

**ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE**

**AN ANALYTICAL REVIEW OF ISLAMIC
BANKING AS PRACTICED IN IRAN**

Prepared By:

Iraj Toutouchian

Professor of Economics

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FOREWORD

This paper is the product of both close observations of the Iranian banking system and thoughts given to its theoretical foundation. The period of investigation goes back to fourteen years ago when the Usury-Free Banking Operations Law (The Law) was put in practice.

The rules and regulations of the Law were prepared, after the enactment of the Law, by some of the draft-initiating committee members (of which the present writer was a member). There was then a feeling on the part of some scholars and academicians to initiate the theoretical framework of the Law. Although the draft-initiating committee was greatly inspired by the books and few papers which were available at the time, but the Law had its own peculiarities which made it somewhat different from the proposals made by some scholars. There, a great opportunity was created to write papers on different aspects of the Law. Returning back to academic life from the Ministry of Economic Affairs and Finance, I had the chance to write few papers on the underlying principles of the Law (see bibliography). Being away from everyday problems and challenges facing the banking system due to the Law, it was felt that there should be some close ties with some of the banking staff. This opportunity was given to me by the Iran Banking Institute. I was invited to the institute, on a part time basis, as a senior research economist to do research and teach a course in Islamic Banking at graduate level and also to supervise some of the Master's theses. This was the right opportunity at the right time for which I am grateful. Almost four years of close contact with many students all of whom from the banking

staff (from member of executive directors down to some ordinary banking experts) made it possible for me both to sharpen my theoretical ideas as well as to extend the frontiers of my thoughts.

During those years the institute was dominated by academic method of thinking rather than banking, per se. This gave us (as academicians) the chance of collecting valuable data, time series, never existed before and put them in use for testing some theoretical hypotheses of the masters' theses we supervised mostly on Islamic banking. This was time the graduate students started to appreciate the data put into theoretical framework in order to enhance the applicability of theses. There, definitely, were mutual benefits gained, quite often acknowledged, by both instructors (myself included) and the students. We also organized annual seminar, ever since, on Islamic Banking on the same week the Law was passed.

In this paper effort has been made to evaluate the performance of the Iranian banking system. Section I reviews the Law and its implications, in second II the transformation required to make the environment suitable to make the Law work is discussed. After this stage the performance of the Iranian banks are reviewed in section III. It has been noticed that three contracts, Musharahah, Installment Sales, and Mudarabah had some applicability problems of their own. Impartial evaluation has been made with considerable honesty as much as possible, in Section IV. Given the existing conditions, proposals have been made for a pilot study aiming at its extension to the full coverage, whenever appropriate.

Final Remarks: This paper complements:

1-The Law

2-Regulations and Instructions of the Law, and

3-Different forms of Contracts used in everyday transactions.

The translation of the last two complementary parts have not been made available to the author; however they must have been translated into foreign languages for use of Iranian bank branches outside Iran.

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In doing this research IRTI has provided me with the opportunity to work in a pleasant environment. Had this chance not been given it would not have been possible for me to concentrate for almost three months on this subject. I hereby acknowledge my deep gratitude to IRTI/IDB, especially to Dr.M.A.Al Jarhi, the Director, and to Dr. Munawar Iqbal, the Ex-Head of Special Assignments Unit. It shall not go without mentioning that the initial step to initiate the External Scholar Scheme and extending a proposal to me was taken by Dr.A.H. El-Ghazali. That proposal was not pursued for some reason, unknown to me.

The author has been appreciably inspired by the talks of some scholars of IRTI as well as those in the Center for Research in Islamic Economics, King Abdul-Aziz University with whom I discussed some important Islamic economic issues. Specially, I am grateful to Dr.Ausaf Ahmad, Dr.M.A.Al Jahri, Dr.M.A.ElGari, Dr.Sami Hommoud, Dr.Munawar Iqbal, Dr.Monzer Kahf, Dr.M. Fahim Khan, Dr. Tariqullah Khan, Dr.M.N. Siddiqi, Dr.M.A.Zarqa for their superb blend of insights. I would like to offer a special thanks to Br. Veyis Al-Tinkaya for his being ultra protective and concerned and also to Br. Sh. M. Rahsied for his admirable patience and technical skill who did the secretarial work of the paper. My thanks also go to all IRTI'S as well as library's personnel I had very enjoyable time working with them. I can not also leave it without mentioning that my stay here in Jeddah brought me the blessing of Allah (S.W.T.) to perform Hajj, accompanied by my wife. I offer my most profound gratitude to my family

(especially my wife) who not only coped with my absence, without which this work could not have been accomplished but provided enthusiasm and hope.

If the ideas presented in this paper make the Iranian banking system, as well as other Muslim countries, a better one my efforts will have been more than repaid!

Iraj Toutouchian

AN ANALYTICAL REVIEW OF ISLAMIC BANKING AS PRACTICED IN IRAN

SECTION I: THE USURY-FREE BANKING OPERATIONS LAW OF IRAN

1-1 The Process and Rationale for bank Islamization

1-1-1 The Process

In one of the comments of 1360 (1981-82) budget law, the government of Iran, on constitutional grounds, was mandated to take action about Islamization of the banking system. It was directed to the Ministry of Economic Affairs and Finance to take the responsibility. The draft initiating committee, composed of seven persons from different areas was organized by the Vice Minister for Banking Affairs. The sessions were held in the Ministry. Three of the committee members were from banking sector, one from business sector three economists (myself included) from different universities, and two alternating religious scholars. The draft law was prepared after long sessions each of which going through details from different aspects as far as the expertise of the committee allowed¹. It was then decided the draft should first get the feedbacks of Money and Credit

¹ A parallel committee was also heard to have been set up in the Central Bank. Not much is known about its output, but it was soon realized that it should discontinue its session, and it did.

Council (Central Bank) and then those of the High Council of Banks. With minor modifications, the draft was given to the then Minister of Economic Affairs and Finance to take it to the Cabinet. The next step was to hand-over the draft law to the parliament (The Consultative Assembly). The parliament voted for a special committee on banking to be set up. Most members of this committee were religious scholars interested in the issue at hand. Once-in-a-week (and sometimes) long sessions were held in the special committee of the parliament. The special committee members showed deep interest in the fundamentals of the issue. Three out of seven members of the initiating committee (the present author included) were assigned to respond to the upcoming questions of the special committee. At its final stage, the draft was taken to the open session of the parliament. It was approved under the title: “Usury-Free Banking Operations Law” (hereafter referred to as the Law, unless otherwise specified) on September 1, 1983 and ratified² by the Council of Guardian to be effectively implemented as of March 21, 1984.

Ratification process for this important and comprehensive law did not take long for two basic reasons. Firstly, the detailed discussion of the special committee, on record, seemed satisfactory. Secondly, the comments and observations of the special representative of Imam Khomeini, a trustworthy known to all members of Council of Guardian and present at all sessions of the High Council of Banks, had already been taken care of.

² The entire process, from the first day of the work of the draft-initiating committee till its final approval by the parliament, took almost one and half years.

The Law has been, and still is, believed to be one of the best, if not the best, law for Islamization of the banking system. It is not only a full-fledged and comprehensive³ laws but also it goes into some details to avoid any major misconception and misunderstanding possible.

1-1-2 The Rationale for Bank Islamization

The corrupt political system of old regime, already notoriously convicted, was, on economic grounds, dominated by a few factories, many assembly plants, and a few big trade companies mostly owned either by a member of the Kingdom family or closely related to them; thus hardly of any accountability. There only remained the financial sector to go under their control. This by no means meant that they did not have easy access to this sector, but rather it being highly profitable business and probably more important than that easy to hide illegal transactions, it was attractive enough to establish new banks. To give the reader an idea how many banks had been mushroomed in a short period of time after the oil price hike in 1973-74, it suffices to mention that Bank Tejarat and Bank Mellat, created after the Nationalization Law, were composed of the following banks:

Bank Tejarat:

- 1-Irano-British Bank
- 2-Bank Etebarat Iran
- 3-Bank of Iran and the Middle East
- 4-Bank of Iran and Holland
- 5-Bank Bazargani Iran

³ Some scholars have argued that the Law should not have gone through details. The details could be taken care of in the rules and regulations to be prepared thereafter.

- 6-Bank Iranshahr
- 7-Bank Sanaye Iran
- 8-Iranians' Bank
- 9-Bank shahryar
- 10-Bank Kar
- 11-International Bank of Iran and Japan

Bank Mellat:

- 1-Bank Tehran
- 2-Bank Dariush
- 3-Bank Pars
- 4-Cooperative Credit and Distribution Bank
- 5-Iran Arab Bank
- 6-International Bank of Iran
- 7-Bank Omran
- 8-Bank Bimeh Iran
- 9-Foreign Trade Bank of Iran

Interestingly enough, all above banks followed the central decision-making rule, practiced in Iran for decades. Their headquarters were established in Tehran (Capital city) where the owners resided. This made access to both King and his immediate family quite easy to get their highly influential orders on any probable up-coming problems⁴.

The rationale of having an Islamic financial system does not lie in changing the instruments used in interest-based system to a one through

⁴ It has become rather clear why Iranian Banking System had been declared nationalized. Details will be discussed later.

which the financial intermediation takes place. Islamic financial system is an integral part of a value system prescribed by Shari'ah⁵. The value system is in itself a means to achieve the goals of an Islamic state, the most important of which is equity, Quest. Furthermore, elimination of Riba is not all that powerful to be expected to transform the entire system in accordance with the Shari'ah. It certainly works better in an Islamic environment than in a non-Islamic one⁶.

The present author, along with a few others, all of whom members of the then Council of Money and Credit (Central Bank of Iran) stressed, which is on record, the fact that the remaining task, after the law was initiated and enacted, to others to pursue. These included, among other things:

- 1-Appropriate changes in legal framework and accounting procedures.
- 2-Proper training of bank employees and of the general public.
- 3-Sponsoring researches and seminars aimed at better understanding of the working of the system and exploring new frontiers for further development.
- 4-Necessary changes in university textbooks,
- 5-New courses offered at university level.

Certain steps have been taken in regards to above recommendations. Admirably, accounting procedures have already been prepared by experts

⁵ W.G.Greider observes that the moral concept of usury was always in fundamental conflict with the dynamics of capitalism. Usury implied social obligation; capitalism depended on individual gain.

⁶ On the grounds that Islamic rules can be considered universal, it may well be argued that the instructions could be so tailored as to fit a non-Muslim world.

and announced to the banking system for adoption⁷ . Legal framework is far from being Islamic. For example, violations on the part of entrepreneurs (fiancées) from the context of a contract can not easily be settled in law courts.

Bank employees had, to some extent, short courses in Islamic Banking. The course period was not long enough to make it meaningful. Furthermore, case studies were hardly discussed in classes. Most important of all, the qualification of the instructor(s) chosen has rather been questionable.⁸

Several seminars have been set up at local, national (and seemingly international) levels. Had there been competent panel members, these seminars could have an appreciable impact on understanding and workings of the system. They could bring real-world problems to the attention of the bankers in order to seek for an Islamic answer. The bankers have long been exposed to conventional banking procedures. It was extremely hard, if not impossible, for them to change their attitudes from old system to a newly introduced one. Long and intensive courses aimed at solving newly developed problems could make them prepared to appropriately do their jobs; what they never have been given a chance to go through. Quite naturally, there has always been a tendency to find solution to upcoming problems leaned towards what they had been acquainted with, not necessarily Islamic. Lack of advisory committee at local and national level has made the problem even more complicated.

⁷ Most, if not all, accounting instructors are ignorant of such procedures. Standard methods applicable to interest-based system are still being taught at university level.

⁸ Some misunderstandings still exist among several of them as to the distinction between interest and profit (and their manifestation as bond and stock, respectively) and their implications.

