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Islamic Banking and the Conduct of Monetary Policy

Lessons from the Islamic Republic of Iran

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ABSTRACT

Following its Islamic revolution of 1979, the Islamic Republic of Iran has undergone a comprehensive reform of its once traditionally interest-based banking system to conform to interest-free banking principles. This article begins with a review of the stated duties of the banking system under the Iranian Islamic banking laws; it then surveys authorized banking facilities and means and methods of providing credit in the country. Various instruments of monetary policy as employed in the I.R. Iran are also discussed. These include those instruments common to both traditional and Islamic systems, and those instruments of monetary policy unique to an interest-free system. The paper concludes with a discussion of common modes of bank financing in the Iranian model, exploring ways in which the central bank may use these modes of financing to conduct economic policy.

I. INTRODUCTION

Islamic banking prohibits the payment of a predetermined interest. This leads to a seemingly valid question as far as monetary policy is concerned: how would the monetary authorities exert control over the banking system without the interest mechanism?

> "With the elimination of interest from all banking operations, one of the most basic policy instruments is out of the domain of the monetary and credit authorities. In the traditional banking system, any change in interest rates by the central bank, more or less, would lead to a similar change in the market rates of interest in general and the banks' rates of interest in particular. In the absence of interest, the monetary authority, in addition to classical instruments of monetary policy must rely on a few distinct but inter-related instruments such as the minimum expected rate of profit, profit ratios, and profit margins to influence the economy."[i]

This article aims to address the means of monetary policy available to the central bank in the absence of the interest rate mechanism. The paper begins with a brief introduction to the concept of Islamic banking and presents the Islamic alternative—the profit-and-loss-sharing scheme. Various instruments of monetary policy are then discussed, including those instruments common to both traditional and Islamic systems, and those instruments of monetary policy unique to an interest-free system. The paper concludes with a discussion of common modes of bank financing with which the central bank in an Islamic system may supplement monetary policy tools in conducting economic policy.

II. BANK REGULATIONS IN IRAN[ii]

In the Islamic Republic of Iran, the *Law for Usury-Free Banking* was passed by the parliament in August 1983, defining the objective of the banking system as "the establishment of a monetary and credit system based on rightness and justice as delineated by Islamic jurisprudence for the purpose of regulating the sound circulation of money and credit to enhance the health and growth of the country's economy."[iii] Additional objectives of the banking system are stated as the employment of appropriate monetary and credit mechanisms to achieve the government's economic goals, policies, and plans; the creation of facilities necessary for the public extension of cooperation and *Quard al-Hassana*; the attraction and absorption of surplus funds, reserves, savings and demand deposits; the maintenance of the currency value along with equilibrium in the balance of payments; and the facilitation of commercial exchanges.

The law goes further to define the duties of the banking system as a whole to include such traditional functions as issuance of notes and coins, regulation, control and guidance of the circulation of money and credit, performance of all banking operations in foreign exchange and local currency, and the implementation of monetary

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and credit policies. In addition, the banking system is made responsible for the opening of various *Quard al-Hassana* accounts, acceptance of term investment deposits, and the distribution of loans and credits free of interest charges.

A. Authorized Banking Facilities

To promote the activities of various productive, commercial and services sectors, banks may provide a portion of the capital and/or resources required by these sectors on a partnership basis. They may directly invest in productive and development projects or activities as long as the evaluation of the project indicates no loss. Banks, however, are not allowed to invest in the production of luxury and non-essential consumer goods. In addition, to provide facilities required for the expansion of commercial activities, banks may put the necessary financial resources at the disposal of the customers on the basis of *Muzara'a*. They, however, may not enter into a *Muzara'a* contract with the private sector for imports.

In promoting the expansion of industry, mining, and agriculture, banks are empowered to purchase movable properties and to sell them to customers on a secured basis and on installment terms. Banks may additionally purchase either movable or immovable properties and place them at the disposal of the client in accordance with hire-purchase arrangements. Similarly, for the purpose of providing facilities necessary for the expansion of housing activities, banks may be involved in the construction of low-priced residential units for sale on installment or hire-purchase.

