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Islamic Banking: Experiences in the Islamic Republic of Iran and Pakistan

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Abstract

In an Islamic system, as interest is prohibited, banks are expected to operate solely on the basis of profit and risk sharing. This paper describes the developments in Islamic banking in Iran and Pakistan. As these two countries have initiated the most far-reaching experiments with Islamic banking, their experiences have a significant bearing on the feasibility of such a system. The developments in these countries are evaluated against the theory underlying the Islamic banking, and suggestions are made to achieve a more efficient system.

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The purpose of this paper is to describe the developments of Islamic banking in Iran and Pakistan. As these two countries have inititated the most far-reaching experiments with Islamic banking, their experiences, particularly with regard to how the system was introduced and how it has been functioning since its inception, has a bearing on the feasibility of Islamic banking in these and other Muslim countries.

The plan of the paper is as follows. In Section II we describe briefly the main characteristics of an Islamic banking system, looking at both the institutional and theoretical features. The intention is to establish a broad reference point against which developments of Islamic banking in the two countries can be assessed. Section III discusses the progress of Islamic banking, as well as the problems encountered, in Iran and Pakistan since the adoption and implementation of the system. The final section contains some concluding remarks and an evaluation of the experiences of the two countries.

II. The Islamic Banking System

As mentioned above, the principal restriction under which the Islamic financial system must work is the injunction against interest. 1/ However, it is important to note that what is forbidden by Islamic law is the fixed or predetermined return on financial transactions, and not an uncertain rate of return represented by profits. For this reason the modern concept of Islamic banking has developed on the basis of profit sharing. In the last few decades a variety of models of Islamic banking have been proposed, but in general the operations of a typical system would have the following features:

1. Sources of funds

Besides its own capital and equity, the main sources of funds for an Islamic bank would be two forms of deposits--transactions deposits and investment deposits. Transactions deposits are directly related to payments, and can be regarded as equivalent to demand deposits in a conventional banking system. Although a bank would guarantee the nominal value of the deposit, it would pay no return on this type of liability. Investment

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1/ There has been some controversy in the past on whether the Quran's explicit condemnation of "riba" refers to interest or to usury. However, it would be fair to say that by now Muslim scholars are generally in agreement that all forms of interest payments are prohibited, not necessarily only those considered excessive. This particular interpretation is also the one adopted by the policymakers in Iran and Pakistan.

I. Introduction

A central tenet of an economic system based on Islamic principles is the absolute prohibition of the payment and receipt of interest. 1/ It is this prohibition that makes Islamic banks and financial institutions differ in a fundamental sense from their Western counterparts. As the use of the interest rate in financial transactions is precluded, Islamic banks are expected to conduct operations only on the basis of profit-sharing arrangements or other modes of financing permissible under Islamic law.

At present about 45 countries, encompassing most of the Muslim world, have some type of Islamic banking or financial institutions. This development, which has gained momentum since the second half of the 1970s, has basically taken two forms. The first has been an attempt to establish Islamic financial institutions side-by-side with traditional banking. In such attempts, two types of institutions have evolved: Islamic banks established mostly in Muslim countries, and Islamic investment and holding companies operating in some Muslim but mostly in non-Muslim countries. In both cases, generally, the banking operations of Islamic banks are subject to specific regulations that apply to all banks. Examples of Islamic banks are the Faisal Islamic Banks in Egypt and the Sudan, the Dubai Islamic Bank and the Jordan Islamic Bank. Examples of investment companies having either a national or international mandate include the Darul Mal Al-Islami (Geneva), the Islamic Investment Company (Bahamas), and the Bahrain Islamic Investment Bank. These institutions compete with conventional banks to attract deposits--but without paying a predetermined interest rate--and invest these funds wherever they find profitable investment opportunities. The majority of these institutions were established through private initiatives.

The second form has involved an attempt to restructure the whole financial system of the economy to accord with Islamic concepts. This has taken two directions, one in which the entire economy and its institutions, including financial, are transformed into an Islamic one, as in the Islamic Republic of Iran, and the other where Islamization of the economy is undertaken through a gradual process beginning with the banking sector, as in Pakistan.

