

In the Name of Allah, the Compassionate, the Merciful

Islamic Leasing and its Impact on Islamic Banking in Iran

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1- How Leasing (Hire-Purchase) Has Been Interpreted in Iran and Abroad?  
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The precise nature of the leasing product differs in many respects from one country to another. So too does the perceived extent of national leasing industries. In each single country there is a tendency to assume that leasing is whatever leasing companies do. For example, in the UK the leasing industry is conceived as being confined essentially to the leasing of equipment to customers in the business sector. This does not include consumer business, where the range of financing facilities is more limited, nor real-estate leasing where the companies involved as lessors tend to be widely different.

In the financing of business equipment there are distinct types of facility. As in some countries, there are operating leases for assets which have a reasonably reliable second-hand value, and where either lessors or equipment suppliers can assume residual value risk by writing leases which provide less than a full payout on the capital cost and run for shorter terms than the useful life of the asset.

These leases are common for such equipment as vehicles, aircraft, ships and some types of computer and printing equipment; and they are sometimes arranged in conjunction with equipment service contracts.

At the other end of the scale in the UK is Hire-Purchase (HP) where the hire term provides a full payout to the lessor (who is usually known in this case as the “financier”), and the lessee (who is known as the “hirer”) has a purchase option at the end of the hire period.

Hire-purchase facilities in the UK are never referred to simply as leases, but sometimes described as “lease purchase” rather than hire-purchase—though these two alternative terms have the same meaning.

In between the operating lease and hire-purchase is a third facility which is not paralleled in many other companies. This is the finance lease. It is a full-payout structure, and in commercial terms not fundamentally different from Hire-purchase; but there are critical differences in legal and taxation terms since the lessee does not have a purchase option and can not at any stage take title to the equipment (World Leasing Yearbook,1996).

The size of the market plays a crucial role in the extent of using above-mentioned contracts. More importantly, the success of each one of these contracts heavily depends on the strength of social capital. Among contracts named above, it seems that, only a different version of hire-purchase and in limited scope is in operation in Iran. The sluggish demand might be attributed to both small size of the market, in conjunction with the quality of social capital, and the historical psychology of Iranians. Almost 100 % of Iranians were, and still are, Muslims and sometimes very cautious about Quranic prohibition of Riba (interest). They have long been apprehensive about the conventional banking practices based on Riba. Even if those who did not care much about the problem of Riba, they used to prefer buying commodities and equipments on cash basis rather than on any other terms. According to my long and casual observations, those whose periodic income fell short of the price of a durable asset preferred to buy it from the immediate suppliers on installment basis rather than through any other fund intermediaries. As will be made clear, things have gradually changed and made the climate suitable for such intermediaries.

Unlike UK where: (1) operating leases are used for such equipments as aircrafts, ships, and some types of computer and printing machines;(2) real-estate leases used mostly for commercial buildings such as shops and offices; and (3) cross-border leasing which is heavily involved in international leasing transactions and mainly through international corporations, Iranian laws, before and after the revolution in 1979, have come just to recognize hire-purchase. Furthermore, the interpretation of the banking sector reveals that there is not much, if any, difference between hire-purchase and installment sales. Just for the record, Ministry of Sciences, Research and Know-how following the banks' interpretations in a step towards granting privilege to academicians have recently decided to sign leasing contracts with them to buy automobile, which is in fact installment sales in the sense that before a full payout is made the lessee will be able to take title to the asset. Banks have also extended such contracts to include household furniture.

It seems that Iran is among those countries such as Denmark, Germany, and India that national requirements and practice do not conform with International Accounting Standards; IAS 17.

It is possible that on the grounds of a probable tax evasion or even law bindings, some manipulations have been made to register the realized rather than accrued profits. This has long been the controversial issue between tax authorities and leasing firms (banks or otherwise) in Iran. This has become especially an important issue between Auditing Organization (a subsidiary of the Ministry of Economic Affairs and Finance) and state-owned banks. According to my own examination, Auditing Organization believes that all incomes and expenses have to be recorded as they accrue but the Central Bank of Iran is on the belief that all incomes and expenses should be recorded on cash basis (i.e., as soon as they are realized). Either of the two opinions has its own merits and implications as to the value of some specific documents exchanged between the two parties involved in certain transactions. This may or may not apply to low-valued assets in

leasing contract, but when it comes to highly-valued asset items it might become a problem the solution of which is a matter of a separate research.

International Accounting Standards 17 classifies leases under two headings: (1) a finance lease, which transfers substantially all of the risks and rewards incident to ownership of an asset, whether or not title is eventually transferred, and (2) an operating lease, which is any lease other than finance lease. Some other lease contracts have also been recognized such as: Sales-aid lease, Leveraged lease, Sale-and-Leaseback, and Cross Border Lease. The last three are essentially the extension of finance lease contract. It seems though that Operating Lease has not yet been used in Iran but only hire-purchase which has been interpreted to be the same as installment sales contract prescribed in the Law for Usury-Free Banking Operations (hereafter, the Law unless otherwise specified) of 1983. Article 12 of the Law reads as follows:

In order to create the necessary facilities in the expansion of services, agricultural, industrial and mining activities, banks may purchase movable properties, at the request of a customer and against his undertaking of hire-purchase for personal use, and put them at his disposal on a hire-purchase basis.

According to several investigations made by the author, as pointed out earlier, some, if not all, Iranian banks surprisingly consider Hire-purchase contract to be similar to Installment Sales. Admittedly, there are similarities between the two contracts, as seen by some bankers, except for the following:

The ownership of the merchandise under Hire-purchase contract remains the property of the lessor until the last payment is made by the lessee. In case of Installment Sales, the ownership is transferred to the applicant as soon as the contract is signed.