For the last eight years Iran Banking Institute⁹ (affiliated with the Central Bank) has held seminar at national level¹⁰. Most papers presented in these seminars took it for granted that the Law was being fully implemented; an assumption far beyond reality. Surprisingly, on the basis of false assumption they tried to make some unqualified recommendations¹¹. There were quite a few papers, which ignored the Law and tried to use the conventional analytical tools to prove their own hypotheses.

What has not been explicitly heard in these seminars was the rate of interest, guaranteed rate of profit¹² was, and still is, a good candidate.

⁹ Present writer has been one of the members of organizing committee of the first six seminars (and presented one paper in each; see bibliography). Monetary and Banking Research Institute (another institute affiliated with the Central Bank) has organized eight seminars in the last eight years with the main focus on exchange rate and monetary policy in conventional framework. Agricultural bank has also set up a few independent seminars on Islamic banking.

¹⁰ Efforts have been put to invite Muslim scholars from other Muslim countries, but their attendance was few to be viewed as international seminar.

¹¹ A few papers focused on different modes of contracts and called it one of the weaknesses of the law, hence recommended that some modes could be combined. Contrary to such idea there was rather consensus among those involved at different stages, from initiation to its approval, that it was one of the strong points of law being able to fulfill different needs in different circumstances. Unfortunately it was not fully put into practice to reveal its advantages. Admittedly, the monitoring cost of Islamic banking is relatively high, compared to conventional banking, which is expected to be outweighed by its benefits.

¹² This refers to the rate interest paid to deposit account holders. The interest rate received by banks from their customers stipulated in different modes of contracts has been termed “profit share” or “expected rate of return”. Rate of profit can not, by definition, be guaranteed since profit itself is ex-post concept whose magnitude will be determined at the end of fiscal years is subject to change. Profit rate is also a cover-up terminology used by bankers.

Profit share between two parties takes one of many forms as (i,j) in percentage such that:

$$i+j=1; \quad 0 \leq i, j \leq 1$$

What does it mean to say, for example, that the expected rate profit is 20% and at the same time the recipient has to pay 20% of the principal amount of finance? If it is the expected rate of profit arrived at by a banker it is not supposed to be disclosed publicly. Rather, it should be announced to other bankers that this 20%, or whatever figure they have arrived at, shall be shared, as mentioned above, between bank and the customer. Furthermore, if deposit holders are getting their own realized share of profit how is it possible, in accounting terminology, to consider it as operational expenses, as is commonly practiced? Profit is the leftover after all expenses, paid or incurred, is taken into account. If it was somehow admissible, on accounting grounds, to consider partner’s share of profit as expenditures of the other partner, the end result would have been different from what was originally agreed upon. Any misunderstanding in this regard calls for sound principle of accounting applicable to dividends paid to the shareholders.

Special care has to be taken about Muslims' antagonism against Riba. The further the gap between substance of the Law and what is being practiced, the greater is the danger to the Muslims of becoming indifferent about Riba whose payment and receipt is, according to Qur'an, to declare war against Allah (S.W.T.) and his Prophet (P.B.U.H.). Making Muslims indifferent on the subject matter of Riba, for whatever reasons, is a real harm to their beliefs, which can not perhaps be easily overcome. Not many evidences can be found in the above-mentioned institutions to finance a research project on specific Islaming banking issue.¹³

Given that a well-organized and sound research has been undertaken, the question is what is the mechanism through which the message of the paper could be transmitted to the authorities? The transmission mechanism is very weak, indeed, if non-existent. It requires mutual understanding from both sides of the issue; the researchers and the decision-makers. Shortages of classified information and data coupled with unrealistic assumption made by researchers have made their products unrealistic and inapplicable. Seminars¹⁴ are full of such products. Decision-makers also have to come to a point that research is not a luxury "good" to be undertaken after the economy has taken certain steps of development; it is a necessary good and a

¹³ Agricultural bank has been an exception in few instances; one minor opportunity was also provided by Iran banking institute.

¹⁴ Cosmetics of seminars, in some cases, seem to be more important than the substance. For instance, a high quality seminar is believed to be the one, which is inaugurated by a high-ranking official.

prerequisite of development. This gap can not be filled artificially, it has to be endogenously realized and felt within the system.

1-2 Some Spotlights of the Usury- Free Banking Operations Law

It was almost three years after the breakout of war with Iraq that the Law was enacted. The Law was, as mentioned above, a full-fledged one designed to replace interest-based banking by usury (interest)-free banking. Banks were mandated to convert their deposits to the new system within one year and their other operations within three years from the date of the passage. The Law specified the kind of transactions that shall lay basis for asset and liability acquisition by banks. The Central Bank was held responsible for the banking system, and the instruments required to perform its duties was also specified.

Banks were permitted to accept two types of deposit accounts (Article 3):

A.Qard-ul Hassan

i) Current

ii) Saving

B.Long-term Investment

The latter deposit account could be used in a variety of different modes of contract (comment on Article 3) such as equity-participation, mudarabah, hire-purchase, installment sales, mozara'ah, mosa'qat, direct investment, salam and joalah. Banks were supposed to act as proxies of the deposit holders (comment on Article 3); hence any finance has to have an

external demander, of course from outside the bank¹⁵. Banks are under the obligation to guarantee the safety of the current and saving deposit accounts and may also undertake and/or ensure the repayment of the principal amounts of long-term investment deposit account (Article 4). To guarantee the principal may, at first sight, look as a controversial issue. However, bank, as mentioned above, act as a third party not as a user of deposits. In such a system, three parties are involved: (1) deposit holders, (2) the bank, (financier), and, (3) entrepreneur (fiancée). The commissions and fees earned by banks (Article 23) makes it clear that these incomes, in a addition to all other incomes received from regular banking services are the properties of the bank and are received from the deposit holders for the services they provide to them; especially so when it is explicitly expressed that they are not supposed to be distributed among the deposit holders (Article 23). It should be noted that the guarantor is not the fiancée (entrepreneur); hence compatible with Shari'ah.

All deposits are expected to be pooled¹⁶ and comprise a composite fund to finance two types of contacts:

- (a) Primary contracts with variable return such as Musharakah, Mazara'ah, Mosa'qat, direct investment, and Mudarabah, and
- (b) Secondary contracts with pre-determined rate of return such as hire-purchase, installment sales, salam and joalah.

¹⁵ All financing has to be at the request of an entrepreneur or a firm with only one exception outlined in Article 8.

¹⁶ Banks can also use their own funds in conjunction with the deposits but priority has rightly been given to deposit holders (part C of Article 6).

This means that each and every unit of money deposited in each bank across the country will finance different needs and the returns shall also be pooled to make “pooled profit”. This profit will be allocated to deposit accounts according to the amount and the time period it has been deposited with the bank. The holder of these deposits are entitled only to the realized profits earned from different projects financed through bank. If properly practiced, the deposit holders act as the buyers of the so-called “stocks” via an Islamic bank.

The important task of an Islamic bank is to safeguard the buyer of “Stock” (i.e. the depositor) from any fraud that may occur. This calls for a close inspection and evaluation of every single project offered to it¹⁷. It has to prove it is a trustworthy institution. Other assets are most often bought in a definable form and the buyer can examine their quality, etc. But the buyer of a “stock” buys entitlements to some parts of some businesses, his part in each business being undefined¹⁸. This gives one a reason to believe that an Islamic bank is no more a monetary institution in which money is bought and sold but a financial institution¹⁹, and hence practices financial policy. To exert financial policy, the Law has provided a flexible profit ratio tool for both equity participation and Mudarabah contracts (part one of Article 20).

¹⁷ In the following sections specific proposals will be recommended to this effect.

¹⁸ An analogy exists between the purchaser of share in Islamic stock market and a depositor of an Islamic bank. For an excellent argument as to how to protect the rights of a share-buyer, see M.Akram Khan’s paper in :Monetary and Fiscal Economics of Islam edited by M. Ariff (1982); pp.237-259.

¹⁹ Hence the monetary policy practiced by conventional banks is no more valid and financial policy takes over.

To properly supervise and exert power on hundreds of projects financed by Islamic banks requires considerable amount of expenditure. However, the resentment of fiancées to disclose financial transactions shall not be neglected²⁰. It may seem, at first, hard to justify the prohibitive costs involved in monitoring so many projects. Nevertheless, the price of having a sound and viable system is expected to be high. In the meantime there seems to be ways and means to minimize the monitoring cost especially in this world of highly developed electronic devices which makes it quite possible to check and cross-check the activities, which concerns the banking system, at reasonable time and price. The Law is not explicit²¹ as to what measures have to be taken to guarantee the soundness of both the banking system and the entrepreneurs' activities. It is left to the Islamic Central Bank to decide.

It seems that an Islamic bank is supposed to operate in a cooperative environment. From the one hand, deposit holders benefit from the profits of those firms whose projects have been financed by the bank. Firms enjoy the necessary capital provided by individual Muslims, through Islamic bank, and pay them part of the profit, on the other hand. This practice will, most probably, bring demand for and supply of finances into equilibrium without much difficulty. Any activity by an individual person or a firm in this direction is beneficial to the Muslim community as a whole. Hardworking

²⁰ There has to be sufficient tax, finance ceilings, and the like, incentives, in addition to favorable profit ratio wherever applicable, in order to overcome the reluctances of exposing financial statements to the bank.

²¹ Again, there may be argument against the view that the details should be spelled out in the Law. However, being new with no precedent, the Law should have been explicit on some important issues in order prevent misinterpretation.

on the part of both deposit owners and the firms means more saving, less cost, higher profits, higher level of investment, high level of employment, and finally simultaneous shift in aggregate demand and aggregate supply. This will produce a prosperous and developed economy. Development is undoubtedly geared with cooperation Islamic teachings stress so much. It is what we, as Muslims, need most.

On the grounds that finances are mostly project-based (not collateral-based), it seems easy finance small and medium size firms from which most of the employment of labor force comes about. It, hence, induces new small firms to be established. The mutual benefit enjoyed by both the employee and the employer is the spirit of Islamic teachings. Muslims are advised to cooperate in the activities regarded suitable by Shari'ah. It, among other things, guarantees, at the final analysis, the success of an Islamic state.

SECTION II

APPROPRIATE ORGANIZATION AND FUNCTIONS REQUIRED TO IMPLEMENT THE LAW

The Law was enacted as stated before, in September 1983 and was mandated to be put into action in March 1894. The banking system was, naturally, held responsible to do the important job of Islamization and laundering its activities. The system which had long period of experience in conventional banking²², the Law was believed, by all members of the draft initiating committee, to be the first step²³ towards Islamization of Iranian financial system. It could not obviously work in a vacuum; further steps had to be taken to make it work. It contained thoughts, which was supposed to induce actions. There are continuous and simultaneous feedback loop between thoughts and actions. Thoughts induce actions and actions induce thoughts. There is an inseparable inter-connection between thoughts and actions; each is impotent without the other. What type of decisions was necessary to put newly created thoughts into motion? Goals had changed, so should have the instruments needed to go through several processes in order to translate ideas into chains of activities that support the visions and stated goals. The Law called for, implicitly, a transformation to achieve these goals; the one which is suitable to both goals and instruments. Instruments were the banking system staff. Organizations, in this sense, became living organizations. Like people they needed holistic medicine not organ-by-organ

²² The history of: banking in Iran goes back to over hundred years ago. But modern banking, as is understood today, started with the establishment of Bank Melli Iran in 1307(1928-29). Its function also included the conventional function of Central Bank up until 1339 (1960-61) when Central Bank of Iran was established with the help of IMF.

²³ See footnote 20 of section 1.

treatments. The banking system on the basis of past experience needed the medicine badly.

Transformation is defined as the orchestrated redesign of the genetic architecture of the organization, achieved by working simultaneously, although at different speeds--along the four-dimension²⁴ of reframing, restructuring, revitalization and renewal.

Reframing is the shifting of the organization's conception of what it is and what it can achieve. It addresses the organization mind. Organizations often get stuck in a certain way of thinking, and lose the ability to develop fresh mental models of what they are and what they could become. Reframing opens the organization mind and infuses it with new visions and new resolve.