1/ Islamic law (Shariah) lays down a set of well-defined rules governing economic behavior and relationships. These include, apart from the prohibition of interest (the Arabic term is "riba"), rules covering individual and property rights; buyer and seller behavior in the market; the right and enforceability of contracts; and the role of the state. For descriptions of the Islamic economic system see Mirakhor (1987a) and Pryor (1985).

Contents

deposits constitute the principal source of funds for banks and they more closely resemble shares in a firm, rather than time and saving deposits of the customary sort. The bank offering investment deposits would provide no guarantee on their nominal value, and would not pay a fixed rate of return. Depositors, instead, would be treated as if they were shareholders and therefore entitled to a share of the profits, or losses, made by the bank. The only contractual agreement between the depositor and the bank is the proportion in which profits and losses are to be distributed. The share (distribution) parameter has to be agreed in advance of the transaction between the bank and the depositor, and cannot be altered during the life of the contract, except by mutual consent.

2. Asset acquisition

The bank can acquire profit-sharing assets via two principle modes of transactions: mudarabah and musharakah. Under the provisions of the first mode, surplus funds are made available to the entrepreneur to be invested in a productive enterprise in return for a predetermined share of the profits earned. 1/ Financial losses are born exclusively by the lender. The borrower, as such, loses only the time and effort invested in the venture. This arrangement, therefore, effectively places human capital on par with financial capital. In musharakah, on the other hand, there is more than a single contributor of funds. All parties invest in varying proportions and the profits (or losses) are shared strictly in relation to their respective capital contribution. This financing method corresponds to an equity market in which shares can be acquired by the public, banks, and even the central bank and the government. Traditionally, mudarabah has been employed in investment projects with short gestation periods and in trade and commerce, whereas musharakah is used in long-term investment projects. These two modes have their historical counterparts in farming (called muzar'ah) and in orchard keeping (called musaqat), where the harvest is shared between and among the partners based on prespecified shares.

In transactions where profit sharing is not applicable other modes of financing can be employed which include:

(i) Qard al-Hasanah (beneficience loans)

These are zero-return loans which the Quran exhorts Muslims to make available to those who need them. Financial organizations that provide

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1/ This financial mode of transactions was given the name "Commenda" by the Scholastics; see Mirakhor (1983).

these loans are permitted to charge the borrower a service charge to cover administrative costs of handling the loan so long as the charge is not related to the amount, or the time period of the loan, and represents solely the cost of administering the loan.

(ii) Bai' Mua'jjal (deferred-payment sales)

This mode allows the sale of a product on the basis of deferred payment in installments or in a lump-sum payment. The price of the product is agreed to between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

(iii) Bai' Salam or Bai' Salaf (purchase with deferred delivery)

In this transaction the buyer pays the seller the full negotiated price of a product which the seller promises to deliver at a future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made, i.e., agricultural and manufactured products.

(iv) Ijara (leasing)

In this transaction, a person leases a particular product for a specific sum and a specific period of time. He can also negotiate for lease-purchase of the product, where each payment includes a portion which goes toward the final purchase and transfer of ownership of the product.

(v) Jo'alah (service charge)

This is a transaction in which one party undertakes to pay another a specified sum of money as a fee for rendering a specific service in accordance with the terms of the contract negotiated between the two parties. This mode facilitates consultation, fund placements, and trust activities.

The above list is by no means exhaustive. Under Islamic law the freedom of contracts provides the parties with a flexibility which makes possible a virtually open-ended menu of various forms of financial transactions and instruments. There is nothing to constrain the system from creating any contractual form so long as the contract does not include interest and both parties are fully informed of the details of the contract.

The replacement of an interest-based banking system by an alternative system that relies primarily on profit-sharing arrangements raises a number of fundamental theoretical and practical questions. Among the most important of these are: First, how will an Islamic banking system function? Second, what would be the effects of adopting such a system on the economy, and in particular on macroeconomic variables like savings and investment? And third, what role, if any, would monetary policy play in the Islamic system?