The equipment under the question remaining the property of the lessor, in hire-purchase, till the last payment is made by the lessee seems to be the great advantage of hire-purchase over installment sales. This is especially true when the so-called financier has, already, in his possession the asset under the question. This might, in many cases, prevent actions from any conceivable fraud. Whereas, hire-purchase contract necessitates the fulfillment of two distinct stages. First, to take possession of the requested item and second, delivering it to the client (i.e., Qbz-wa-Iqbaaz). This great advantage of hire-purchase, seems to me, can, in many cases, prevent the money market from developing. The fear is that as soon as these stages are removed Riba would emerge, as will be briefly explained in the following pages.

The similarities of these two contracts, seen by some bankers, have had two unfortunate effects:

- (a) Banks have mostly become indifferent between them to the effect that they seldom keep separate accounts for each. More importantly, is the following:
- (b) Mere presentation of invoices has been considered to be sufficient evidence for the intention of the applicant to buy the equipment applied for.

This last effect has led many applicants to engage in unbelievably high levels of fraud. Briefly speaking, fake invoices are presented to banks without banks having to take possession of the equipment and then delivering the same to the applicant. This has produced, as far as my investigations allow, formal statistics that show the total face value of fake invoices to be far more than the total value of the real equipments and assets exchanged. This will, according to my analysis, undoubtedly develop money market whose equilibrating rate is Riba via the process of Money-Commodity-Money (M-C-M); a brief review of which will be given below.

To make it further clear that how the Law was supposed to be implemented, the Regulations under the Law defines a Hire-purchase as:

A hire purchase is a hire contract in which a condition is incorporated that, the hiring party shall become the owner of the exact hired article, at the end of the tenure of the hire, and provided that he has fulfilled the conditions incorporated in the agreement.

Some of the most important stipulations incorporated by banks in the contract, in hire purchase agreements, besides the stipulation of security and the stipulation of authorization for abrogation by the bank, in accordance with the Law and the relevant Regulations and Operation Rules, are:

- A- Supervision: The lessee shall directly manage, in favor of the interests of the lessor, the exact subject of the lease, except in cases of emergencies and acts of God, to be determined by the bank.
- B- Insurance: The exact subject of the lease shall be insured by The lessee, at his own cost, in favor of the lessor, for the duration of the lease.
- C- Other stipulations: Protection and proper utilization of the leased property or goods, payment of all repair costs, non-alteration of any kind, payment of all relevant taxes and levies.

According to Operation Rules for Hire-purchase transaction, the following terms of operations have been put in place, (H. Shirazi,1988;pp.179-187):

For the creation of the necessary facilities for the expansion of services and production (agricultural, industrial and mining) activities, the bank may, at the written request of the applicant, purchase movable or immovable properties, and put them at the disposal of the applicant, through a leasing contract, stipulating that at the end of the lease, if stipulations included in contract have been fulfilled, the lessee shall become the owner of the exact leased property.

In hire purchase transactions, the bank may act to purchase only on the written request and undertaking of the applicant to enter into a hire purchase transaction and use of the same for himself, and thus, the ownership of the properties involved in the transactions remains vested

with the bank, and the lessee is the owner of the benefits thereof, and may make use of the same, only in accordance with the specific provisions of the agreement. The lessee must exercise direct supervision in the use of the benefits of the exact leased property, and shall have no right to:

- 1- Transfer temporarily
- 2- Pledge
- 3- Sub-let
- 4- Lend
- 5- Transfer

The property included in the hire purchase transaction, or, to put it at the disposal of another person, partly or fully, in any manner whatsoever, except with the written agreement of the bank. The responsibilities of the bank, in such cases, are as follows:

As the bank purchases the relevant properties selected by the lessee, solely for leasing them to the applicant, it follows that the bank shall not be responsible for any interference, judgment, responsibility of selection, construction, technical specifications, transport, installation, manner of working and utilization. It is the applicant who selects assets of his choice, in accordance with his own needs and professional requirements, and recommends them to the bank, for purchase.

The terms of purchase of movable equipment, in hire purchase transactions are similar to the terms of purchase for tools, machinery and installations in installment sale contracts.

For the purchase of immovable assets, evaluation of the subject of the transaction is a must.

The obligations of the lessee have also been outlined as:

The lessee is under obligation, according to the current procedural rules, and in accordance with legal requirements and common practice, to use the properties covered by the contract, only for practicing his professional activities, and to maintain and protect them, at his own cost, and with the greatest attention, and in the best manner possible. The lessee shall also be responsible for all kinds of damages suffered due to negligence of proper use of the leased equipment. He shall not, without obtaining prior written permission of the bank, make changes in the exact item of the lease, and/or remove it from its place of installation, and transfer it to another location.

Any sums paid by the bank for purchase price, insurance, customs duties, transportation, commercial taxes, bank charges, installation and start-up fees, etc., shall be added to the cost price, and the amount of the rent shall be computed after taking into consideration the cost plus the pre-determined bank's profit margin.

Advance payment has also been taken into consideration for hire purchase contract. Prior to entering into a hire purchase agreement, the receipt of a minimum of 20% of the cost price of the equipment involved, as part of the rent for the duration of the lease, is compulsory. This advance payment shall be deducted from the cost price for the computation of bank's profit margin.

Rental charges in equal or unequal installments are tied to the useful life of the asset. The receipt of the rent for the leased asset, in equal or unequal installments, at fixed maturities is permitted. However, the duration of the hire purchase agreements shall not exceed the useful life of the equipment in question in the contract. In case, the lessee, arranges to pay and settle the remaining rent in toto, before the end of the lease period, the necessary discount in the amount of

the remaining rent shall be granted, and the exact leased asset shall also be transferred to the lessee as the owner, according to the stipulations of the agreement.