Provision of working capital needed by the productive units is allowed through banks' purchases of raw materials and spare parts needed by productive units and their resale to the said units on credit, and on the basis of forward purchases of the said units' easy-to-sell products. Finally, banks are obliged to provide a portion of their resources as *Quard al-Hassana* to applicants. The procedures for enforcement of this requirement are determined by the central bank of Iran—Banke Markazi—and must be approved by the Council of Ministers.

Banks may engage in authorized banking operations with state-owned institutions, government-affiliated organizations, and public corporations. In its dealings with other banks, Banke Markazi is not authorized to engage in banking operations that involve usury, nor are banks to do so among themselves. Any funds received as commissions and fees constitute a bank's income and cannot be divided among the depositors. Exemption from commercial tax, and/or tax exemptions granted by law to factories and productive enterprises also apply to banks when they act as agents in matters of import or ownership.

B. Mobilization of Financial Resources

General liabilities of a bank comprise *Quard al-Hassana* with no accrued returns, and Term Investment Deposits. Banks are authorized to accept two types of term investment deposits: short-term investment deposits, which enable the depositors to use their funds as they wish; and long-term investment deposits, which based on the stipulated incentives for such deposits must be placed with the bank for at least one year. These deposits, over which the bank enjoys the power of attorney, must be used in joint ventures, *Muzara'a*, hire-purchases, installment transactions, *muḏāraba*, *Musqat*, direct investment, forward dealings, or *Jo'ala* transactions.[iv]

Accrued profits resulting from a bank's credit operations may be divided between depositors and the bank in proportion to duration and amount of term investment deposits, and with due observance of the bank's share of resources in total funds utilized for such operations. However, banks may not announce or pay any pre-determined sum as profit to any term investment deposits. For the acceptance of the term investment deposits, banks may receive attorney's fees from the depositors' share of the profits, based on maximum and minimum rates dictated by the Currency and Credit Council. To attract such current and saving deposits, banks may in turn offer incentives such as non-fixed prizes and bonuses in cash or in kind, discounted commissions or fees, and priority in use of banking facilities.

C. Methods for Provision of Credit Facilities

Provision of credit facilities out of the deposits received by banks can be based on one of the following methods: partnership (civil and legal), direct investment, *muḏāraba*, installment sales, hire-purchase, sales on credit, forward delivery transactions, *Quard al-Hassana*, *Jo'ala*, *Muzara'a*, and *Musqat*. Moreover, credit facilities must be provided in such a manner that the principal amount as well as any expected profit be returnable within a specific period of time. The determination of the minimum and maximum rates of profit and/or of the expected rate of return on the credit facilities provided by banks is a matter of government policy. The determination of the period over which banks provide credit facilities and the details of the return of the principal together with any profits are similarly approved.

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Banks must supervise the proper performance of the concluded contracts with regard to both the procedures of utilization and the return of credit facilities provided. The provision of facilities is contingent upon a sum of money entitled "Advance Deposit," the determination of which depends on sufficient security to safeguard the interest of the bank and the satisfactory performance of the respective contracts. When dealing with properties that, in the opinion of the bank, have limited, exclusive, or sub-economical utilization, the bank can grant facilities after taking additional security.

Finally, the joint provision of credit facilities by two or more bank to individuals or to legal entities is authorized under any one of different types of facilities. The administration of such facilities would be undertaken by one bank as chosen by the participating banks. During the term of the contract, banks must arrange for the annual insurance of properties and/or the securities obtained in respect thereof, for an amount at least equivalent to the outstanding balances due from the provision of such facilities.