Restructuring is "a girding of the [organization] loins getting it to achieve a desired level of performance "²⁵. It deals with the body of the organization. Restructuring is the domain where payoffs are fastest and, naturally, difficulties are greatest. The anxieties associated with them are unavoidable side effects. The payoffs, however, if invested in revitalization and renewal, can be used to lessen their severity. Many organizations stop at the stage of restructuring, contented with their "quick wins". But they do not gain true health unless they use those wins to fuel longer-term transformation programs.

Revitalization is about igniting growth by linking the organization body to the environment. Everybody wants to grow, but the sources of growth are often elusive, making the process of achieving growth more challenging and protected than restructuring. Revitalization is the single

²⁴ See J.M.Bryson (1995), pp.155-56,175-181,188-190, and F.J.Gouillart and J.N.Kelly (1995); pp.7-9, 21-23.

²⁵ Op.cit, p.7.

greatest factor that clearly distinguishes transformation from mere personnel reshuffling, what one witnessed quite often in the past.

Renewal deals with the people side of the transformation, and with the spirit of the organization. It is about investing individual with new skills and new purposes, thus allowing the organization to regenerate itself. The skills required, implicitly, in the Law were of the type of cost-benefit analysis, portfolio and risk management and the like vital tools in Islamic banking. Renewal involves creating a new kind of metabolism, the rapid dissemination of the knowledge inside the organization, and it involves the cultivation of a reflex of adaptation to environmental changes mandated by the Law. It is believed to be the most subtle and difficult, the least explored, and potentially the most powerful transformation's dimensions. The people involved here were those whose long experience had been of conventional banking type. It could have been a real challenge to them.

The important task, at the stage of transformation was to mobilize the organization of the banking system towards the goals stated in the Law. Mobilization could create potential in the organization of the banks, prepare them to create a better future, as everybody expected from the beginning of the revolution. Mobilization governs the process of mustering the mental energy needed to feed the transformation process. It involves expanding the realm of motivation and commitment from the level of individual to the team, and finally to the entire banking system. Creating the mobilization system involves working from the top level down and from the grassroots level up. There existed, and still does, considerable potentialities in the banks but little chance had been provided to be put into actualities. The mental energies reflected in written propositions and suggestions rarely used to feed the needed transformation. The potentialities required a suitable

environment to be transformed into actualities. The environment was not created and sometimes discouraged.

Reorganization is thought²⁶ to be governed by three elements:

(1) Achieving a large-scale mobilization. It was unfortunate that in that environment the banking staff had reasons to believe that the old system was better, even more so when they had to cope with new modes of contract with no more remuneration. Their long experience of the conventional method added a new factor, making them more reluctant to accept the Law. If properly used, it would have been at this stage of reframing that people--both the managers at the top and the clerks at the bank counters--overcome the resistance and the denial associated within the change. It was here that they could begin to believe in the promise of a brighter future for the country, whatever that future might have been.

(2) Creating the vision, arming the organization with a sense of purpose that will sustain its newly found motivation overtime. This vision could give a more tangible form to the promise of a brighter future. It could become something people could get a sense of, something they would believe was attainable, and something they could see coming closer as they continued to change overtime.

(3) Establishing a measurement system. It is hard to motivate individuals to change their behaviors for nothing, unless they can see with their own eyes the impact, financially or spiritually, of their own new behaviors. Measures allow our minds to test the hypotheses we formulate about which causes produce which effects, and to verify on a rational level that we are on our way to higher plateaus of performance.

²⁶ Op.cit.p.23

The reorganization, needed to make the Law work, was to break apart the organization's "conventional wisdom" (its existing mode of thinking, mind rest or paradigms), abstracting the useful elements, bringing in new ideas contained in the Law and constructing a new mental frameworks for the entire banking system. Something seldom done in substance, except, sometimes, the cosmetics of the Law. More importantly, the necessary effort have not been put to bringing in the idea of "Profit and Loss Sharing" and its underlying promises for a better future. To see whether the three elements governing the reorganization have been strived to sustain in order to guarantee the success of the Law, we further proceed as follows:

Some important efforts has been put in practice; however, not on a large but a small scale. It was confined to short-period training of a limited number of banking staff. It was not designed to that extent and depth to be able to overcome the resistance of the banking personnel emerging from the conventional wisdom accumulated over time during their long experience in interest-based banking. Furthermore, the vision necessary to produce a sense of purpose that would sustain over time was not created. The personnel were not made capable to appreciate the merits of the Law. A small deviation between the performance and the Law at its early stage of implementation brought about a big hurdle; as they moved onwards, the goals left further away and the problem more severe. How is it now possible, after over 14 years of practice, to correct some vital part of system and put them back on their own tracks? It deals with the mind, with fundamentally changing the source of the digression. It is about convincing hundreds and thousands of people to adopt a new mental framework, with their loyalty tend to rest with the status quo. It is not a simple task. It is about almost loss of faith in the past experience and creating confidence in the outcome of a transformation,

when that outcome is uncertain. Few of us are natural explorers; fewer still are willing to gamble the present against the hope of a better future. Contentment lie within existing prerogatives, ruling passion, enough so to make us fiercely protective to our own existing positions.

To ensure reorganization will become a success, establishment of measurement becomes essential. It is a fact that no sensible measurement in some vital parts was established; probably a few will be established. This might characterize one feature of developing countries, where accountability is hardly witnessed. The authorities seem to be reluctant to offer any to the public. They would finally end up with the public assessment as to what degree they were successful and kept their promises. Do really people count? Even if there were criticism, if any, or even corrective suggestions, but seemingly unpleasant and impartially made by banking staff, the evidence suggests that, some of them would end up with demotion and/or transfer wherever far from the scene.

The transformation needed to make the Law work was the choice made by the parliament in the wake of a long period of study by experts. The monetary authorities were mandated by the Law to commit themselves to achieve a set of goals. They were expected to mobilize all the potential energy existing in the banking system as the means of creating that shared commitment. This responsibility, as it appeared, was not taken seriously on the grounds that the conventional banking has had long years of successful experience. However, it could, at least, be subjected to pilot study to test whether it was apt to failure or not.

The Iranian banks have gradually become rather hypocritical. They articulate an inspiring mission on Islamic values but in some instances act on

capitalist set of standards. They seem to have mild sense of commitment to the goals stated in the Law.²⁷

Admittedly, transformation in the organization and in proper functions to be performed to that end is hard work-- long hours, new responsibilities, new enemies, risk of losing job, etc. Why support, at all, something you have every reason to fear? There are walls of reluctance and denial to break through; old values and long experiences to discard and new ones to assimilate. That is usually painful because the ramparts are thick and they are made of human motions and prejudices. Reframing, one dimension of transformation, is about breaking through those walls and becoming mentally prepared to move beyond them.

On top of all above, reorganization invariably involves someone else telling you that you need to change. That means that what you have been doing is wrong, inadequate in some way. Whose job is to define your failure in the existing environment? Why start with me? However, those who were expected to lead the transformation process largely determined its course.

²⁷ It was once stated that Islamic banking in countries like Iran was a highly sensitive political issue; see the Banker magazine, June 1993; pp.51-52.

SECTION III

PERFORMANCE OF THE IRANIAN BANKING

Announcements were made to the public, after the Law was put in practice, to change their deposit accounts from the old system to the newly established ones. The period covered in this study starts from 1364 (1985-86), one year after the implementation of the Law, due to disharmony that existed in different accounts and different banks in 1363 (1984-85). Statistics show (Table 3-1) that both components of Qardul-Hasan (Current and Saving) accounts have increased in nominal terms over time, from Rls. 1,272 billions to Rls. 8,294 billions and from Rls. 559 billion to Rls. 2,320 billions, respectively, so have in real terms. Current account, in nominal terms, shows a constant increase of 20% for the period 1364-69 (1985-86 to 1987-88) and an unpredictable change onwards. In the real terms, the changes are quite unpredictable for the period under study. However, a big jump from 5% to 29% is witnessed in 1368 (1989-90) when war ended, then a constant decline till 1372 (1993-94), the beginning of deregulation policy where a big jump (from 15% to 38%) is observed.

The two important incidences:

(a) End of the war in 1368 (1989-90) and

(b) deregulation policy announcement in 1372 (1993-94),

showed their impact on Qardul-Hasan saving deposit account. There are big jumps in these two years. However, Qardul-Hasan Saving deposit account, in nominal terms does not follow a regular pattern, just a big jump in 1373(1994-95). Qardul-Hasan deposit (both current and saving accounts)

have been used by banks, for whatever purposes they wished, as if they were they own funds.²⁸

²⁸ It was the intention of both the members of the draft-initiating committee and the legislators on the basis of explanations given to them by the initiating committee members that these funds shall be used through banks for just Qardul-Hasan purposes. However, it has been interpreted as the bank's own property, as if depositors, on the humanitarian grounds have paid Qardul-Hasan to banks (!) which could be used as they wished. These deposits have been used as a source of lending funds on interest. Considerable profits of the banks come from this source which entails no cost.

TABLE 3-1
BANKS' DEPOSIT ACCOUNTS* AT CURRENT AND CONSTANT
PRICES

1364 to 1373: (1985-86 to 1994-95)

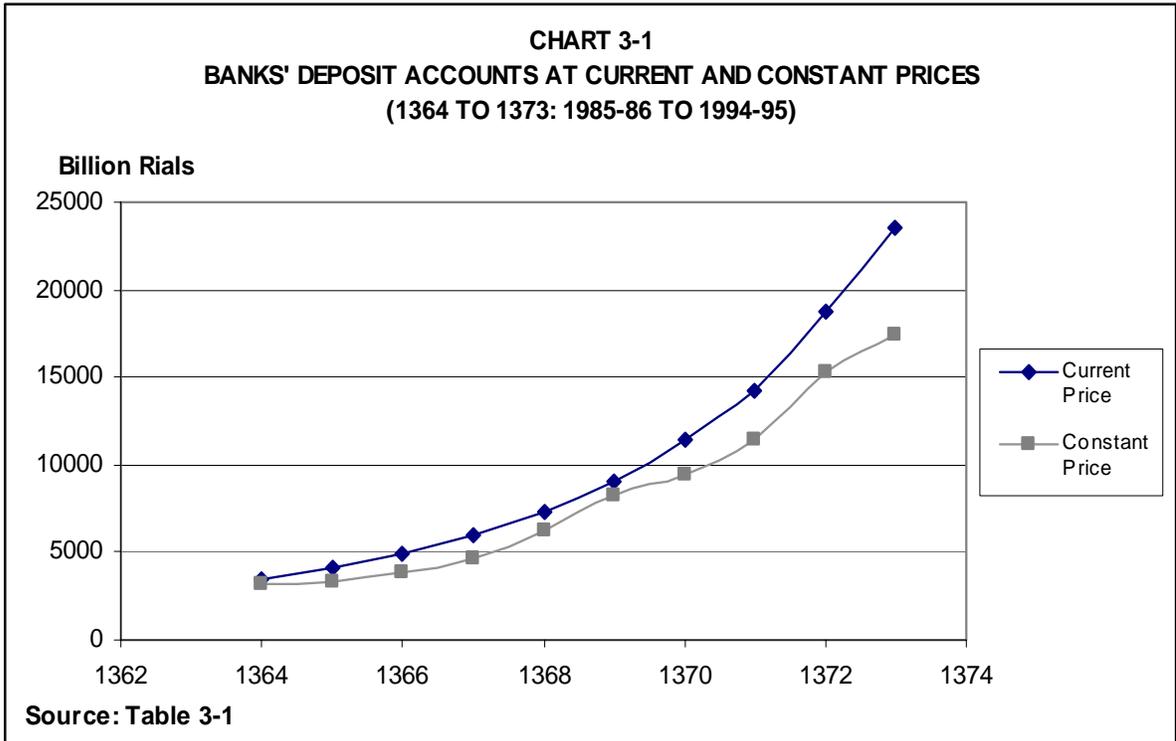
Billion Rials

Year Deposit Account	(1) Qardul-Hassan		(2) Investment		Total (1)+(2) (current price)	Inflation Rate (+)	Total (Constant price)
	Current	Saving	Short- term	Long- term			
1364 (85-86)	1,272	559	896	706	3,433	6.9	3,211
1365 (86-87)	1,548	545	1,226	847	4,166	23.7	3,368
1366 (87-88)	1,907	579	1,492	920	4,898	27.7	3,836
1367 (88-89)	2,025	634	2,079	1,278	6,016	28.9	4,667
1368 (89-90)	2,384	657	2,636	1,694	7,371	17.4	6,276
1369 (90-91)	2,840	693	3,062	2,411	9,006	9.0	8,262
1370 (91-92)	3,674	813	3,666	3,242	11,395	20.7	9,441
1371 (92-93)	4,340	1,154	4,473	4,298	14,265	24.4	11,467
1372 (93-94)	5,894	1,303	5,840	5,674	18,711	22.8	15,236
1373 (94-95)	8,294	2,320	6,549	6,396	23,559	35.2	17,425

Source: Gozearsh-E Owza-E Eghtesadi Wa Ejtemaee-E Ostanha; Central Bank of Iran (Various Issues).