In hire purchase contract attention to the following points is essential:

- 1- Whenever necessary, for good performance of the agreement, sufficient security should be obtained from the lessee.
- 2- Although hire purchase contracts are among obligatory documents and are within the jurisdiction of the Regulations for the Execution of Legal documents, wherever transactions are required, by the relevant rules and regulations, to be performed in notary public offices, it is essential that the transaction documents should be prepared in the notary public offices on the basis of the real prices ( and not official prices, which are generally lower than the real transaction prices).
- 3- As necessary, during the period of the lease, the exact property should be sufficiently inspected and supervised.

As was made rather clear, the essential properties as to the nature of leasing, the responsibilities of the lessor and of the lessee, the way applications have to be filed and processes to be followed both abroad and in Iran are, in general, the same. What remains to be examined are: the history of leasing operations in Iran, doubts and worries about the emergence of money market, and the prospects of leasing in Iran.

## 2- Brief History of Leasing Operations in Iran:

Leasing operation in Iran goes back to the establishment of the Leasing Company of Iran which was jointly financed by Iran's private sector, Credit bank of Iran, and one of the leading French companies in this area ( a subsidiary of a French bank) which was legally put into operation in 1975 (1354). Then in 1977-78 (1356) Leasing Company of Industry and Mine under the name of Arya Leasing Company started its operations. The name of this firm was later changed to Pey-Kharid (Post-Purchase) in 1982 (1361) and subsequently in 2002 (1381) to Industry and Mine Leasing Company.

These two leasing companies are now operating under the management of Tejarat Bank (Commerce Bank) and Bank of Industry and Mine, respectively. These two firms had not only been jointly financed by Sliball International Company and Societe General Bank, both of them of French origin, but also relied heavily on the management and expertise of French specialists. Due to some considerations to be explained later, their operations were not considered successful as expected. The number and the value of their contracts signed were sluggish until 2001 (1380). The nature and the size of the operations of these two companies could hardly be documented. Some unreliable information shows that the number of leasing companies has reached to 95. Whatever the margin of error, this figure might be used as an indication of a momentum that has been gained in this respect and is hoped, by the beneficiaries, to improve even further in the future ( Andisheh Gostar, 2004;p.7).

The statistics on the number of operating leasing companies in Iran is not yet conclusive. It varies from 81 to 95 and perhaps even much more; the small ones, probably unaccounted for (ibid, various pages).

After the Islamic revolution in 1979(1357) due to drastic changes that took place in almost all socio-economic aspects of the country, the first two leasing companies underwent through difficulties which forced them to discontinue their operations. Evidently, these changes have been severe especially during the transition period but gradually slowed down as the state felt secure enough to implement her own plans in a more secure political climate. Subsequent to the enactment of the Law in 1983(1362) and close compatibility which was made between Leasing and Hire Purchase (HP) contract these two firms resumed their operations. It has repeatedly been anticipated by the authorities that the leasing industry with all its well-documented attributes would grow fast. However optimistic these expectations were, they did not fully materialize. There seems, as I understand, to have been two distinct reasons, as mentioned earlier for this failure, which will be explored more in the following pages.

It was mistakenly interpreted by some bankers that it was mandated by the Law that it was the exclusive right of the banks to be engaged in hire purchase contracts. Furthermore, the lack of social and structural pre-requisites, as observed by some expert, had to do with the relatively low attractiveness of this industry. On the part of the banking system, the multiplicity and huge daily banking transactions was one of many reasons not to be able to respond to the potential demand, if any. State-owned banks have also been accused of the lack of knowledge about new banking products.

Another important factor contributing to the low attractiveness of this contract to the private sector, as observed by some leasing managers, (ibid, various pages), has been that neither the general public nor the government had ever supported it. It is further believed, by some academicians, that the overwhelming influence of state-owned banks on the entire banking system is the principal factor for preventing the private sector to actively participate in this industry. Nonetheless, I have my own reasons to believe that this does not provide a satisfactory answer. The proper and ultimate answer shall be found both on religious and social capital grounds as explained in my book (I.Toutounchian, 2001, Chaps.4&5).

Apart from my analysis about Islamic money and banking, referred to above, the general public has its own sensitivity and tolerance that have to be seriously considered. On the part of the Iranian general public, as noted earlier, serious doubts about the Riba-involvement had been surrounding the banking operations even before the revolution. This has to be added to the psychology of the Iranians about consumption expenditure habit. They are, in general, thrifty people. They do not, in general, embrace purchase of durable items whose prices far exceed the monthly incomes of the households. In other words, unlike people in Western countries, Iranians do not feel happy to see themselves under “debt” pressure, unless they have to. Whatever its origin, Islam or otherwise, it still exerts its power on Iranians’ consumption expenditure habit. Good or bad habit is something and not sufficiently and equitably compensating the labor force is something else.

It is totally a mistake, as I understand, to under-pay the labor force and then find ways and means to pursue them to spend, at least in Islamic countries. I firmly believe that in such economies in order to boost aggregate demand, there is a better way, if not the best, and that is to fully and equitably compensating the labor force by profit sharing than under-paying and keeping it in desperate condition and then offering installment sales and putting it under debt till the end of its life. It is preferred, as a principle, to see labor fully compensated and then voluntarily demand durables as opposed to keeping him in poverty and forcing him to involuntarily demand such commodities. It has been demonstrated that for any given marginal propensity to consume, the investment multiplier in an Islamic economy is much higher than that in a capitalistic country (for details, see I. Toutounchian, 2001, pp.591-595). It should be kept in mind that the relevance of full compensation is always there and it does not necessarily negate the existence of such contracts, but what has been happening in some countries like Iran is both under-payment and desperate situation of many households.