III. THE CENTRAL BANK AND THE CONDUCT OF MONETARY POLICY

Monetary authorities operating under the Islamic banking system must continue to have regulatory powers over the banking system and financial operations in the economy. In order to ascertain the allocation of resources in conformity with the priorities of the society, and to direct monetary policy toward specific areas of activities and other policy objectives, the central bank should retain control of high-powered money and the money-creating ability of banks. Under an Islamic banking system, where interest as a classical instrument is removed from the banking system, such objectives may be achieved both through general instruments of monetary policy as known in traditional banking, and certain other instruments applicable to profit-and-loss-sharing activities.

A. Islamic Banking and Traditional Instruments of Monetary Policy

Imposing reserve requirement against private bank deposits and various other liabilities does not violate the requirements of Islamic banking. The central bank could impose such an obligation on banks in order to execute its control over monetary expansion through the absorption of banks' resources, which could otherwise be used for the expansion of credit. In Iran, the required reserve ratio of "no less than 10 and no more than 30%," in effect since 1972, remained effective even after the metamorphosis of the traditional banking system in 1980. Some Iranian economists have even proposed a 100% reserve requirement ratio against demand deposits of the private sector, hoping that fluctuations of the rate of profit in the usury-free banking operations would not weaken the payment system.[v]

Open-market operations may be considered the most important monetary policy instrument in countries with a well-developed financial market. This instrument, however, cannot be used effectively in countries where financial markets are still undergoing development unless some adjustments are made in its execution. In Iran, to conform to Islamic banking principles and to avoid pre-determined interest payments, investment deposits may only be utilized through Islamic contracts, after deducting required reserves. It is nevertheless compulsory for banks to hold government securities against certain liabilities. The problem is that while the charging and payment of interest among government entities is not considered *usury* and is permitted, any financial contract between government and the public must be based on profit-and-loss-sharing principles. As such, the public can finance only profitable government projects, and in the case of private banks only this form of financing is possible.

Under an Islamic banking system, the central bank remains the lender of last resort and should be able to provide any required liquidity in case the need arises and banks find themselves in need of liquidity. Nevertheless, discount rate policy is not broadly applicable in Islamic banking as it is in the traditional banking system. Discounting true bills, issued based on a real transaction, however, is permissible under the *sharīᶜa*; this instrument is applicable in an Islamic banking system with certain qualifications. Since any changes in the terms and conditions of extending such facility would have an impact on the monetary conditions of the economy, it is used as an instrument of monetary policy under Iran's Islamic system of banking.

Imposing credit ceilings is another effective instrument in the execution of monetary policy and in directing credit to desired areas. In Iran, Banke Markazi imposes ceilings on the growth of credit and limits facilities extended to the whole or certain sectors of the economy, in order to prevent the total credit, and thus the money supply, from exceeding the target level. Additionally, to abide by the priorities set in the economic plan, the central bank uses this instrument in allotting credit and facilities to different sectors of the economy. Although this instrument could be quite effective in controlling liquidity and allocation of credit according to priorities set, it has proven difficult in Iran to supervise banks to ensure their observance of the regulations. In fact, lack of appropriate supervision could leave the goal of the policy-maker unachieved.

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B. Instruments of Monetary and Credit Policy Unique to Islamic Banking

Under the banking laws of Iran, several methods may be, and are, used in providing credit facilities. They are divided into two broad categories: first, the instruments that implement the policies of Banke Markazi by increasing and decreasing the volume of savings, primarily aiming to increase *Quard al-Hassana* deposits. These monetary policy instruments include prizes and rewards granted in relation to interest-free deposits, discounts, or the exemption of holders of these accounts from banking charges and/or commission fees, and required reserve ratios.

Adjustments in reserve ratios complement the instrument of commission fees for managing the deposits through regulation of the volume of deposits. For example, as the profit paid to investment depositors is determined after making allowances for the required reserves on such deposits, the higher the reserve ratios on investment deposits, the lower the profit payable to the depositor. This would clearly decrease the willingness of depositors to place funds in such accounts. Of course, the lower the reserve ratios, the higher the profit payable to depositors and the higher the volume of investment accounts.