* Composed of: Eight Banks (Melli, Sepah, Tejarat, Refah, Keshavarzi and Maskan).

(+) Edareh Hesab-Haye Eghtesadi; Hesab Melli-e-Iran; Central Bank of the Islamic Republic of Iran.



Investment accounts (both short and long term) do not follow any particular trend, both in nominal and real terms. Long-term account shows a big jump in 1367 (1988-89) and a sudden drastic decline in 1373 (1994-95) while war ended in 1368 (1989-90) and deregulation started in 1372 (1993-94), as mentioned earlier. Two humps occur in both short-and long-term deposit accounts but at different periods; (Table 3-2).

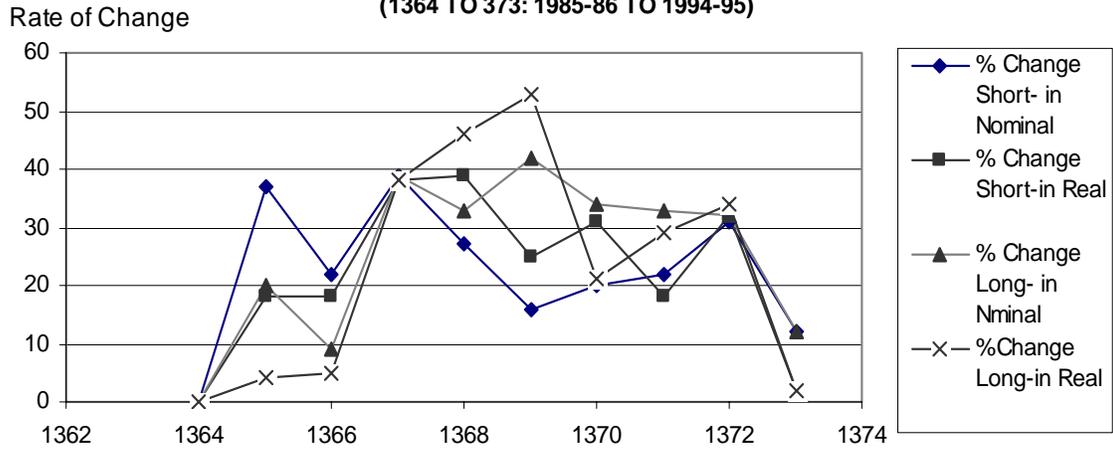
TABLE 3-2
RATE OF CHANGE OF BANKS DEPOSIT ACCOUNTS NOMINAL
AND REAL TERMS

1364 to 1373: (1985-86 to 1994-95)

Deposit account Year	Qarul-Hasan				Investment			
	Current		Saving		Short-term		Long-term	
	% change in nominal terms	% change in real terms						
1364 (85-86)	-	-	-	-	-	-	-	-
1365 (86-87)	20	5	-3	-16	37	18	20	4
1366 (87-88)	20	19	+6	+3	22	18	9	5
1367 (88-89)	20	5	9	8	39	38	39	38
1368 (89-90)	20	29	4	14	27	39	33	46
1369 (90-91)	20	28	5	14	16	25	42	53
1370 (91-92)	30	17	17	6	20	31	34	21
1371 (92-93)	20	15	41	38	22	18	33	29
1372 (93-94)	40	38	13	14	31	32	32	34
1373 (94-95)	40	28	78	61	12	2	12	2

Source: Table (3-1)

CHART 3-2
RATE OF CHANGE OF BANKS' DEPOSIT ACCOUNTS IN NOMINAL AND REAL TERMS
(1364 TO 373: 1985-86 TO 1994-95)



Source: Table(3-2)

TABLE 3-3
DISTRIBUTION OF FINANCES MADE BY SIX BANKS ⁽¹⁾ (1364-1373)
(1985-86/1994-95)

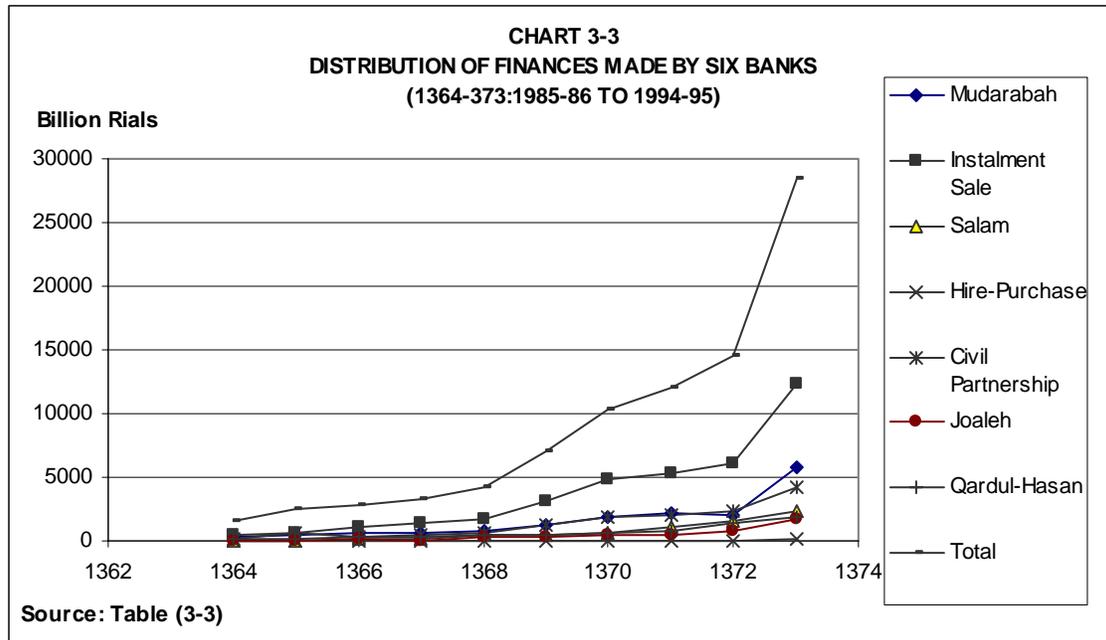
Billion Rials

Contract Mode Year	Qardul-Hasan	Mudarabah	Intallment Sales	Salam	Hire-purchase	Civil Partnership	Joalah	Legal Partnership	Direct Investment	Misc. ⁽²⁾	total
1364 (85-86)	146	389	468	43	6	176	8	-	2	289	1,527 ⁽³⁾
1365 (86-87)	219	527	681	70	5	640	10	-	-	320	2,472
1366 (87-88)	284	701	1,068	119	12	327	106	-	-	202	2,819
1367 (88-89)	300	631	1,408	203	23	524	62	-	-	96	3,247
1368 (89-90)	395	774	1,734	409	12	622	238	-	-	41	4,224
1369 (90-91)	453	1,314	3,145	537	13	1,188	306	-	-	27	6,983
1370 (91-92)	573	1,885	4,772	645	30	1,900	461	-	-	27	10,293
1371 (92-93)	722	2,137	5,374	1,151	48	2,101	466	-	-	50	12,049
1372 (93-94)	1,425	2,032	6,166	1,631	76	2,309	858	-	-	43	14,540
1373 (94-95)	1,901	5,741	12,381	2,341	169	4,146	1,694	-	-	94	28,497
Total	6,418	16,131	37,197	7,149	394	13,963	4,209	-	2	1,189	86,651 ⁽⁴⁾

Source:Gozaresh-e Owza-E Eghtesadi Wa Ejtemaee-Ostanha;Edareh Amar-e Eghtesadi.

- 1 Composed of of:Melli, Sepah, Tejarat, Refah, Keshavarzi,and Maskan
- 2 Includes outstanding debts and debt purchase.
- 3 Figure does not include Bank Tejarat's Transactions for the first six months.
- 4 Row figures may not add-up to total due to rounding.

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Distribution of finances made by six banks during 1364-1373(1985-86 to 1994-95) reveals interesting transactions to have taken place; (Table 3-3). Every tear payments made as Qardu-Hasan²⁹ is a fraction of Qardul-Hasan deposit account of the same year, the balance has been assumed to be banks' own funds (as noted earlier). Qardul-Hasan deposit account has increased 13 and 10 folds from 1364 (1985-86) to 1373 (1994-95) in nominal and real terms, respectively.

Another glance at (Table 3-3) surprisingly shows that legal and direct investment payments accounted for a negligible amount; what the country needed most, especially after the war ended. The explanation will be given in the upcoming section and a proposal is also in order.

²⁹ Qardu-Hasan institution has a long history of more than 30 years in Iran. These institutions are private organizations, established on Islamic ethics and humanitarian grounds to help those in need of consumption loans. These institutions work very efficiently and least paper work possible. In almost every district of the provinces there is at least one Qardul-Hasan fund. Some of them have recently started to charge one per cent for handling services. However, this practice has been subject to criticism by religious scholars on the grounds that service charge should not vary with the amount of loan granted. Quite obviously needs are much better served through these institution than the banking system.

Installment sales are the fore-runner of all other modes of finances both in each and every year and, hence, combined over the entire period. This mode of contract was designed to be used on raw materials and equipments required by businesses and some professionals like dentists, radiologists, etc. However, it has been, and still is easy to get proforma invoices³⁰ from the sellers of these items and get them financed without having the possession of the equipment to be passed on to the user (buyer). It is because the demander is paid by the bank, not the seller. Given the circumstances, during the period of consideration its amount has increased in 1373 (1994-95) twenty six times as that of 1364(1985-86). Whether Rls. 37,197 billions have really been put into the claimed operations, has yet to be answered.

Another abnormally appealing contract is Mudarabah, the entire amount has to be used in trade, according to the Law. This contract is usually signed for one year. The principal amount plus some percentage, the so-called “expected rate of return” has to be repaid at the end of the year; see (Table 3-4). With inflation rate over-running the interest, i.e. the expected rate of return paid on this contract in addition to the turn-over rate, of at least three times in a year, makes this contract extremely attractive; hence big

³⁰ Had there been any control over the number and amount of proforma invoices issued by the seller, there would not have been such a controversy. These equipments are often imported from western countries from which detailed specifications are collected in the central bank which could easily be used as a powerful control device. Cases may easily be found that the number of equipment of a certain type being quoted in proforma invoices by a specific seller and accordingly financed by banks would out-number the total number of the same item imported into the country.

Another important aspect of installment sales which adds even more to its complexity, as stated earlier is that blank and unofficial invoices can easily be obtained in any number desired. Regulations require that invoices have to have detailed information as to the name and address, telephone, fax number, all detailed specifications of the equipment, the name and signature of the dealer, date, serial number, etc, and more importantly they have to be declared legal documents and being able to be used in law courts.

excess demand for it. During the period 1364-73(1985-86 to 1994-95) its disbursement has been multiplied by fifteen-folds.³¹

Civil partnership is the mode of finance often used for housing construction whose amount in 1373 (1994-95) has increased 23 times as that of 1364(1985-86).

