do it and they assumed it as a failed plan in advance, but the Islamic banking in Iran could achieve considerable successes with building trust of depositors and borrowers. These banks profitability has increase in a period of the global economic crisis when some banks of the world were collapsed. This shows the strength and success of Islamic banking in Iran.

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

Table 4: Bank Profit (Interest) Rates in Iran

Term – Investment Deposit Rates							Expected Rate of Profit on Facilities				
Year	Short term	One – Year	Two – Year	Three – Year	Four – Year	Five – Year	Exports	Trade and Services	Construction and Housing	Manufacturing and Mining	Agriculture
1979	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1980	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1981	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1982	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1983	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1984	7/2	9	NA	NA	NA	9	8-12	8-12	8-12	6-12	4-8
1985	6	8	NA	NA	NA	8	8-12	8-12	8-12	6-12	4-8

1986	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1987	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1988	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1989	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1990	6/5	9	10	11	NA	13	17-19	17-19	12-14	11-13	6-9
1991	6/5	9	10/5	11/5	NA	14	18=<	18=<	12-16	11-13	6-9
1992	7/5	10	11/5	13	NA	15	18=<	18=<	12-16	13	9
1993	8	11/5	13/5	14/5	NA	16	18	18-24	12-16	16-18	12-16
1994	8	11/5	13/5	14/5	NA	16	18	18-24	15	16-18	12-16
1995	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1996	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1997	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1998	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1999	8	14	15	16	16	18/5	18	22-25	15-16	17-19	13-16
2000	8	14	15	16	17	18/5	18	22-25	15-16	17-19	13-16
2001	7	13	13-17	13-17	13-17	17	18	23=<	15-16	16-18	14-15
2002	7	13	13-17	13-17	13-17	17	17	22=<	14-15	15-17	13-14
2003	7	13	13-17	13-17	13-17	17	15	21=<	15	16	13.5
2004	7	13	13-17	13-17	13-17	17	14	21=<	15	15	13.5
2005	7	13	13-17	13-17	13-17	17	16	16=<	15	16	16
2006	7	7-16	7-16	7-16	7-16	16	14	14	13	14	14
2007	8-11	14	14/5	15	16	17	14	14	12	14	14
2008	12	NA	NA	NA	NA	19/5	12	12	11-12	12	12
2009	9-12	15	16	16/5	17	17/5	12	12	11-12	12	12
2010	6-11	14	14/5	15	16	17	12	12	11-12	12	12

Source: Central Bank of Iran, Annual and Economic Reports, Various years

Problems and Challenges

Since the 1979 revolution led by the late Ayatollah Khomeini, Iran has time and again tried establishing what its clerics consider to be the world's purest system of Islamic banking and finance. The fundamental spirit of Islamic banking is not averse to a profitable return on an investment. It is just opposed to the idea of pre-determined returns, such as interest paid on deposits, which is considered akin to usury. Additionally, there are bans on investments in businesses dealing with alcohol, pork or gambling.

Consequently, a number of Islamic countries have chosen to allow the concept of profit and loss sharing for Islamic bank depositors and borrowers - a method considered acceptable to scholars of Islamic Sharia or jurisprudence.

What is the future of Islamic banking in Iran and perhaps elsewhere? This question could be answered in light of some developments in the recent past. In the 1980s, there were three countries in the world which announced full conversion of their banking and economic system to an Islamic system – Pakistan, Iran and Sudan. From the three, Pakistan and Sudan have already gone back to dual banking systems, i.e., the co-existence of Islamic and conventional banking practices. Islamic banking in Iran is currently facing tough time in the wake of dire economic sanctions against them. The trend seems to indicate that Iran would revert to a dual banking system!

In the trillion dollars Islamic banking and finance industry, Iranian statistics feature prominently. If we exclude Iranian Islamic banks and financial institutions from the global list of Islamic financial institutions, the total size of the Islamic financial industry drops significantly.