On the part of the state-owned banks it has to be noted that ever since we have had Central Bank in 1960 we have suffered from having a dynamic banking system even with having more than 25 private banks right before the revolution. Long waiting lines, slow operations, high rate of interest, and also direct interference in the money market by permitting them to print the so-called Guaranteed Checks by state banks were, and still are, all evidences of a kind of primitive banking.

Private banks, in general, did not have better records than the existing publicly-owned banks. It is noteworthy that on charges of fraud and malpractices of private banks they all announced to be nationalized by the Revolution Council. Total value of their debts far exceeded the total value of their assets. Although profit can be considered a strong incentive for the development of new banking products but more important factor than profit, as I understand, is social capital as one of the most important determining factor of the Rule of Law. It is a common thread which invisibly connects all individuals and institutions, directly or indirectly, either in private or public sector. Hence, whatever the state of the social capital, positive or negative, strong or weak, it equally affects private and public sectors. This implies that the adequate and satisfactory answer has to be found somewhere else.

On the false belief that unconditional market mechanism, privatization, and also interest-based banking practices and its immediate derivative, i.e., speculation, necessarily guarantee socio-economic justice, considerable restrictions have been removed, in the past several years, from the private sector activities; some of which justifiable but not all.

Several unprecedented policies have been followed to the extent of the Rule of Law negligence. Unconstitutionally, private banks have been allowed to practice and speculation on many durable commodities has gained shaky momentum and is progressively increasing throughout the country. As the result we have, according to Lord Keynes (1964; pp. 222-23), many interest rates on such commodities in terms of themselves. Tax exemption on speculative activities has also been another incentive to produce noticeable money whirlpool; the consequence of which has been high disguised unemployment rate, high rate of inflation, and inequitable distribution of income and wealth; not reflected in formal statistics.

Weak or sometimes non-compliance with the Rule of Law on the part of the Central Bank, one of the most important institutions of the country, have paved the way for others, private or public, to follow suit. In a recently issued memorandum by the Central Bank 106 private leasing firms have been alleged of fraud. Furthermore, they have also been prohibited, in the memorandum, to accept deposit from customers on the ground that deposit taking had been solely restricted to the banking system. Any violations on the part of these firms would be subject to legal prosecution by the Central Bank, the memorandum says.

Let us go back to the historical development of leasing firms in Iran. Pars Leasing Company is the first, totally private, leasing company to have engaged in this area after the revolution. It is hardly known when it started its activity. There are also six major leasing firms whose volumes of transactions are as yet unknown to me unless some developments occur before my speech in the conference. They are summarized in the following table.

Table 1: Major Operating Leasing Firms in Iran

	<i>Name of the Firm</i>	<i>Establishment Date</i>
1	Arian Leasing	2000(1379)
2	Sheed Leasing	2000(1379)
3	Iran Khodro Industrial Leasing	2000(1379)
4	Khodro Leasing	2000(1379)
5	Labor and Industry	2000(1379)
6	Parsa Leasing	2001(1380)

Generally speaking, there exist nowadays 81, (the most frequently number cited), notable leasing firms in Iran, plus many small ones. During the period 1991-2001(1370-1380) only eight firms started their active operations. But in 2001(1380), 2002(1381), 2003(1382), and the first quarter of 2004(1383) five, nineteen, twenty nine, and eighteen firms were born, respectively. Historical record of these companies is summarized in Table 2 below.

Table 2: Historical Record of Leasing Firms in Iran

	<i>Name and Number of Leasing Firms</i>	<i>Starting Time of Operation</i>
1	Iran Leasing Company	1975(1354)
2	Arya Leasing Company	1977(1356)
3	Five firms	2001(1380)
4	Nineteen firms	2002(1381)
5	Twenty Nine firms	2003(1382)
6	Eighteen firms	2004(1383, first quarter)

In addition to 81 major leasing firms, in operation, several Iranian banks have become active in this area. These include Mellat, Refah-Karegaran, Maskan, and Keshavarzi.

On the aggregate, Iranian banks and financial institutions own five; Khodro-Sazan jointly with banks, together, two; Iran-Khodro, four; Saipa, one; and Bahman Group, one such firms, respectively.

Total initial capital of the 81 leasing firms is estimated to be 680 billion Rials (Iranian formal currency) which at \$1=8,800 Rials is equivalent to \$73 millions. It accounts only for 0.09% of the Iran's GDP equivalent to 662,240 billion Rials in 2001(1380); (Central Bank of Iran, 2001, p.182).

Major activities of Iranian leasing companies center around automobile; nevertheless, some surveys show that road, mining and medical machinery and equipment transactions comprise negligible figure. The reason that automobile has become the forerunner in leasing, goes back to a serious national debate on air pollution mainly, thought to be, caused by old cars. It appeared that the most reasonable scenario would be to encourage households to replace their old cars with new ones, either through Installment Sales or Leasing (Hire-purchase) contracts. The mark-ups on either of the two contracts range between 26 to 29 percent (F. Amini-Pour, 2004, p.10). These figures, high or low, are mistakenly considered, not only by laymen but also some educated people, to be interest (Riba), Muslims have long been keen about it. It seems that overall Riba-based banking transactions have led everybody to generalize it to even Riba-free transactions, of which Installment sales and Leasing, if properly conducted, could be the ones. The state-banks' rate of interest has gone up even higher than 30%, in some cases. This has, definitely, put a lower bound to other Riba-based transactions.

There has, recently, been a hot debate over the doubtful transactions of banks to have been Riba-involved. The Parliament has on its agenda a firm ground to, initially, somehow reduce the banks' rate of interest on the belief that it would relieve part of the Iranian industries' problems.

The most experienced car producer in the country is Peykan which sells its product, with lowest possible international standard, for \$7,200(63 million Rials). Comparing this price with similar automobile in some other countries, it seems to be prohibitively expensive. This is even more so if 26-29% mark-up is added to it in installment sales. The price of this automobile, like any other major commodities which comprise high fraction of household budget, has been both the cause of higher prices of other commodities and the effect of inflation, as demonstrated in my aforementioned book.