Research on these types of questions is still in its very early stages. Nevertheless, in recent years there have been a number of studies that have attempted to conceptualize the basic ideas underlying Islamic banking, as well as the likely consequences that would follow from the institution of this system. 1/ Taking the view that the reliance on profit-sharing arrangements makes the Islamic system akin to an equity-based system, relatively straightforward theoretical models have been developed analyzing the workings of the system. 2/ In these models, depositors are treated as shareholders (as in a mutual fund or investment trust, for example) and banks provide no guarantee on the rate of return or the nominal value of shares. Symmetrically, banks themselves become partners with the borrowers and accordingly share in the returns obtained from the borrowed funds. An interesting result to emerge from such models is that the Islamic system may be better suited than an interest-based banking system to adjust to shocks that can lead to banking crises. In an equity-based system shocks to the asset positions of banks are immediately absorbed by changes in the nominal value of shares (deposits) held by the public in banks. Therefore, the real values of assets and liabilities would be equal at all points in time. In the conventional banking system, since the nominal value of deposits is guaranteed by the bank, an adverse shock to assets of the bank can create a divergence between real assets and real liabilities--leading possibly to negative net worth for the bank--and it is not clear how the disequilibrium would be corrected and how long the process of adjustment would take.

The elimination of a risk-free asset with a positive predetermined return is expected to have significant consequences for savings, investment, and financial development, as well as for the conduct of monetary policy. For example, there is a presumption that the removal of a fixed interest rate increases uncertainty, which in turn would reduce savings and make lenders worse off. 3/ However, this will depend on the behavior of financial rates of return in the economy. Models that allow for variations in rates of return as well as in risk derive the basic condition that has to be met in order for savings to decrease as risk increases. This condition requires that the rate of return on the asset must not be higher after the increase in uncertainty than it was before it if savings are to fall. If the rate of return also increases as risk increases, then savings may in fact rise. Serious issues also arise in the area of investment as the adoption of a profit-sharing arrangement between lender, i.e., the bank, and investor may raise monitoring costs and discourage

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1/ See the papers contained in Khan and Mirakhor (1987). Other relevant papers include Iqbal and Mirakhor (1987) and Mirakhor and Zaidi (1988).
2/ See Khan and Mirakhor (1987).
3/ See Pryor (1985).

investment. To avoid this adverse effect, and moral hazard issues that arise when the lender and investor have diffferent information on the profits from the investment, requires the implementation of a legal and institutional framework that facilitates appropriate contracts. The form of these contracts, and the mechanism for enforcing them, still need to be spelled out. Insofar as monetary policy is concerned, the central bank would lose the ability to directly set financial rates of return in an Islamic banking system. However, theoretical work has shown that indirect methods through control of credit extended by banks, reserve requirement changes, and varying of profit-sharing ratios, can achieve similar results for monetary policy to those in a conventional interest-based economy.

In summary, while there have been significant advances in the development of the theoretical foundations of Islamic banking and finance, many important issues are as yet unresolved. For example, the role and conduct of fiscal policy, and particularly the financing of fiscal deficits, is as yet undefined. Nor has there been much attention paid to exchange rate and trade policies, and foreign debt questions. It is clear that even if countries fully re-orient their economies along Islamic concepts, the fact that these countries must co-exist with non-Islamic countries raises a variety of issues that have a significant bearing on foreign economic relations.

At present, aside from theory, there is also a serious lack of systematic empirical evidence on how an Islamic banking system functions. This is understandable as the experience with such a system is very short. We turn now to a description of the experience of the two countries that have proceeded the furthest in implementing the Islamic financial system.

III. The Experiences of Iran and Pakistan

Due to the fact that these are the only two countries in the Muslim world to have replaced interest-based banking with Islamic banking it would seem convenient to analyze their experience jointly. While the two share the same objective, there are however significant differences in their approach to introducing Islamic banking. Pakistan's approach has been cautious and deliberate, 1/ but in Iran, on the other hand, the Islamic Revolution permitted a very rapid process of Islamization. Hence, despite the similarities, the implementation of Islamic banking has in fact been quite different in these two countries. For this reason the experience of Iran and Pakistan with Islamic banking will be treated separately here.