This is a contract composed of two contracts:

- (a) Civil partnership, to build a house,
- (b) Installment sale, to sell the bank's share to the fiancée.

A fixed so-called "profit rate" is applied to the principal amount paid at the time the contract is signed.

Distribution of average deposit account of eight banks is exhibited in (Table 3-5). Quite expectedly, Tehran (the Capital City; No.22) has had the highest average deposit for the six years under study in both Qardul-Hasan and Investment Deposit Accounts. The least deposits are those of Kohkiluye-Boyer Ahmad (No.15). These figures do not necessarily mean that it is the most deprived and poorest region of the country; population³² also count and can have an appreciable impact on the classification of provinces. Furthermore, per capita deposit gives a better idea of the economic condition of a province.

³¹ Its monitoring cost being prohibitive; there have been many objections to the misuses of funds in this contract. There has to be a formula, somehow, as to the total amount of funds available and a reasonable percentage allocated to this contract.

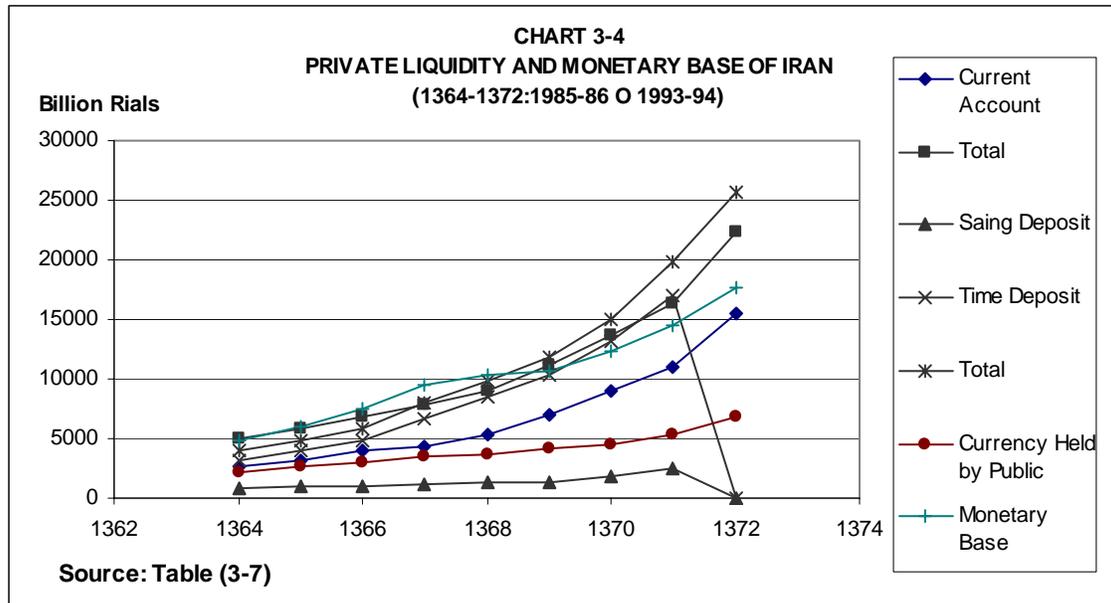
³² Coherent time series compatible with other data used in the text were not available to the author.

TABLE 3-4
 GUARANTEED RATES OF PROFIT IN DEPOSIT ACCOUNT AND
 EXPECTED RATES OF RETURN ON MAJOR ACTIVITIES

1370-74: (1991-92 to 1995-96)

(Percent)

Subject Year	Guaranteed rate of profit on 1-year deposit account	Inflation Rate	Real Rate of Interest*	Expected Rate of Return on				
				Industry and Mine	Housing and Construction	Agriculture	Trade and services	Export
1370 (1991-92)	9	20.7	-11.7	11 to13	12 to 16	6 to 9	18 and higher	18 and higher
1371 (1992-93)	10	24.4	-14.4	13	12 to 16	9	18 and higher	18 and higher
1372 (1993-94)	11.5	22.8	-11.3	16 to18	12 to 16	12 to 16	18 to 24	18
1373 (1994-95)	11.5	35.2	-23.7	16 to18	15	12 to 16	18 to24	18
1374 (1995-96)	14	49.4	-35.4	17 to19	15 to 16	13 to 16	22 to25	18



Source: Central Bank of the Islamic Republic of Iran. *These figures are simply the difference between the preceding two columns. It remains to calculate the profits' share of the banking system for the period covered.

To get a better idea, figures have to be in real terms. Each province is provided with its own rate of inflation⁽⁶⁾ for the simple fact that items to be used to calculate the inflation rate will differ from one province to the next, depending upon several variables such as income, wealth, distribution of income and wealth, habit, population, etc.

In order to be able to gauge the absorption capability of each province, (Table 3-6) has been prepared for all provinces and for the period 1368 to 1373 (1985-86 to 1994-95). This table has more interesting feature than the preceding one. Two columns has been provided for each year, left column shows the amount of finance made in that year and the next column is the deposit account balance for the same year. The ratio of the left column to its corresponding right column is a rough measure of absorption capacity of a particular province. The bigger the ratio, the more the capacity of a

province to absorb its own financial resources. For all the years covered, Hormozgan,(No.24), has had the lowest ratio in all years in a row. Implication of that is Hormozgan has not even been able to absorb its internal resources during these years. It being a borderline southern province of Iran where illegal activities, like smuggling commodities from gulf states, are common has not given care to healthy transactions. The balance (finance minus deposit accounts) must have gone to other provinces where most needed and probably where legal and healthy opportunities are more appreciated.

TABLE 3-5
DISTRIBUTION OF A AVERAGE DEPOSIT ACCOUNTS OF
EIGHT BANKS * IN PROVINCES OF IRAN
(1368-73:1986-09 TO 1994-95)
(Billion Rials)

	Deposit account Province	Qardul-Hasan		Investment		Total
		Current	Saving	Short-Term	Long-Term	
1	Azarbaijan Gharbi	131	57	150	42	380
2	Azarbaijan Sharghi	246	89	276	116	727
3	Bushehr	75	28	100	46	249
4	Chahar-Mahal Bakht.	35	15	72	46	168
5	Eelam	24	10	38	6	78
6	Esfahan	461	122	557	375	1,515
7	Fars	369	138	688	492	1,686
8	Guilan	119	70	190	80	459
9	Hamedan	80	30	125	46	281
10	Hormozgan	160	87	132	58	437
11	Kerman	210	57	213	94	574
12	Kermanshah	105	36	124	48	313
13	Khoozestan	314	119	480	183	1,096
14	Khorasan	472	168	488	233	1,361
15	Kohkiluyr-Boyr-Ahm.	20	8	18	4	50
16	Kordestan	57	32	44	15	148
17	Lorestan	63	24	93	35	215
18	Markazi	71	43	98	38	250
19	Mazandaran	256	149	338	117	860
20	Semnan	47	22	69	28	166
21	Sistan-Baluchestan	107	57	97	38	299
22	Tehran	4,046	610	3,449	3,655	11,760
23	Yazd	130	22	137	118	407
24	Zanjan	80	46	103	36	265

Source: Gozaresh-e Owza-e Eghtesadi Wa Ejtemaee-e Ostanha; Central Bank of Iran (various Issues).

* Composed of : Mellat, Melli, Saderat, tejarat, Keshavarzi and Maskan.

TABLE 3-6
DEPOSIT ACCOUNT BALANCES AND FINANCES MADE BY
EIGHT * BANKS IN PROVINCES OF IRAN
1368-1373 :(1989-70 TO 1994-95)
(Billion Rials)

Finances Made & Deposit Account Province		1368		1369		1370		1371		1372		1373	
		Fin.	Dep.	Fin.	Dep.	Fin.	Dep.	Fin.	Dep.	Fin.	Dep.	Fin.	Dep.
1	Azarbaijan Gharbi	202	187	297	241	340	312	400	393	560	510	801	640
2	Azarbaijan Sharghi	374	441	507	543	710	674	762	834	937	822	1,678	1,047
3	Bushehr	70	144	100	161	125	190	172	238	217	334	264	429
4	Chahar-Mahal Bakht.	67	105	96	105	127	125	200	160	202	222	242	291
5	Eelam	34	36	53	43	62	67	99	83	142	102	168	134
6	Esfahan	625	822	1,066	969	1,556	1,300	1,868	1,528	2,164	1,971	2,617	2,501
7	Fars	375	994	490	1,166	535	1,351	656	1,704	831	2,185	1,186	2,722
8	Guilan	192	221	277	296	397	376	410	472	559	608	714	780
9	Hamedan	128	148	163	181	215	224	250	286	297	382	492	468
10	Hormozgan	67	243	100	304	120	349	127	430	176	570	206	730
11	Kerman	205	263	311	342	361	447	436	556	647	787	772	1,048
12	Kermanshah	127	153	172	184	225	220	291	314	328	448	485	558
13	Khoozestan	317	581	363	676	472	832	537	1,082	754	1,533	955	1,874
14	Khorasan	694	694	969	851	1,320	1,100	1,531	1,356	1,831	1,848	2,721	2,319
15	Kohkiluyr-Boyr- Ahm.	28	26	46	32	46	35	75	47	84	70	118	92
16	Kordestan	63	67	92	85	105	113	133	146	191	208	301	270
17	Lorestan	124	120	159	143	179	166	235	211	275	280	338	367
18	Markazi	147	123	177	158	229	199	268	253	348	351	460	416
19	Mazandaran	511	469	712	561	785	690	895	854	1,017	1,106	1,293	1,480
20	Semnan	98	89	135	110	172	140	171	174	234	213	301	267
21	Sistan- Baluchestan	77	159	94	185	124	219	144	276	190	408	213	544
22	Tehran	2,338	6,440	4,558	7,781	7,507	9,793	9,576	11,951	10,881	15,558	20,616	19,035
23	Yazd	205	229	336	277	388	337	462	406	552	543	845	653
24	Zanjan	141	152	204	198	275	272	317	337	255	283	312	349

Source: Gozaresh-e Owza-e Eghtesadi Wa Ejtemaee-e Ostanha; Central Bank of Iran (various issues).

* Composed of :Mellat, Melli, Saderat, Sepah, Tejarat, Refah, Keshavarzi and Maskan.

Kohkiluyeh-Boyer-Ahmad, (No.15), on the contrary has had an excellent record in terms of being able to absorb its own funds available. In four out of five years it had a ratio larger than unity, with the exception of 1368 (1989-90). Opportunities have to be created and those already in existence to be promoted. Opportunities have been appreciably utilized in this province. All credit goes to its inhabitants and some to governmental representatives to have been able to keep this province at such a high standard and level of competence. Other measures used in other studies, but irrelevant to our discussion, support this idea.

Tehran, (No.22), is excessively populous and is the final destination of most migrants from all over the country. Disguised unemployment is soon noticeable in almost all streets where there is hardly a check and balance. Tehran being an administrative and service city with least commodity-production activities, is incapable of absorbing such huge amount of finances, especially so when it is realized that no firm is allowed to be operated within a radius of 25 kilometers. Iran does not have a comprehensive development planning scheme, but rather partial planning. However, due to the fact that major activities are performed and crucial decisions are made in Tehran it makes it reasonable for all factories located beyond a radius of 25 kilometers to have their headquarters in Tehran for a better access to authorities.

Had the Law been properly practiced, the profit ratio between banks and entrepreneurs could have been properly manipulated to correct the biases in favor of under-developed areas. The so-called “guaranteed profit rate” and “expected rate of return” are flat rates and evenly applicable to all regions of the country irrespective of great imbalances that exist among

them.³³ If the existing circumstances are going to continue, the situation becomes even worse and more complicated. The deprived regions will be discriminated against while the developed regions will be overly protected. The dual economic system which has long been persisted between developed and underdeveloped regions is the main reason for migration from rural toward urban areas, (especially to Tehran). The longer the situation lasts the more difficult the problem of migration becomes. Unemployment is not the only outcome of heavy migration but social imbalances such as crime, law violation, misconducts, etc.