It was almost a decade ago that Central Bank started to gradually under-value Iranian Rial, consequently, prices jumped up to the point where they soon adjusted to \$1=8,800 Rials. But the government failed to launch income policy compatible with price policy. As I understand, as has been demonstrated in my book (2001, Chap. 5), there are two inter-related reasons for inflation in Iran. Firstly, speculation in many markets which is the immediate derivative of interest (Riba). Secondly, inequitable distribution of income and wealth, which could analytically be demonstrated, would result in low price elasticity of demand for many commodities. This is mainly due to the dominant role the rich people play in the country. Both of these two factors are rooted in interest-based banking. For this reason I have repeatedly called interest (Riba), "the prime fallacy" which does not allow the economy to reach equilibrium. This general idea has been put forward, one way or another, ever since Silvio Gesell, Lord Keynes, Abba Lerner, Maurice Allais, G. Ramsey, and Milton Friedman; to name just a few. I think I have been rather

successful to demonstrate this phenomenon for 12 industrial countries in my book (2001, Chap. 4).

You can hardly find a commodity, in Iran, being free of speculation. This, unnecessarily increases the prices of many items. Taking all above into consideration, one can explain the gradual movement of the middle-income class to low-income class. Under these circumstances we can expect leasing and installment contracts to pick up; however, there are other household needs more urgent than automobile.

As mentioned above, the automobile industry has been one of the most profitable industries in Iran. Bank Parsian which took over Iran-Khodro(Iran Automobile)'s leasing company in 2003(1382) has recorded the following transactions.

Table3: Iran-Khodro Leasing Company's Transactions

<i>Year</i>	<i>Number of Contracts</i>	<i>Value (Million Dollars)</i>
2001(1380)	896	2.5
2002(1381)	4,832	16.9
2003(1382)	5,820	28.0
2004(1383)	1,190	6.5

**Note: (1) Conversion factor is \$1=8,800 Rials; (2) Transactions prior to 2003(1382) belongs to Iran-Khodro;(3) Figures for 2004 belongs to the first quarter.**

Relatively high optimism surrounds the managers of leasing companies. Hire-purchase (leasing) contract, seems to me as mentioned earlier, has with it, if properly conducted, the least doubt about Riba-involvement. It will, undoubtedly, help many Iranian households. It is unfortunate, but has to be admitted, as pointed out earlier, that poverty has gradually become reality in this country, in recent years, to which the Leader has repeatedly warned the authorities. Households have un-noticeably come close, or even fall below, the poverty line. They have to, inevitably, refer to leasing companies to satisfy their essential needs such as automobile, refrigerator, and furniture.

One side of the problem which makes the leasing companies happy is to take the state bank's interest rate as their bench-marks. The other side of the problem, i.e., the demand for durable goods, has still remained unanswered. Meanwhile, middle and low-income classes have no other choice than referring to leasing firms, despite their prolonged psychology. Another factor contributing to a better outlook for the firms has been to replace Installment sales for Hire-purchase (Leasing). This will reduce their overall costs without being worried about costly leasing. All figures about Hire-purchase contract on automobiles are mostly, if not all, are of Installment sales nature, even if not explicitly admitted. My own casual observations prove this claim. Statistics show that the balance of Hire-purchase in state-owned banks for the year 2001(1380) accounts for 0.7% of the balance of all Islamic contracts. The corresponding figure for Installment sales is nearly 58%; that is, 83 times as much as that of Hire-purchase (Central Bank of Iran, 2001, p.124). This might also confirm my observations.

To respond to above-mentioned urgent needs of the households, many so-called "leasing companies" have been established in short period of time whose transactions are not totally

approved by the Central Bank. To protect the households from any wrong-doing on the part of these firms, close check and balance measures has to be put into action by the Central Bank. To ignore this important issue, will greatly damage the confidence of the general public which would, in turn, have adverse effect on the prospects of these companies. Meanwhile, one shall not forget, in any way, the Iranian's general view over such operations about them being involved in Riba-practices. The author does not subscribe himself, one way or another, to such misconception about Hire-purchase (leasing) contract.

### 3- Why Worry about Leasing?

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Weak social capital in developing countries, in general, and in Iran, in particular makes it rather hard for laws to be properly launched. They are either easily by-passed or half-implemented. The Law for Usury-Free Banking Operations (the Law) in Iran is no exception to this general rule. Furthermore, the executive branch, contrary to the Constitution, acts, in many instances, also as legislative branch in interpreting the passed laws. In brief, unlike developed countries, executive branch in this country is the most powerful branch. This may or may not be the same in other developing countries, however, there are many common attributes in these countries to have been categorized "developing", the most important of all appears to be "weak social capital"; rarely accounted for in the classification. As the result of this deficiency, rule of law, one of the determining factors composing social capital, is rather weak; check and balance, weaker. Numerous evidences show that during the last two decades of implementing the Law there have been many obvious violations; for some unexplained reasons never disclosed to the public. By-laws issued by autonomous Central Bank of Iran have led Iranian banks to be reluctant to engage in PLS contract. This contract is mainly used by Industry and Mine bank, as was in old regime. Direct effects of by-passing the Law, via instructions issued by the Central Bank, are mainly:

- 1- Overall transactions diverted to interest-based loans; quite contrary to the Law. It is noteworthy that the Law stipulates Qard-ul Hasan to be the only loan-based contract; other remaining contracts deal exclusively with the real sector.
- 2- High rate of interest imposed on financees (finance users) as high as 30% and more. This rate has been taken by other monetary institutions to be the lower bound for their interest charges.
- 3- Changing the nature of Islamic bank from being financial institution to monetary institution. This has, in turn, changed the so-called Islamic banks to play role in the monetary sector instead of in the real sector.

