



## BANKING II. BANKING IN THE ISLAMIC REPUBLIC OF IRAN

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### ii. In the Islamic Republic of Iran

Islamic banking is based on the principle of profit-earning on equity participation, the earning of interest (*bahra*) being forbidden. The merits of such a system compared to the system more common in the West (fixed interest rates and guaranteed value of deposits) is a matter of debate among economists. On the one hand, the Islamic system has certain disadvantages compared to the Western system: The equity investment principle makes Islamic banks less liquid and therefore perhaps not as flexible; the profit-sharing concept requires businessmen to share more information with banks than they may be prepared to do; banks must devote much effort to analyzing businesses because their capital is at risk; and Islamic banking is not well suited for financing consumer purchases or government deficits. For these reasons among others, pre-twentieth-century efforts to implement Islamic banking were not particularly successful.

On the other hand, some economists have argued that an equity-based system is better suited to adjust to shocks and to avoid banking crises precisely because it excludes predetermined interest rates and does not guarantee the value of deposits. Indeed, the Islamic banking system bears a striking resemblance to proposals made in the 1930s and 1940s by eminent economists for reform of the U.S. banking system (Fisher, Simons, Friedman).



Furthermore, it may be suggested that Islamic banking permits the payment of a high return on capital which is economically justified in less developed countries but which would be unacceptable to regulators who set interest rates under a Western-style banking system.

On the deposit side, banks accept two basic sorts of deposits: *qarż al-ḥasana* and term investment deposits. In theory, the principal in *qarż al-ḥasana* deposits is guaranteed but the account earns no profit, while the term deposits do not have a guaranteed principal but earn profit. In practice, however, banks offer bonuses and prizes for *qarż al-ḥasana* savings deposits (but not for *qarż al-ḥasana* current deposits), and banks insure at their own expense the principal in term investment deposits (Bānk-e Markazī-e Jomhūrī-e Eslāmī-e Īrān, 1986a). Furthermore, the Bānk-e Markazī (Central Bank) sets one uniform rate which all banks pay on term investment deposits. As practiced in Iran, therefore, Islamic banking involves a guaranteed rate of return, without funds being at risk—which makes the system rather similar to Western banking.

On the lending side, the Law on Interest-Free Banking authorizes a variety of transactions, and the Central Bank closely regulates distribution of credit among the categories and by borrower type (e.g., various industries and types of agriculture). On 20 March 1986 Islamic transactions accounted for 1,833,038 million rials outstanding from the commercial banks to the private sector, while 3,005,792 million rials were outstanding to the private sector on facilities under the previous system (Bānk-e Markazī-e Jomhūrī-e Eslāmī-e Īrān, “The Practical Aspects of Islamic Commercial Banking,” paper presented at the International Islamic Banking Seminar, Tehran, 1986). On the Islamic side, the facilities and their share in the total were: 1. *qarż al-ḥasana* (10.9%): provision of a sum to a borrower who is to pay back the same sum at a later date; 2. civil partnership or *mošāraka* (13.3%): contribution of capital by several persons to a common pool on a joint-ownership basis; 3. legal partnership and direct investment (11.0%): ownership of stock in joint-stock companies or direct ownership by banks; 4. *možāreba* (16.0%): the bank provides the funds utilized by the borrower in trading, with profits split between the two; 5. forward delivery transactions (3.1%): advance cash purchase of products at a fixed price; 6. installment sales (of equipment or materials for production or of housing) (32.1 %): the borrower makes payments over time sufficient to allow the bank to recover the cost and to make a profit; 7. hire purchase (0.9%): the borrower leases a good owned by the bank with the stipulation that the



leaseholder will ultimately receive title; 8. *je'āla*, either as *'āmel* or as *jā'el* (1.3%): one party (*jā'el*) pays another party (*'āmel*) to perform a service; 10. *možāra'a* (not available): the bank turns land over to the borrower for a fixed period for farming in return for a specified share of the harvest; 11. *mosāqā* (not available): the banks turns over trees to the borrower for a specified share of the produce; 12. purchase of debt (10.2%): banks may discount debt documents and commercial papers.

In practice, the profit rate to be earned from each activity is tightly regulated by the Bānk-e Markazī, which sets minimum and maximum profit rates by industry. Furthermore, failure to repay a loan on time results in a penalty which is calculated in the same manner as interest. The Bānk-e Markazī also closely regulates the distribution of credit; for instance, the *qarż al-ḥasana* transactions (on which the banks make no profit) are essentially all at its direction. In sum, Islamic banking in Iran involves lending at rates that are largely set in advance, with additional payment required if funds are kept longer—which makes the system rather similar to Western banking.

To some extent, the similarities between Islamic banking in Iran and Western banking reflect the problems in the transition to the new system; e.g., personnel had to be trained in new skills and techniques, and the confidence of the public in the new system had to be ensured. Furthermore, the Islamic banking system was introduced at a difficult moment, when the banking system was suffering from bad debts extended just before the 1979 revolution and when Iran was in the midst of a deep recession.

More important, however, the characteristics of Iran's Islamic banking system have been shaped by the need to finance a large government deficit. Islamic banking theory provides little guidance on how a government can finance its deficit. The technique used in Iran has been to require banks to lend large sums to the government, both by buying government bonds and by depositing reserves in the central bank for on-lending to the government. In the first eleven months of 1364 Š.(1985-86), these two forms of lending to the government absorbed 58% of the increase in private sector deposits (478.2 billion rials out of 827.6 billion rials; Bānk-e Markazī-e Jomhūrī-e Eslāmī-e Īrān, 1986b). In order that banks could continue to pay rates of profit sufficient to attract deposits when so much of their funds was tied up in loans to the government, the government has paid interest on its borrowing. This has been justified on the basis of a religious ruling (*fatwā*) that it is permissible to pay interest to oneself and that the government and the nationalized banks are all



one corporate person.

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