To change the profit ratio according to some pre-determined criteria is not against the Law. As stated earlier, the profit ratio in Musharakah (or for that matter, in Mudarabah) counteract (s) does not have to be the same for all provinces. The criteria³⁴ can be decided upon by an independent (from the banking system) authority, like plan and Budget organization. Annual country budgets have for long provided too much money to bring balance among provinces. They have not been enough; the private sector can also be persuaded, mostly through financial advantages, to work as complement to the public sector.

To get an idea about the liquidity and momentary bases in Iran (Table 3-7) has been prepared. This table is a complement to the foregoing tables; however, its analysis is beyond the limited scope of the present paper.

³³ Iran enjoying wide range humidity and temperature with different degrees of development for her provinces, surprisingly a flat rate for each variable like interest and tax is used. They could easily be manipulated in order to practically lessen the adverse effects of such variables with the aim of a relatively balanced growth. Recently a mild move in taxation has been witnessed which has had little, if any, impact on correcting the disparities.

³⁴ The author has suggested the deprivation index to be used for specific purposes. To promote activities in deprived regions it was suggested that profit tax exemption to be given on the basis of this index. The idea provides a flexible and self-correcting measure, i.e.; as regions gradually develop so should the advantages but in reverse order.

TABLE 3-7
PRIVATE LIQUIDITY AND MONETARY BASE OF IRAN
1364-1372: (1985-86 to 1993-94)

(Billion Rials)

Subject Year	(1) Money Supply			(2) Near Money			Liquidity	Monetary Base		
	Currency Held by Public	Current Account	Total	Saving Deposit	Time Deposit	Total	(1)+(2)	Bank Notes	Bank Reserves	Total
1364 (85-86)	2,176.3	2,747.3	4,923.6	903.5	3,175.0	4,078.5	9,002.1	2,294.5	2,614.7	4,909.2
1365 (86-87)	2,642.5	3,168.6	5,811.1	940.6	3,971.0	4,911.6	10,722.7	2,759.7	3,302.3	6,062.1
1366 (87-88)	2,982.5	3,974.2	6,776.7	1,045.5	4,845.9	5,891.4	12,668.1	3,084.7	4,457.3	7,572.0
1367 (88-89)	3,445.6	4,312.5	7,758.1	1,193.9	6,735.6	7,929.5	15,687.6	3,679.8	5,839.7	9,519.5
1368 (89-90)	3,644.8	5,342.4	8,987.2	1,280.6	8,485.5	9,766.1	18,753.3	3,922.9	6,387.7	10,310.6
1369 (90-91)	4,119.3	7,075.9	11,195.2	1,392.3	10,382.0	11,774.3	22,969.5	4,464.5	6,247.2	10,711.7
1370 (91-92)	4,579.9	9,060.9	13,640.8	1,868.6	13,119.0	14,987.6	28,628.4	4,963.9	7,345.0	12,317.9
1371 (92-93)	5,359.3	11,009.3	16,368.6	2,441.0	17,056.4	19,797.4	35,866.0	5,840.0	8,626.7	14,466.7
1372 (93-94)	6,832.0	15,580.7	2,2412.7	-	-	25,722.4	48,135.1	7,459.4	10,227.6	17,687.0

Source: Plan and Budget Organization of Iran: Majmoueh Ettelati; Bureau of Macroeconomics; Tehran, Iran 1373 (1994-95), pp. 32-33.

SECTION IV
EVALUATING THE PERFORMANCE AND PROPOSALS FOR A
BETTER PROSPECT

INTRODUCTION

Given that economy is rather highly sensitive to changes in the variables of financial sector, strict compliance of the Law becomes a delicate task. The sensitivity requires several precautionary measures to be taken and quite a few pre-requisites fulfilled. There are procedures and steps which could make this highly-sensitive task easier and free from sudden undesirable fluctuations. Whether these unfulfilled precautionary measures were those, which in some cases, prevented the monetary authorities from implementing the Law remains to be answered. The real question is: during the past 14 years, when and how the authorities began to seriously study the issues involved? What steps and recommendations have been taken thereof?

In their evaluation of Musharakah contract, entrepreneurs have faced with not only Riba but also lot of paper work. They have rather had the old system (based on debt-financing) but with less paper work. There arises a confusion on their part to the effect that if this is “the” Islamic banking what is then anti-Islamic? If interest-based contract (collateral loan) is substituted with equity-based contract while interest still remains intact does it launder the stigma attached to Riba?

The general Muslims have almost lost faith in Musharabah and Mudarabah contracts as well as installments sales practiced in the so-called Islamic Banking. They have gradually become insensitive to Riba. This is believed to be a serious drawback; the cultural harm of this verdict can not be exaggerated. The popular verdict is that the essence of the Law with

respect to these contracts was never put into practice except its cosmetics, not the essence.

To evaluate the success of the Iranian banking system, one may use a number of criteria such as increase in the bank deposits, assets, capital, total amount and number of projects they have financed (all, of course, in real terms), the profitability,.....; just as it is done in a conventional banking system. This can easily be done. Construction of new headquarter buildings, extravagances in furniture and equipment, expansion of branches, increase in number of branches, relatively high salaries and fringe benefits paid to senior and ordinary banking staff are but a few evidences to show that the assets and the profitability of the banking system, in general, has improved over the past 14 years. But this does not necessarily prove that the Islamization of the financial system has been a success. Islamization is not identical with the rate of growth of these variables. The growth rate of these variables may come from other variables such as economic growth, increase in population, urbanization, migration from rural to urban areas, reconstruction of the war damages, and the like. Justice (Qist) being the ultimate goal of an Islamic state (as pronounced several times by Imam Khomeini and the present leader) may have to be used to gauge the performance of the Iranian banking system. One of the quantitative measures of justice is believed to be the equitable distribution of income reflected, to some degree, in the distribution of deposits³⁵. Casual observations show that in some instances a relatively high percentage of deposits (as high as 70%) is owned by a minority (at most 15%) of the depositors.

³⁵ However, it is not fair to put all the blame to the banking system. A series of variables, sometimes inter-dependent, produce the distribution of income.

Islamic banking system categorically operating on the basis of projects and its viability and not on the value of collateral is mostly believed to finance the middle and small-size enterprises. On the contrary, the conventional banking system normally operating on the basis of collateral-loan extend huge amount of loans to already rich and influential individuals and enterprises; hence target of serious criticisms. The scandal over the misuse of Rls.1,230 billions (more thanUS\$400 million) in one of Iranian banks which was recently disclosed is an example of such misconducts.

The following evaluation is based on the Law with some modifications made on it in order to give the necessary leeway for ease of compliance and an evaluation.

4-1 Attitude Toward Islamization

It is important to, once again, keep in mind that the Law was passed in September 1983 and was to be put into practice as of March 21, 1984, in the midst of the war with Iraq. Was it then the right time to implement the Law? One may argue that the experience, especially after the revolution and during the war, showed strong evidence that the Iranian people had been united and one voice could be heard only from Imam Khomeini.³⁶ Consequently, it was commonly believed to be the right time. It was sort of a Jihad behind the war front.

Contrary to above view could be that why put the economy, already in a serve problem of war, into a “worse” position by introducing a new law with almost no experience in the past? This view seems quite contrary to Imam Khomeini’s will.

³⁶ He was quoted as saying that he would like law to be passed (implicit in it was, being implemented) during his lifetime.

Above statements are two extreme ideas. The attitudes of the Iranian monetary authority could take a whole range of spectrums, from passive neutrality, if not hostility, to active support. Irrespective of the position taken by a monetary authority³⁷, the longer the years he remains in his office the greater the impact, one way or another, he would have on the operation of banking system. Close and relatively deep observations on the practice of the Law has, to a great extent, revealed that none of the monetary authorities have taken, since the enactment of the Law, initiative to bring about the kind of legal and institutional changes³⁸ needed to solve the newly created problems or to pursue a comprehensive program to properly train³⁹ the banking system's employees, bank customers (both the depositors and the fiancées), and the general public (who have shown its loyalty to the country in difficult situations) about the mechanics and implications of the new system. Some other aspects of transformation were, to some degree, analyzed in Section 2 above.

4-2 State or Private Banks

There are quite a few scholars who put the blame on the Iranian banking system for its failure to comply completely with the Law on the grounds that states are not good entrepreneurs. They further argue that, being profit seekers, private enterprises take market signals and respond to them as quickly as possible. Opponents argue that not all human beings' need is able

³⁷ In response to a question posed to one of them, an influential one, his position with respect to the new Law, he has been quoted to assert that conventional banking has long period of successful experience. Implicit in this assertion is that Islamic banking was unknown to him, hence a risk.

³⁸ With only one exception, the issue was discussed earlier.

³⁹ They are either doubtful about the outcome or not well-informed on the three controversial modes of contract. In both cases they are not expected to take any serious action towards their implementation.

to be reflected in demand to produce a signal for the private sector for the simple reason that willingness exists but not ability to buy.

The argument has been going on ever since the government duties have been at stake. To avoid any unnecessary controversy, it is widely believed that whatever is good for capitalistic societies may not necessarily be good for Muslim countries. Muslim countries have their own problems and have to find their indigenous way of life.

Islam considers all Mo'mens,religious people, as one family whose members are brothers of each other. Cooperation, shared-goal followed by all these brothers (i.e.Qest), profit and loss sharing, and the very nature of Riba-abolishment which is social obligation are derivatives of brotherhood. The brotherhood feelings bring about externality to the extent that a pure Islamic state can be viewed as "state of externalities". Externality is one reason which makes market operations subject to failure. A private Islamic bank motivated primarily by market forces is hardly believed to be able to be able to properly operate in this "state of externalities" whose goal is to maintain a balance between equity and efficiency.

The distinction between state and private sectors is sometimes based on the comparative efficiency of the two with the neglect of equity. It is the responsibility of an Islamic state to maintain a decent life for its employees. Muslim civil servants, in most cases, have been in a disadvantaged position compared to their counterparts in the private sector. Majority of them nowadays are under poverty line. Low income, compared to living expenses, creates economic insecurity; it is also a cause of inefficiency.

The insecurity resulting from low income pressure does not seem to be compatible with Shari'ah rules aimed at maintaining justices (Qist). Government employees in Iran like many other Muslim countries are over-

staffed by under-qualified Muslims. The quality should increase (compensating them with higher income) and quantity decrease. The released manpower has to be retrained to make them suitable for the private sector. There are still many avenues where new technologies and methods can be introduced in government sector to upgrade the qualifications of the public sector even higher. It seems fair to believe that corruption will gradually disappear; it is not inherent in public sector. Counter-examples can be found in advanced countries.

Two examples will be cited below to see how some of the state-owned institutions have remarkably performed their functions in my country. State hospitals work side by side with private hospitals. The public hospitals have had an average performance much higher than their counterparts in the private sector. They are affiliated with schools of medicine; as a result they provide better specialized services because their medical doctors are teaching at public schools of medicine. They provide better services but admittedly with comparatively old equipments. The beneficiaries of these hospitals are middle class and poor people who need more help than others. Another example is about higher education. There are quite a few state universities which compete with a single private university with many branches across the country.⁴⁰ The quality of subjects and equipments used in state universities are incomparable with the other private university. Rarely prominent state university professors are willing to teach at the private university. (Many examples also are found in Western countries to support the idea).

⁴⁰ Recently small number of higher-education institutions has emerged, but the student body is negligible with respect to the total.