#### CAVEAT

It has quite often been noticed that in dealing with Islamic contracts, Muslim scholars use terms like (money)loan, borrower, lender, and similar words. It should, emphatically, be warned that no Islamic contract, except Qard-ul Hasan, is money-loan-

based. The reasons are: firstly, loan has its own legal definition which makes the responsibilities of the lender and the borrower and the terms of the contract as to the duration, the subject of loan, and other specifications clear. Secondly, money-loan deals exclusively with money market whereas all Islamic contracts, with the exception of Qard-ul Hasan, deal with the real sector. These two crucial points put a sharp distinction line between conventional and Islamic banking systems. Many objectionable features of capitalism are rooted in the money market. Ignoring these crucial points has become the source of many serious confusions and misunderstandings.

There are also indirect effects which have greatly damaged the economy. The most important ones are:

- A- Green light given to the informal (black) money market (part of the underground economy) to raise rate of interest to 60% and up.
- B- Encouraging speculation to become a nation-wide phenomenon mainly due to high rates of interest. It is not hard to show that interest (Riba) is not only necessary condition to develop speculation but also sufficient; it being the most important contribution of J.M.Keynes.
- C- High unemployment and inflation rates, both due to high interest rate; rarely appearing in the formal statistics. The first part is due to Keynes and the second part shown in my book (2001, Chap. 4).
- D- Real-sector activities which could have saved the economy has been dominated by tax-free speculative activities, hardly detected, which has produced inequitable distribution of income and wealth. This, in turn, has had its own impacts on the economy, as:
  - D-1 Decline of price elasticity of most commodities used by households.
  - D-2 Prevalence of moonlighting for many civil servants and fixed-income earners.
  - D-3 Increase in the number of households approaching poverty line and gradual fall below it.

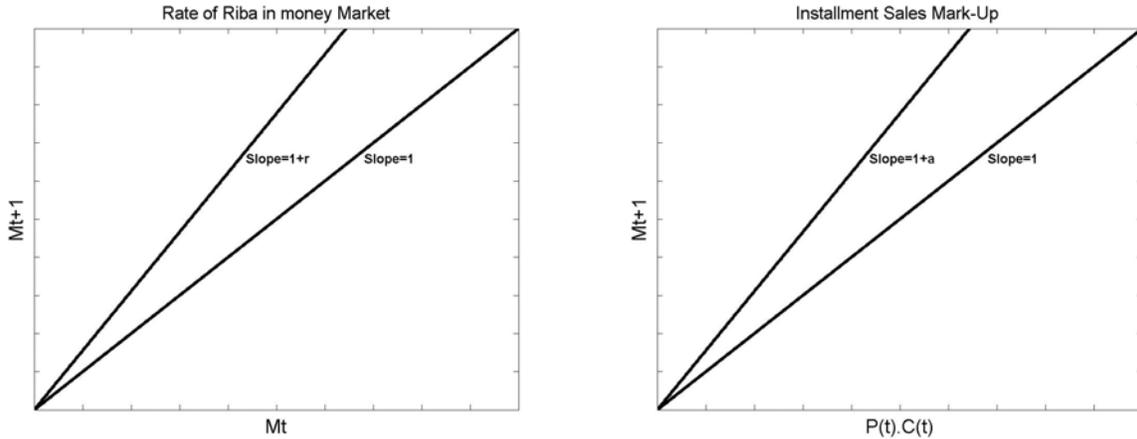
To comply with the instructions issued by the Central Bank to look after profits more than anything else, banks have had great appeal towards short term transactions. Among short term contracts, Installment sales have been the most attractive contract. Specially when fake invoices have advertently, or otherwise, been considered to be sufficient evidence to “borrow” from banks; as was mentioned earlier. Not surprisingly, few banking staff, as well as an ever-increasing newly-developed middle-men class, guide the potential clients how to illegally proceed to ask for

such invoices. This has produced information about those suppliers from whom these invoices can be obtained. Evidently, part of the face value of such invoices comprises their own commission fee. As it appears, the bank's mark-up, plus the sellers' and the middle-men's commission fee make this contract an expensive one. The natural consequence of which is that expensive items would be selected to worth it while. These clients, quite often, happen to be above middle-class citizens. This contract, therefore, which had originally been designed to mostly benefit the low-and middle-income classes, has benefited the rich most.

The newly-developed middle-men class is attractive for two reasons. First, due to the existing situation in Iran least amount of labor, if any, is required to do. Second, its "income" is not comparable to any other activities. Furthermore, it not only increases the prices of many commodities but also absorbs ever increasing portion of active labor whose incomes are considerably below their expenditures. This is the kind of work M.B. Sadre totally rejects, probably, on the grounds that "properties in which labor has no effect, whatsoever, on it can not be privately owned", he further takes a stronger position by saying that "middle-manship in both trade and business transactions, considered as a kind of production, has been prohibited"; (Iqtisaduna, first vol. p.440 & second vol. p.285, respectively).

There are critical differences in legal, as well as economic, terms between Hire-purchase and Installment sales. The problem arises when these two contracts are intentionally considered to be the same as far as the process of taking title to the equipment in question is concerned. In such cases there remains no option for the client because at the time contract is signed the process actually seems to be complete and the title is transferred to him. The problem becomes even more complex when banks accept fake invoices. Such invoices play the role of "C" in the process of  $M(1)-C-M(2)$ , where  $M(2) > M(1)$ , without the client having the intention to own "C". Naturally, then, money is exchanged for money and the difference between  $M(2)$  and  $M(1)$  is undoubtedly interest (Riba).