Granting prizes and other advantages for attracting *Quard al-Hassana* deposits can be a very flexible instrument for absorption of savings. It is accepted, however, that the speed and effectiveness of these instruments in drawing savings might be slower than that of the interest rate mechanism. Moreover, changes in the rate of interest and its effect on deposits may be more definite and can be calculated, while changes in the amounts of interest-free deposits are not foreseeable and the evaluation of its effects on depositors is difficult.

The second category of Islamic monetary policy instruments used in Iran is that which influences the volume of credit facilities: determining the minimum and/or maximum ratios of profit for banks with respect to *murābaẖa* and *mushāraka* transactions; determining the minimum rate of expected return (profit) for *muḏāraba*, *mushāraka*, Direct Investment, *Muzara'a* and *Musqat* transactions; and determining the minimum and maximum margins of profit as a proportion of the cost of goods transacted by the bank in installment sales and hire-purchase transactions.

The "profit ratio" is the bank's share of actual profits derived from transactions on credit facilities extended by the bank. Such ratios differ depending on the field of activity and according to the priority set by monetary authorities, and are determined, as a rule, before the extension of credit. As an instrument of monetary policy, the increase or decrease in the profit ratio would influence the demand for utilizing this kind of facility.

The "minimum expected rate of return" or the yield is the expected profit during a specified period derived from credit facilities extended, and is forecasted and computed prior to actual extension of credit. The minimum expected rate of return could help determine the best form of investment if banks sort their various investment potentials according to this criterion. The demand for credit facilities is also effectively categorized upon examining these ratios. The yield, of course, varies for different types of economic activities, and as a monetary policy instrument is considered a proper means for evaluating and selecting suitable investments in Iran.

It is possible to imagine that increasing the rate of expected return would decrease the potential propensity to invest. However, a number of investment projects that need to use the banks' credit facilities but because of high costs and low efficiency do not have good return prospects, may have no option except to correct their planning and to increase efficiency. Therefore, when a project is selected according to the minimum expected rate of return, in addition to implementing monetary policy by Banke Markazi, the economic efficiency of the Iranian society may also be increased following the improved efficiency of the economic units that demand banking facilities.

Finally, the "margin of profit" is the profit resulting from transactions involving banking facilities as a proportion of the price of goods or services thereof. Since, according to Iran's banking laws, the profit of banks in these types of transactions is directly added to the final price of goods, changes in the profit margin would influence the demand for these credit facilities and its expansionary or contractionary effects would help achieve the goals of monetary policy.

The role of these three instruments in implementing monetary policy encompasses credit rationing. Determining the expected rate of profit or banks' profit margin in various contracts, for example, would impact the distribution of credit and facilities among various sectors of the economy. Neither general economic growth nor sectoral growth would be achieved were the cost of funds to the client to exceed the nominal return in the economy in general, or in particular sectors. Determining the rates would require a thorough understanding of the economy in general and its various sectors. Otherwise, allocation of resources among different sectors of the economy should be left to market mechanisms.

Moreover, since a project could be financed through various methods, in determining the profit margin, Banke Markazi should verify that the minimum cost of funds for the borrower is such that the profitability of the project is the same under all modes of financing. A project in the commerce and services sector, for example, may be financed either through *muḏāraba* or Civil Partnership, and discrepancies in the profitability between the two modes of financing would promote one over the other.

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Another important issue—the impact of changes in the central bank's instruments on monetary parameters and the economy in general, as well as the way and the extent to which these instruments should be used in implementing monetary policy—must be carefully considered. Specifically, in determining the expected minimum rate of profit or the banks' percentage share of the profit, Banke Markazi should consider costs associated with each different type of contract and within different sectors of the economy. This is particularly important when there are certain other non-bank charges such as registration and specific tax charges. It is therefore useful to examine the common modes of bank financing operation in Iran.