Given this prime role played by Iranian Islamic banking in the global context, it is imperative for the global movement of Islamic banking and finance to stand side by side with Iranian Islamic bank, to support them in the wake of economic and financial sanctions against them.

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. For example if the Shariat committees in Islamic Banks or different institutes do what they want and be maverick, we will face many problems in this realm. At the time determining the unique Standard is necessary and actually this Standard for running the Islamic Banks can be one of the dimensions of religious Unity in Islamic world.

Today there exist some centers in Malaysia, Bahrain and Dubai that try to standardize the Islamic Banking system. By making these standards we can avoid the problems we may face in the future. Standardizing Islamic Banking Systems is necessary and this Standard with help in running the Islamic Banks.

A globally acceptable regime covering Islamic banking and finance will succeed only if it is built upon three important pillars.

First, banks involved in Islamic finance cannot be expected to subsidise officially inspired ideas such as offering below-inflation rate loans, while also remaining profitable. What they can be reasonably expected to do is to follow a genuine interest rate policy set by their respective central banks, without influence from politicians.

Second, the promotion of Islamic banking and finance must be built upon the bottom line view that depositors need to be sure of a certain return over a given time period. The purists in the business of Islamic finance often find such suggestions to be completely unacceptable.

Yet there are many examples of countries where the enforcement of a profit and loss sharing regime would raise concerns among depositors. For instance, there are no easy solutions in such countries with weak systems of accountability, where borrowers could declare a loss at the end of a pre-agreed time-frame even if they actually made a profit.

Finally, the business of Islamic banking and finance cannot be seen as a source of social good in the interest of the banking sector. In Iran, recent remarks by the central bank governor and the president appear to suggest an ambition to turn banks into providers of subsidised loans for the poor.

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.

Conclusion

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 for introduction of new products and instruments for banking system in line with innovations in modern banking. 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.

Reference:

[1] Suddin Haron,(1998). A Comparative Study of Islamic Banking Practices, School of Management, University Utara Malaysia, J.KAU: Islamic Econ., Vol. 10, pp. 23-50.

[2] Anwar Muhammad (1992). Islamic banking in Iran and Pakistan: A comparative study, The Pakistan Development Review, 31:4, part II (winter 1992) pp. 1089-1097.

[3] http://www.iranchamber.com/history/articles/banking_history.php

[4] <http://www.pindorialaw.com/iran-banks.html>

[5] Dar, Humayon (2010). Islamic Banking In Iran and Sudan. Business Asia, June 27, 2010.

[6] Noor Ahmed Memon (2007). Islamic Banking: Present and Future Challenges, Journal of Management and Social Sciences, Vol. 3, No. 1, (Spring 2007) pp.01-10.

[7] Hassani Mohammad (2010). Islamic Banking and Monetary policy: Experience of Iran, International Review of Business Research Papers, Volume 6. Number 4. September 2010. Pp. 430 –443, Melbourne, Australia.

[8] Financial Statements of eight banks including bank Mellat, bank Tejart, bank Toseh sadrat, bank Saderat, bank Sanat va madan, bank Karafrin, bank Parsian, bank Pasargad and bank Saman for five years (from 1385 to 1389).

[9] Central Bank of Iran, Annual and Economic Reports, Various years.

[10] <http://www.halaljournal.com/article/919/--irans-islamic-banking-model-faces-challenges>

[11] <http://www.taghribnews.com/vdceo78w.jh8fnik1bj.txt>

[12] www.sbp.org.pk/departments/ibd/Lecture_8_Related_Reading_2.pdf

[13] <http://banki.ir/akhbar/1-news/3920-کجا-پیدا-شد-اسلامی-از-بانکداری>

[14] ارزیابی و مقایسه بسته سیاسی – نظارتی بانک مرکزی در سال 1389 ، دکتر علی راشدی ، تازه های اقتصاد، سال هشتم ، شماره صد و بیست و هفت-ایران