It should be made clear that neither Installment sale nor Hire-purchase, on own legality, in no way consists of any type or Riba, unless the legal processes are somehow violated. Let us take Installment sales case. Present commodity,  $C(t)$ , whose market value is  $P(t).C(t)$ , is exchanged for future money,  $M(t+1)$ . Any excess of  $M(t+1)$  over the market value of the commodity shows "money value of time"(similar, or, the same as time preference). Some Muslim scholars, carelessly, call this excess, "time value of money" which is nothing but rate of interest. Moreover, some Western economists, in a futile manner, have tried to show that time preference is sufficient to show the existence of interest. Installment sales prove to have the least doubt, if any at all, about Riba-involvement. It is, hence, confidently recommended to gain further momentum. The distinction between mark-up in installment sale and interest on loan has been made clear in the following two figures; (for more details, see I.Toutouchian, 2001, Chap. 3).



In above figure, the money value of the commodity,  $P(t).C(t)$ , is assumed to be the same as  $M(t)$ . Even if it happened that  $r = a$  it does not, by any means, imply that “a” is the rate of interest. As I understand, Islamic rules and injunctions on Riba are absolutely directed towards prevention of the money market to develop. For our purpose it suffices to note that Riba (interest) can occur in any one of the following ways:

- (i)  $M(1)$  for  $M(2)$  ;  $M(2) > M(1)$
- (ii)  $M(1)$  for  $C$  &  $C$  for  $M(2)$  ; with no intention to buy  $C$  and  $M(2) > M(1)$
- (iii)  $C(1)$  for  $C(2)$  ;  $C(2) > C(1)$

In the second case “C” has the intermediary role quite often played by speculators. The role of speculator shall not be regarded the same as that of a merchant in that, according to Keynes, at least half of the purchases or sales of investments, made by the former, in the stock markets are entered upon with an intention on his part to reverse them the same day. This is often true of the commodity exchanges, also.

A slightly different version of type (ii) above has increasingly developed in Iran with the intention of Riba to be passed by. That is, a fake document related to “C” is used instead of “C” itself. What makes this type of transaction invalid, is obviously the intention of the client. He/she does not have any intention, whatsoever, to buy “C” but only to have access over “M” by means of a fake invoice.

How this happens in real life? The process is as follows. The client asks the seller of an asset to issue a fake invoice. Knowing that the seller has to pay tax based on the value of his/her transactions, the seller issues the invoice whose face value is larger than the real value of the asset to cover the tax liability as well as his/her own commission fee. Tacit agreement among all like sellers determines the commission fee. By presenting this invoice to the bank, bank issues a check payable to the seller. The client is made liable to pay the bank the value of the check plus

what is normally known to be the Installment sales' mark-up of the bank. After the check is cashed by the seller, his/her commission fee, previously agreed upon, will be deducted and the balance is given to the client who had never ever intention to buy the asset. This is nothing but exchange of  $M(1)$  for  $M(2)$  where  $M(2) > M(1)$ ; the excess of  $M(2)$  over  $M(1)$  is undoubtedly interest charged on what actually is a "loan" in which "C" has been used as a cover up. This is what, I call, "illegitimate deceptive device" which is absolutely forbidden in Islam and unquestionably, Haram.

The rate of interest (Riba) involved in above example is simply  $[M(2)-M(1)]/M(1)$  which is evidently less than that could be obtained in black money market whose rate, in Iran, is as high as 60%. Depending upon the kind of commodity in question, i.e. "C", according to Keynes, a rate of interest develops in terms of itself. Frequent use of such deceptive devices have developed, in the country, Dollar rate of interest, apartment rate of interest, automobile rate of interest, dental equipment rate of interest, and, in general, Installment sales' rate of interest.

What should, in fact, concern us as economists (Muslim or otherwise) is the adverse effects money market will forcefully exert to the economy. The immediate derivative of interest, mentioned above, which naturally develops in the money market, is speculation that will, in turn, produce unemployment, inflation, and inequitable distribution of income and wealth. Again, it does not take much effort to demonstrate that interest (Riba) is both necessary and sufficient condition for speculation.

I would like to draw attention of the reader to the strong assertions made both by Professor Abba Lerner and Professor Milton Friedman, respectively:

1-The zero rate of interest is the indicator that optimum distribution of income has been brought about (1961).

2- Zero nominal interest rates are necessary for efficient resource allocation, (1969); happened to be known as Friedman's Rule.

More importantly, H.L. Cole and N. Kocherlakota, (1998), have demonstrated that zero nominal interest rates are not only necessary but sufficient for efficient resource allocation.

4-Some Brief Observations on Leasing Contract in Iran:

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On a special issue devoted to Leasing, Journal of Andisheh Gostar, (2004), has made interviews with some of the managers of leasing firms in Iran. Below, you will find the reactions of some of these managers about the existing situation of leasing in the country. Obviously, one can not expect from them to be articulate about complex economic concepts. They have all been directly taken from their interviews without making any correction as to the contents of the concepts.

# With high rate of interest, there is no scope for expansion of leasing in Iran, because many low and middle income households are not able to both pay high rate of interest and monthly installments.

# The mark-up (profit) rate in 2003 (1382) had been decided by leasing companies to be pegged at a rate between 35 to 40 percent. But this year, (2004), the profit rate has gradually been declined, and for the group buyers reached 25 percent.

# With inflation rate, in Iran, being above 15-20 percent the bank's profit rate, has to be above 15 percent and bank rate of profit for loans (?) and credits extended to buy automobile should also be above 20 percent.

# Nowadays, nearly 90 leasing companies exist in Iran and the Association of Leasing Companies has been formed with 23 members.