1. Installment Sale and Hire-purchases

In a country like Iran where some sectors of the economy face limits in credit expansion, assigning different minimum expected rates of profit to various sectors based on the marginal rate of return of capital in each sector could be the remedy. Determination of the minimum and maximum rate of profit in an installment sale contract would be justified only if there was good reason to believe that the equilibrium rate is somewhere between these two limits. If even at the maximum rate assigned to a sector, the demand for financial facilities exceeds the supply of funds, the result would be a misallocation of resources along with reduced profitability of banks which itself is to the disadvantage of depositors. Therefore, in the Iranian system of credit rationing, the rate applied to each sector is determined in accordance with the profitability of that sector and regardless of the rate in other sectors.

Machinery and tools may also be financed through hire-purchase contracts. If the minimum and maximum rate of profit of a bank is the same for either of the two types of contracts, and if the amount of down payment for hire-purchase contracts is higher than the down payment in installment sale contracts, the latter would be favored. Even under equal conditions, the desire for ownership might make installment sale contracts more appealing to clients.

From a policy perspective, as long as there is an excess demand for bank facilities in a particular sector, with an increase in the minimum expected rate of profit, and accordingly the maximum rate, more profitable projects would be financed and implemented without having any impact on the total credit extended to the sector. When Banke Markazi intends to extend the volume of credit in a sector, a credit ceiling and the minimum expected rate instruments are used simultaneously. Variation in the amount of down payment would also have an impact on the allocation of credit. For instance, an increase in the amount of down payment would direct the credit toward clients with better financial positions, and thus, would narrow the number of applicants for such facilities.

2. *Muḏāraba*

Muḏāraba is a mode of financing that, according to Iran's Islamic banking principles, is applicable only to commerce. The central bank may influence *muḏāraba* contracts either by imposing a different minimum expected rate of return or by varying the banks' share from profits. Banke Markazi of Iran currently specifies only the minimum expected rate of profit and leaves it to banks to determine their share from accrued profit. As *muḏāraba* contracts are regarded as the preferred source of financing for commercial activities in Iran, the minimum expected rate of profit of banks in such contracts is regarded as the base rate for all commercial activities and relevant rates in other modes of financing are determined accordingly

Although in a system based on credit rationing, the expected rate of return should be used for optimum allocation of resources in each sector, to avoid an increasing rate of inflation the cost of facilities may be fixed at a lower level than equilibrium rate of profit. Since the cost of bank facilities are not pre-determined for the client and will be determined and paid only after the completion of the project, it should not be considered a cost and, thus, not be reflected in the price. Consequently, an increase in the expected rate of profits by banks should not cause an increase in prices.

Upon identifying the equilibrium rate of profits, Banke Markazi, may and does use both instruments foreseen in this mode of financing, given their differing impacts on financial conditions. With the fixed share of profit for banks, an increase in the minimum expected rate of profit would imply only the implementation of those projects with higher rate of return. The demand for funds in commerce sector will fall as a result. On the other hand, given the minimum expected rate of profit, increases in the profit share of banks results in a reduction in the client's share of the profit as a percentage of the capital. When and if the rate of unemployment is high and the opportunity cost of the labor force is low, an increase in the banks' share of profit may not cause a reduction in demand for funds. Otherwise, it will reduce the activities of and the demand for financial facilities in commercial sector.

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3. Civil Partnership

Quite often, Civil Partnership contracts rank second among facilities extended by Iranian banks—up to 18% of total facilities of commercial and specialized bank have been, at times, extended through this mode of financing. According to Iranian laws, banks are allowed to participate in Civil Partnerships in productive, commercial, and services activities. For this mode of financing, the Money and Credit Council determines the minimum and/or maximum share of profit for banks. Regulations limit the maximum participation of banks in each partnership contract to 80% of total required capital, with the client providing at least 20%.

IV. Discussion and Conclusions

Following the substitution of Islamic banking system for traditional banking and the elimination of interest as a monetary policy instrument, practical issues surrounding the central bank's responsibility for monetary policy need careful examination. While in principle the central bank may continue to play the same role in regulating banking and financial transactions, there are certain issues that should be considered. For example, could the central bank conduct effective open-market operations with securities not paying explicit interest? Or should Islamic banks have the same pattern of reserve requirements as those of other banks?