The domain of activities of these two examples is so wide that more families are affected than does the banking system, but wealthy people use more of banking services than middle class. Admittedly, education, health and capital (money) are all important factors in economic development. But when it comes to choose, which one comes first?⁴¹

One important point which has to be kept in mind is that Iran's banking system was nationalized as a response to its corruption and fund abuses in last regime; during its period few banks were state-owned. Articles 1 of the law for Nationalizing Banks (on June, 7, 1979) set forth the following reason for them to be declared nationalized:⁴²

In order to protect national rights and capital, set the wheels of production in the country into motion, and safeguard the deposits and savings of people in the banks, while accepting the principle of right and conditional ownership, and in consideration of:

- a) The mode of acquisition of income of the banks, and the illegal transfer of capital abroad,*
- b) The basic role of banks in the economy of the country, and the natural connection of the economy of the country with the banking institutions.*
- c) The bank debts to the governments, and their need for government managements,*
- d) The need for coordination of the operations of banks with other national organizations,*
- e) The need to direct banks' activities toward Islamic management and profitability,*

⁴¹ El-Ghazali has given the answer, see his illuminating attempt: *Man is the Basis of the Islamic Strategy for Economic Development* (1994).

⁴² See H. Shirazi (1988); pp.283-284

From the date of approval of this law, all banks are declared nationalized.

It seems that the Islamic Revolutionary Council, by enacting this law, took a precautionary action to avoid the bitter consequences of private banking in Iran, experienced once in pre-revolutionary era.

Extravagances in government expenditures financed by borrowing funds from external source under the headings of “ usance” and “ buy-back” combined with the banking system’s resources to finance state objects, with little supervision and study as to their effectiveness heated the inflationary flames of the economy (to over 50 percent two years ago). There were a few number of people and their families who made a fortune out of the created situation. The pre-revolutionary experience on private banking has led some people to believe that these might be among the ones (behind the scene) to raise their voice on the issue of privatization of banking system. The parliament was, and still is, to a greater extent, cautious about the slogan: “Government is not a good entrepreneur”.

Furthermore, there have been criticisms about financing the state-owned, often bankrupt and corrupt, companies through banking system. This was said to be a method to hide the budget deficit. It is further argued that if banks were privately owned it would become difficult to use them to such ends. Moreover, state banking system has made it easy, in several cases, to appointments to be made on the basis of nepotism and favoritism rather than merit. It paved the way for loans (rather than financing projects) to have been given, sometimes without sufficient collateral, on the basis of political alliances of the customer than the merit of the project, what the private banks would hardly go by such practices. All above points, among other

things, seem to make the egalitarian goals of Islam bound to be somehow frustrated in such an environment.

4-3 Expectations

The desired changes for Islamization were believed to start from academic circles. Universities are engines of thoughts; any deficiency in these aspects would definitely affect other fronts.⁴³ University professors were, and still are, expected to fight in the front lines; i.e. seminars and journals. They are the ones who either initiate and/or promote ideas or take positions otherwise.

The papers written and lectures given in seminars are believed to be the feeding instruments of textbooks. Until a relatively consensus has not been reached on specific subject by scholars they are not supposed to appear in textbooks, otherwise they will bring confusion whose harm is more than benefits. Islamic economics, in general, and Islamic Money and Banking, in particular, have not yet been taken as serious issues, in academic circles in Iran. Government can have an important role to play in this regard both in providing financial and moral support. It is truly believed that Iran is far from being considered as an Islamic economic research-oriented Muslim country.

In Iran, the executive branch (among the three branches) is the dominant branch⁴⁴ which could effectively be a source of initiation, inspiration and appreciation. Individual activities on the part of a few university scholars based on personal interest and sense of social

⁴³ Imam Khomeini emphatically stated this point and made it clear to the general public that universities can be held responsible for several reasons.

⁴⁴ However, Imam Khomeini was quoted to have emphasized, several times, that the legislative branch had stood in rank at the top of the other two branches.

responsibility cannot have much of an impact on the course of the events of the subject matter. Lack of appreciation, insufficient financial support, lack of interest, gloomy labor market for the university graduates majoring in Islamic Economics, among other things, have put Iranian Muslim economists (those who are relatively active in research and teaching Islamic economics) in an inferior position. Isolation from other Muslim countries and lack of communication between Iranian Muslim economists (defined above) and the Muslim economists of the rest of the world has added new dimension to the problem. Persian language with its limited audience is another factor complicating the problem.

All courses taught at Iranian economic classes are those of capitalistic system.⁴⁵ Standard capitalistic textbooks (original or their translation with some modifications) are directly used and cited. However, there is one elective course at undergraduate level for Islamic Banking, often with low, and sometimes no, demand and supply for it. One course entitled: “Special Topics in Islamic Economics” is offered as a mandated course at graduate level. Iranian Muslim scholars have quite a flexible choice on the papers they select in this course for their students.

⁴⁵ Present author is on the belief that until a comprehensive and solid textbook in different areas of Islamic economics has not been available; the existing courses have to continue. The state of the art, at present, is such that if one of the existing courses is replaced with its equivalent in Islamic terms, students are apt to pay a high price because they are sometimes offered rather conflicting ideas. Muslim scholars are still far from having consensus on particular subject, with the exception on some parts of Islamic banking and Zakah. Islamic economics is still in its embryonic stage of development, as expected. Islamic micro-foundations of macroeconomic are not as yet quite clear. Years have to come to reach an acceptable level of understanding and consensus. It invites intensive, as well as extensive, efforts made by both Muslim scholars and their respective authorities to reach at a desirable level of understanding. However, there seems to be a harsh solution. It takes a serious and dedicated Muslim economist to choose and properly integrate all the relevant ideas, in specific subjects, coherent and without being in serious conflict with each other. However, he might not be in full agreement with a few or some of them.

The present author was, for several years, a member of Economics’ Curriculum and Planning Committee in the Ministry of Culture and Higher Education. His ideas were, sometimes, influential especially in Islamic economic courses suggested to have been offered.

Research and teaching Islamic economics requires both Fiqh and economics to be put together in a meaningful fashion. Most Iranian religious scholars are not familiar with economics and majority of economists have not had chance to study Fiqh. Imam Sadeq (A.S.) University in Tehran and Mofeed University of Qum have found a rather reasonable solution to this problem. Attention is first given to Imam Sadeq (A.S.) University. Starting its academic activities after the revolution, in their curriculum they have offered both conventional economics and Fiqh, with much emphasis on Arabic language, in the pursuance for M.A. degree in economics. The economic research division managed mostly by the graduates of economics department, an auxiliary to the department of economics, puts its emphasis on Islamic topics.

They have been, to some extent, successful in digging Fiqh subjects and bringing them up to the surface. They are mostly written in Persian. The economic instructors are both religious scholars as well as secular economists.

At Mofeed University (Qum) the students, very much like Imam Sadeq (A.S.) students, have to study both conventional economics and Fiqh. Most students, being would-be religious scholars, put heavy emphasis on Fiqh and they can do their thesis (M.A. degree) on the topic of their interest. It is noteworthy that some students have already obtained their undergraduate degrees in areas alien to their career such as mathematics, physics, and engineering but later became interested in Islamic theology.

These two universities are largely financed through Awqaf proceedings and are not by any means considered state universities. Imam Sadeq (A.S.) University has recently started its Ph.D. program in economics. If properly educated, whose most students are Fiqh graduates could

eventually narrow the existing gap between theology and economics. The more emphasis is put on their curriculum and the quality of courses offered, the greater would be the chance for the future generations of Iranian economists to close the gap between economics and Fiqh. Furthermore, the more the idea of integration of Fiqh and economics is spread over to economics departments the greater the hope will be to the momentum required for a silent evolution in Islamic economics as a subject of its own.

4-4 Proposals

It seems that many people have a tendency to maintain the status quo, they resist changing their long-lasting way of life, and also they are reluctant to accept new ideas. Fear and apprehension both act as darkness but knowledge acts as light shed on the dark spots. Understandably, apprehension existed on the part of Iranian monetary authorities for whatever reasons at the time the Law was supposed to be put in practice. But the pressure could be, to a great extent, lifted if certain precautionary measures had been taken. Law has to be acted upon, any resistance or violation from it, is subject to question. The Usury-Free Banking Operations Law having had the peculiarity of being both complicated and specialized seemed uneasy for the general public to detect the resistance or violation, especially when the cosmetics, in some cases, are right.⁴⁶

There are several recommendations that could be put forward in order to pave the way for a nearly complete correspondence between the Law and practice.⁴⁷ These proposals are all to be considered complements which will

⁴⁶ Almost all contractual forms of the modes of finance are in conformity with the specifications spelled out in Fiqh as well as the Iranian Civil Law.

⁴⁷ Some religious scholars, across the country, have shown their real concern about the digression of Iranian banking system, especially the present leader who has been quoted of being keen about the subject matter

have some interactions among them in order to better facilitate the realization of the said correspondence. The set of proposals suggested here is themselves an integral part of a whole package. This package itself is complement to the existing transactions.

4-4-1 A Window for Musharakah⁴⁸ Account

There are still many Iranian Muslims who are reluctant to sign Musharakah contract with Iranian banking system. Those who are practically involved, they are either given green light and clearance from any appreciable wrong doing or because they feel they were in Idtirar (emergency condition) and are not heartedly happy.

The suggestion here can take one of the following forms: a city (with relatively more religious inclinations than others), a specific bank, a branch of each bank in every city, or at least one window in each bank and in every branch be chosen for the true Islamic banking operations, let us call it Musharakah Account. Rules and regulations for this transaction have to be carefully written and properly announced for those interested. A prerequisite to guarantee the success, among other things, is to have the pertinent employees properly trained⁴⁹ and the best ones selected with considerable fringe benefits with incentive schemes that follow.⁵⁰

Another important issue about these so-called “windows” is that those enterprises enjoying equity participation contracts have to be somehow

and has, accordingly, ordered two independent committees to look carefully into the problem and report to him. In certain circumstances, they have proved being valuable political assets of the country.

⁴⁸ The term selected does not intend to mean that the only contract used in the window would be Musharakah, it is just a terminology which conveys the idea and the true nature of transactions to be used. Close to this terminology was used and prescribed in a pioneering effort by M.N. Siddiqi(1973).

⁴⁹ Instructors are very important at this stage because experience shows that many of them lack the required qualification.

⁵⁰ Otherwise, banks would not be able to find the required number of candidates.

compensated for any discrimination that may arise because of these contracts. Under a dual system (Islamic banks alongside the conventional banks) profit is taxed while interest is exempted from tax on the ground that it constitutes a cost item. To maintain proper incentive to the Islamic finance seekers, appropriate tax provision has to be established to let them, at least, enjoy their opportunity cost of⁵¹ capital.

4-4-2 Preferred and Common Deposit Accounts⁵²

The so-called “window” for Musharakah account is hereby suggested to accept two types of deposits:

- a) Preferred Deposit Account which will actually be put, via banks, into all Islamic (interest-less) transactions (like Musharakah, Mudarabah and installment sales) and earn part of the ex-post pooled profits accumulated from such transactions which may vary from one year to the next;
- b) Common Deposit Account⁵³. This type of deposit is similar to the preferred deposit, in that they are both profit-based, with the

⁵¹ In this suggestion the author has assumed the on-going practice in Iran not being very different from an interest-based system, the so-called “guaranteed rate of return” (i.e. the interest rate) is the opportunity cost of capital. However, in purely, full-fledged, Islamic system he has a different idea, see his paper “A Brief Comparison between Cost of Capital in Interest-Based and Interest-Free Systems” (1988).

⁵² These terms have been borrowed from finance literature applied to stocks (shares).

⁵³ The borrowed terms have reversed connotations from those in finance. This choice has been made for four reasons:

- i) to be distinguished from ordinary deposits which is being practiced
- ii) to convey the idea that new deposit accounts being accepted would better serve the economy than the ordinary one
- iii) to spread the idea that new deposits are based on profit and loss sharing approved by Shari’ ah, and
- iv) the preferred deposits will provide higher real rate of return over the other two especially in an inflationary environment that nominal profits, to a great extent, go up with the rate of inflation.

All these merits have to be properly announced to the public.

only exception that rate of return applied here is fixed⁵⁴ (in this sense it is identical to preferred stocks).

Preferred Deposit Account is more compatible with Shari'ah than the Common Account; hence appropriate selection.