# The financial need to sell automobile in Iran gave a green light to leasing companies.

#### 5-Summary:

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Hire Purchase (Leasing) has relatively old history in Iran. Its origin goes back to 1975 (1354) when the first leasing company started its operation. It was years after the revolution that new firms were born. The Law for Usury-Free Banking Operations (the Law) of 1983 has plainly endorsed it and paved the way for new entrants. Being one of the contracts in the Law, it removed any Riba-involvement doubts on the part of Iranian general public. At present, there are 81 operating leasing firms whose total initial capital in comparison with Iranian GDP in 2001 (1380) accounts only for 0.09 percent.

While most of them are privately-owned firms but the volume and the value of each firm's transactions has been kept as secret apparently to avoid any possible misuse by the rivals?!

The similarities that exist between Hire-Purchase and Installment Sales contracts have become sources of malpractice on the part of Iranian banks. The banking system had been strongly recommended in the early nineties by the Central Bank of Iran to go exclusively for profits. This was, as I understand, quite contrary to the explicit articles of the Law and its spirit. The Law originally was aimed at equitable distribution of income and wealth as stipulated in the Constitution. Short-term contracts with highest return and lowest cost possible became attractive to the system, of which Installment sales were most attractive. This was coupled with misinterpretation made by the Central Bank, reflected in the instructions issued, about all Islamic contracts to be of "loan" nature.

The overall banking transactions of the state-banks were diverted to interest-based operations; the rate of interest charged went up as high as 31 percent. The nature of the state-banks' operations put the bench-mark for similar institutions to follow suit. The rate, set the floor rate for both black money market and many other activities.

Hire-purchase seemed costly to the banking system, as was repeatedly declared by the Central Bank even in reference to the implementation of the law. It was soon replaced by Installment sales in an attempt to reduce cost. More importantly, fake invoices had been explicitly announced to be accepted as sufficient evidence of the intention of the client,(in case of leasing, lessee) to buy equipment. From then on, contrary to the Law, money market developed inside the state-owned banks to the extent that installment sales, mostly via unreal invoices, made by these banks accounted for nearly 60 percent of all contracts in 2001 (1380). Naturally, this volume of transaction has developed within itself a newly middle-men to guide the clients how to illegally proceed in order to have access to bank loans. However, it should be mentioned that illegitimate processes and also illegal actions might not be exclusive attributes of Iran. It might happen everywhere due to some basic reasons such as weak or lack of social capital, most developing countries suffer from. Whatever the reason for violating the Law, it has had its adverse effects on the economy. As I understand and have demonstrated in my book, (2001), complete reliance on the Law and avoiding any illegitimate deceptive devices would have definitely produced both low unemployment and inflation rates, if any, and reasonable distribution of income and wealth during last two decades. My expectations are in line with both Friedman's Rule (subsequently substantiated by two Federal Reserve economists) that zero nominal rate of interest is not only necessary but sufficient for efficient resource allocation, on the one hand, and Abba Lerner's assertion that zero rate of interest is an indication of optimal distribution of income, on the other. Formal statistics, quite often with underestimated figures, show the contrary which is, by itself, a proof of improper implementation of the Law.

As poverty, unfortunately, has become a prevalent phenomenon in Iran and considerable portion of households reached the poverty line, or even fell below it, the Installment sales, (due to their low monitoring cost from the bank's side, instead of Leasing, inevitably become appealing to them. Meanwhile, two opposing reasons are at work to make it unattractive. Firstly, the psychology of the general public to keep away from "debt burden" as much as possible. Secondly, high mark-up as high as 29% which makes the "burden" heavier. If past trend of poverty keeps persisting in the future and mark-ups decline, the prospects for leasing companies become bright. The type of psychology, referred to above, would gradually be undermined by the pressure of essential needs. We have to hope for prosperity in the light of Islamic rules and guidelines; something quite often neglected. In such a case, Leasing, on its totality, which has the least Riba-involvement doubts, ever, might even extend to industrial, agricultural and hospital equipments and assets as well as air-planes, ships and the like.

## 6-Conclusions and Recommendations:

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Islamic developing countries having relatively simple system, compared to industrially developed countries, are highly recommended to adhere closely to Islamic banking before social multi-interactions become more complex in the course of economic development. There has always

been a fear, at least on my side, that such banking would be misinterpreted and unintentionally produce money market of any sort. In so doing, two important tasks play central role. In the first place, strengthening the factors determining the social capital is “the” pre-requisite as well as underlying conditions for any economic development plan. Of course, this is not unique to Islamic countries but common to all developing countries. The second, being extremely cautious to use vague connotations for four major economic concepts, i.e. money, capital, interest and profit; the most confusing concepts not only among laymen but also educated people.

Islamic economic system which can best be described, according to my interpretation, as “a grand cooperative” system, the attribute of cooperation is fundamentally incorporated in Islamic banking. Loan, borrowing and lending have their origins in individualism, not in cooperative system. All the efforts have to be directed towards avoiding money market to develop.

One of the least doubts about Riba-involvement is leasing contract, provided that it is not misinterpreted and is fully implemented. Close supervision, check and balance is necessary to guarantee success. Admittedly, the monitoring cost of implementing Islamic banking, in general, and leasing, in particular, is high compared to loan-based conventional system. Meanwhile, social benefits shall not be disregarded. Costs of unemployment and inflation, in almost all interest-based banking economies, whether developed or undeveloped, are prohibitively high. Reducing this cost nearly to zero, is an absolute advantage of Islamic banking in which leasing may play special role. If leasing is properly launched as outlined above, the author highly recommends it for which relatively strong social capital is a “must”.

My recommendation is to avoid poverty to become the determining factor for the leasing companies to prosper, but to fully compensate the labor force, on grounds of Islamic guidelines and principles, in addition to close compliance with the Law to boost aggregate demand. It is through this line of thinking, I believe, that guarantees the Islamic economies to contain self-regulating and self-adjusting mechanisms; the type of capitalistic promises never materialized.

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