In addition, if the economy suffers from imbalances in different sectors and credit rationing is used to correct them, it would be necessary to use other instruments in addition to the general instruments of monetary policy. Coordination among these instruments is more complicated than simply setting the rate of interest under traditional banking. Moreover, although implementation of credit ceilings is not a requirement in Islamic banking, it is not in contradiction with it either, and in certain cases it could play a vital role in money and credit control.

In using instruments such as the minimum expected rate of profit and the share of banks' profit, it is important to try to determine the minimum cost of funds to clients in different sectors of the economy. It is obvious that a sectoral approach to the economy stems from certain biases toward various economic sectors. In the case where the rate of profitability is low in the favored sector, either a subsidy should be paid to its products, or it should be provided with cheap financial facilities. In the latter case, the cost of funds should be determined according to the marginal profitability (rate of return) in the sector.

In the application of different instruments available to monetary authorities, credit ceilings determine the volume of private investment financed by the banking system on the one hand, and control the growth of liquidity on the other. The expected rate of profit in different contracts and share of banks from profits should only be used for efficient allocation of resources within the sectors in order to prevent further inefficiencies. In cases where banks are faced with scarce or excess resources, the central bank could use other instruments to absorb or free bank reserves.

Another constraint on the successful implementation of an Islamic banking system, and in conducting monetary policy under such a system, is the lack of appropriate non-interest-based investments for financing budget deficits, especially since the government may account for a major component of demand for credit. In Iran, financial transactions between the public sector agencies, private enterprises, and nationalized banks take place on the basis of a fixed rate of return, which indeed is considered interest. The Iranian government may borrow from the nationalized banking system without violating the interest-free banking principle for the stated reason that such amounts are ultimately posted to government revenues on one hand and its expenditures on the other and, consequently, have no bearing whatsoever on the government resources.

The more reasonable solution to this problem requires work on certain inter-related fronts, including greater emphasis on fiscal policy based on Islamic precepts, which require the government to justify and rationalize all its expenditures, and on ensuring appropriate tax structures so as to discourage tax evasion. This should go hand-in-hand with steps aimed at resolving technical difficulties in developing and putting into operation new financial instruments designed specifically for an Islamic type financial system. Only then may government borrowing take place at a non-fixed rate of return basis.

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[i] Maysami, Ramin Cooper. "Islamic Banking." SES Journal 25(8) (August 1997). pp. 54-59.

[ii] For a complete introduction to the banking law of Iran, see Maysami, Ramin Cooper, H. Golriz, and S. A. Hedayati. "Pragmatic Interest-Free Banking: Metamorphosis of the Iranian Financial System." Journal of International Banking Law 12(3) (March 1997). pp. 1-6.

[iii] "The Law of Usury-Free Banking." Objectives and Duties of the Banking System in the Islamic Republic of Iran. Chapter 1, Article 1, Clause 1.

[iv] As specified in the glossary to "The Law of Usury-Free Banking," *Jo'ala* is the undertaking by one party to pay a specified amount of money to another party in return for rendering a specified service in accordance with the terms of the contract. *Musqat* is a contract between the owner of an orchard or garden with another party for the purpose of gathering the harvest of the orchard or garden and dividing it, in a specified ratio, between the two parties. *Muzara'a* is a contract wherein the bank turns over a specified plot of land for a specified period of time to another party for the purpose of farming the land and dividing the harvest between the two parties at a specified ratio. *Muḏāraba* is a contract wherein the bank undertakes to provide the cash capital and the other party undertakes to use the capital for commercial purposes and divide the profits at a specified ratio between the two parties at the end of the term of the contract.

[v] Khan, Mohsin S. "Islamic Interest-Free Banking: A Theoretical Analysis." International Monetary Fund draft, August 1985.

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