If the profit rate of the Preferred Deposit has proved to be higher than that of Common Deposit, the public might be attracted to the former. One advantage attached to this scheme is that it splits the depositors into two groups: risk averters who will stick to Common Deposit and those who are not against risk which will normally choose Preferred Deposits.

It can be expected that the ordinary depositors (in the existing situation) to convert their deposits, in the long run, to one of these two newly suggested deposits⁵⁵ on the ground that standard theory of investment (under imperfectly-competitive assumption) says that the rate of profit would be higher than the rate of interest, the latter being next best alternative to investment.⁵⁶

Apart from their reluctance to expose their financial books to the public,⁵⁷ entrepreneurs will also find it preferable to choose Musharakah contract over a fixed rate of return to be paid on borrowed fund, under the present system, for two reasons:

(a) The bank's share of profit (in fact the depositors' share) in this contract is not to be treated, in standard accounting method, as cost. This

⁵⁴ One may argue about its compatibility with Shari'ah. However, both kinds of deposits, suggested here, are based on realized profit, and profit by definition is exclusive of all costs. Furthermore, the proposals made in this section are interim recommendations, they may easily be removed in the long run if found contrary to the Shari'ah rules. These are transitory recommendations, definitely preferable to the on-going practice.

⁵⁵ Under the present inflationary condition of the country the rate of profit paid to the Common Deposits have to be higher than the on-going "guaranteed rate of profit". More will be discussed about the impact of inflation.

⁵⁶ See endnote (16) above.

⁵⁷ More will be said about how the pressure emanating from reluctance can be lessened. All proposals are integral parts of a whole, as mentioned before.

implies that the cost of production will decline, so would the price which shows comparative advantage over debt financing; hence higher demand and, possibly, higher revenue,

(b) Musharakah contract gives more flexibility in the balance sheet of a firm compared to a fixed liability to bank.

It is hereby recommended that, in the long-run, no expenditure under the title “interest charges” would be allowed, for tax purposes, as “acceptable expenses”.

As shown earlier in Table 4, the real rate interest paid to the depositors, in Iran, has, and still is, negative. For some years we had inflation rate of 50% and “guaranteed rate of profit” for one-and five-year deposit of 14%. Last year inflation rate was announced 25%, interest rates remained intact, still ahead of deposit rate of interest.⁵⁸ As a result of this phenomenon that lasted for several years, there has been tremendous excess demand for loans which had increased the rate of interest in money black-market to as high as 55% for some years. The existing situation has provided the monetary authorities an opportunity to take full advantage of and persuade the public to change their deposits to the recommended ones.

If this process is properly fine-tuned there would be a great chance for the Iranian expatriates’ capital to flow into the country because casual

⁵⁸ Above situation has provided an empirical case which can be used as a proof of a skewed and inequitable distribution of bank deposits in favor of a large deposits held by a few. When deposits are normally distributed, the theory, based on I. Fisher’s idea, predicts that at the zero rate of interest saving will be withdrawn from financial institutions. In most Western economies whose rates of interest are above their respective rates of inflation can be taken as a proof of this phenomenon. This implies that saving function (if believed to be a function of interest-rate) has to start from the origin. Contrary to the theory, experience showed that deposit withdrawal, even on the assumption of skewed distribution of deposits, did not happen in Iran. It implies that the saving function should start at a negative intercept. (For further details of the phenomenon see the author’s book: *Economics of Money and Banking*” the chapter on inflation). Above discussion implies that inflation, however, harmful, can be effectively used here as a “blessing” to convince the public that these recommendations are to their own benefits.

observations show that the profit rate in this country is incomparable to that of a western country. Hence the economy will be further strengthened. If an advantage can be given to the expatriates' funds to be transferred abroad again, any time they wish, at formal exchange rate the incentive would be even more effective.

4-4-3 Third-Party Involvements

Casual observations and the existing data persistently prove the idea that one of the main reasons Musharakah contract does not appeal to entrepreneurs is to keep government away from their books and accounting records. It is more so because, as mentioned before, the Iranian banks are all state banks, and more important than that the banking system is under the supervision of the Ministry of Economic Affairs and Finance, where they have to pay profits tax. They prefer to borrow money even from money black-market at high rates of interest because they are often able to pass on interest charges to the consumers, even more so when their product market is far from competitive.

It is advisable to suggest a third party to enter into the play. Certified accountants, independent from Iran's Institute of Auditing (itself under the supervision of the Ministry of Economic Affairs and Finance) can best play the role. If financial statements of a firm enjoying the finance from the banking sector is approved by these accountants, both the financier (i.e. the bank) and the Ministry of Economic Affairs and Finance should accept. This will give entrepreneurs a high degree of confidence and will attract them to the bank for Musharakah contract.

4-4-4 Need for Consultancy Agents

Seemingly, the kind of contracts under the cover” Islamic” now being used in the country do not require specialized techniques such as cost-benefit analysis, risk and portfolio management. Because they are mostly of collateral-loan basis upon which the principal plus interest charges has to be repaid at the maturity date. As gradual steps are taken towards a true Islamic banking, it certainly requires highly skilled staff to do above analyses. Most, if not all, banks lack such expertise. However, it is not advisable to hire a large number of technical staff, not available in short run. Efficient use can be made from the relatively high skills of the technical staff of Bank of Industry and Mine as consultants, for consultant fees whose amount shall be agreed upon on the basis of the activity, fixed capital asset, working capital assets, volume of production, etc. Finance departments at the universities can also be used alongside the said bank.

Bank also needs engineering services for technical evaluations and assessment of the projects offered to them. Schools of Engineering which are almost scattered in all Iranian provinces can provide the engineering services, a complement to financial assistance.

As more and more firms are attracted to the banking system to finance their projects in compliance with the Shari’ah, more students graduated from different colleges will find it easier to fill the jobs appropriate to their specialty; jobs that are hard for them to find these days.

This proposal will hopefully narrow the gap which has long persisted between high educational institutions and firm. This gap can not be filled through issuing memorandum of understanding, but through a genuine need.

4-4-5 Shari'ah Advisory Board

Islamic banking being a new phenomenon in financial system and going through its embryonic stage without much, or any, precedent has to be implemented with proper care. It is highly recommended that an advisory board consisting of religious scholars, economists, bankers, lawyers, finance experts to be set up at different levels of geographical areas. The members have to be selective on the basis of competence and loyalty to the Law and are recommended to be appointed by the Minister of Economic Affairs and Finance. This advisory board will act as assistant to the Supervision and Control Bureau of the Central Bank (referred to in next proposal). Its task shall include constant contact with different branches of banks to give them specialized advice and proper guidance whenever asked for, in addition to their routine job to check and balance the conformity of performance with the Law.

Banks shall take their advices and put them into practice. A hierarchy for this board is also to be formed. Complicated problems should go to the highest level of the advisory board. There should be a close relationship among the echelons of the hierarchy. Such an advisory board has never existed and has not been recommended to be established.

4-4-6 Urgent Need for Supervision and Control Bureaus

Islamic banking being primarily based on the principle of Profit and Loss Sharing (PLS) calls for, by its very nature, a close supervision and control body. Its tasks shall be very important and vital to make sure that all transactions (contracts, forms, applications, amount of finance, etc) are properly performed. Realizing its highly important value to Islamic banking it seems most appropriate that the respective staff to be selected from the

most-skillful personnel by officials other than bank authorities. It may well be recommended that the members of the highest echelon be authorized by the Minister of Economic Affairs and Finance and being held responsible solely to him. This shall replace the existing passive Bureau of Supervising Banks, in the Central Bank, whose head is appointed by the Governor of the Central Bank. The functions of the Bureau of Supervising Banks are incomparable with the highest echelon of the above-recommended bureau.

The members of these bureaus shall have high command on all modes of contracts, loyal to the banking system, to the Minister and to the society as a whole. External expertise and scholars from Muslim countries with long period of experience can be of great help in both cases discussed; i.e. proposals 5&6.

Each bank and in every branch has a bureau called “Bureau of Inspection” whose responsibility and function and skill of the members is far below the recommended bureaus.

4-4-7 Incentive Schemes

Profit ratio is a strong incentive instrument⁵⁹ which has rarely, if any, been used in Iran.⁶⁰ It seems that-Shari’ah does not have binding measure in Musharakah contract on the profit ratio (to the effect that it has to be the same as the capital ratio⁶¹), then the agreed upon ratio is always valid. Hence, it can act as a powerful instrument, one way or another, if profit ratio

⁵⁹ It can be argued whether the goal of a Muslim entrepreneur is to maximize his profit. However, if all aspects of Islamic codes of conducts have properly been observed, the assumption, contrary to the common belief, seems implausible.

⁶⁰ The Law provides, as stated earlier, provision for this instrument.

⁶¹ In case of a loss it has to be shared according to the capital ratio; see, for example, M.Umer Chapra’s book (1985); p.72.

used would be different from capital ratio. The ratio can also be changed favorably according to the activity or region to be intended to promote.⁶²

A caveat is in order here. Musharakah contract has two dimensions:

- a) Finance, and
- b) Managerial involvement⁶³

This is in contrast with debt-financing which has just the first dimension and probably this is why it is so attractive to entrepreneurs. An entrepreneur asking for Musharakah contract may only need the finance but not the managerial assistance of the financier (bank). However, in this contract both dimensions go together and cannot be separated. If a suggestion can be made to meet the needs of entrepreneurs this contract might very well be attractive and welcomed. It is hereby suggested that in Musharakah contract banks (the financiers) will hold their shares until certain requirements have been fulfilled, after that they have to sell their share in an Islamic stock market.⁶⁴ This certain requirements can take on different forms like: profit rate, volume of sales, asset accumulation, etc. After one or two of such measures, according to the terms of contract, have been realized the financier whose primary goal was to help the needy entrepreneurs be obligated to sell its

⁶² With respect to region, some measures like the deprivation index can be used and the profit ratio can favorably be altered on the basis of the said index. The higher the index the higher shall be the profit share of the entrepreneur. The Plan and Budget Organization can easily estimate this index. Some tax exemptions can also be used as additional incentive.

⁶³ See the provoking paper by Tariquillah Khan (1995).

⁶⁴ The market free of any harmful speculative transactions in which the stock price is asset-based (i.e. the intrinsic value of the stock has to govern the market) rather than market based as excellently outlined by M.Akram Khan; see Monetary and Fiscal Economics of Islam edited by M.Ariff (1982); pp.237-59 especially pp.240-42. There are other alternative solutions to the Islamic financial instruments and stock markets. Each of which has its own merits. Some Islamic instruments for Islamic banks, Non-Bank Intermediaries, and Business Enterprises have been proposed by Dr.M.A. Al Jahri (1997). A different view has been suggested by another scholar; see H.H. Hassan's paper (1993). With respect to Islamic stock market, free from gambling but some healthy restrictive measures M.Ali El Gari has few suggestions; see his paper (1993).

share to the public, but the fiancée should be given the priority right to buy these shares.

Above recommendation has two advantages:

- 1) State ownership is transferred to private ownership (remember, all banks in Iran are publicly owned).
- 2) A state Big-Brother is transformed to quite a few private small brothers. With often too many shareholders (in a corporation) they rarely exercise their power in the management system of the fiancée.

Both advantages are those liked by entrepreneurs. This proposal will not only induce the fiancées to try hard to meet the condition(s) specified in contract but put halt on the size of the government. Furthermore, banks will be able to find a channel to release their locked-in funds in order to finance new demands and increase their transaction turn-over; hence completed the mission of an Islamic bank to a needy entrepreneur.

Banking staff playing important role in the proposals made have to be provided with some benefits, linked to their performances without which the scheme may not lead to the desired level of competence. Some portion of pooled profits may be allocated to these employees in accordance with their skill and initiation.

All these proposals can be most effectively put together to make a package of gradual transformation of the banking system. A computer software program composed of all “Musharakah” transactions can be used as a complement to this end.

Above proposals and recommendations are by no means exhaustive, they require details to be spelled out whenever applicable.

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