1/ Ahmad (1987).

1. Islamic Republic of Iran

Briefly, the process of Islamization of banking system in Iran has gone through three distinct phases. In the first phase (1979-82) the banking system was nationalized, 1/ restructured, and reorganized in order to remove the weaknesses of the inherited system. 2/ External and internal developments in this phase did not allow the policymakers to develop a coherent plan for Islamization of the banking system, although various piecemeal attempts were made toward this objective.

The second phase began in 1982 and lasted until 1986. In this phase a legislative and administrative quantum leap was made in adopting and implementing a clearly articulated model of Islamic banking. 3/ The Law for Riba-Free Banking was passed in August 1983, giving a very short deadline of one year to the banks to convert their deposits in line with Islamic law and their total operations within three years from the date of the passage of the Law. 4/ During this phase the central bank was implicitly envisioned as a quasi-independent economic institution similar to that in most western banking systems, with considerable degree of autonomy from the rest of the government. As in other countries, the central bank exercised extensive control over the operation of individual banks.

The third, and the current phase which began in 1986 defines a role for the banking system different from the earlier phases in that the system is now expected to be an integral part of the Islamic government, and thus a direct instrument of its policies. This development is a direct result of the political debate within Iran surrounding the proper role of the government in an Islamic economy. This debate culminated in a recent ruling by Imam Khomeini which confirmed a highly activist role for the central government in shaping the structure of the Iranian economy and legitimized a trend in the interventionist posture of the government vis-a-vis the economy. 5/ This ruling also indirectly affirmed the use of the banking system as an instrument for promoting social and economic development.

1/ There is no hard evidence from Islamic Law suggesting the necessity of nationalization of the banking system. Although both Iran and Pakistan have nationalized their banking system, this has to do with perceived national priorities rather than being a necessary prerequisite for Islamic banking.

2/ See Iqbal and Mirakhor (1987).

3/ See Iqbal and Mirakhor (1987).

4/ See Iqbal and Mirakhor (1987), Appendix, pp. 31-43, for the details of this Law.

5/ See Petrossian (1988).

Much of the trend in Islamic banking in Iran has been influenced by factors which have their roots in the pre-revolutionary economic structure, as well as post-revolutionary external and internal political developments. The post-revolution economy had inherited a host of difficult economic problems. Before the revolution, the Iranian economy had become highly dependent on oil revenues as well as on the imports of raw materials, intermediate goods and food. 1/ The industrial sector was organized without due attention paid to efficiency or comparative advantage and with very weak forward and backward linkages to the rest of the economy. The agriculture sector, which was producing surplus commodities up until late 1960s, began to contract and there was a massive migration of farmers into the cities. Poor economic planning, influx of enormous oil revenues, and a rapid increase in government expenditures stimulated the growth of a private sector enjoying import controls, exclusive licenses, low-interest loans, and low taxes on profits. The result of these policies was that at the time of the revolution Iran had a private sector which had a perception of its role in the economy quite different from that envisioned by the Islamic leadership of the country.

The revolution brought with it a host of economic problems including, inter alia, massive capital flight, which almost led to the collapse of the banking and financial system. 2/ The problems began to multiply for the economy at a rapid pace as the revolution took roots. The economy, already vulnerable to internal and external shocks, faced the freezing of foreign assets, economic sanctions, interruptions in production, the influx of nearly two million Afghan refugees, the war with Iraq, and drastic reductions in oil revenues. 3/ Concurrently, the constitution of the Islamic Republic specified objectives for the economy to be pursued--such as income redistribution, self-sufficiency in production, strengthening of the agriculture sector, creation of an active cooperative sector in the economy, and reduced reliance on oil revenues--all of which required fundamental restructuring of the society's economic behavior and institutions. The fall in oil revenues, plus the political objective of non-reliance on external financial resources, inevitably meant that the banking system would have to be relied upon to play a role far broader than that of pure intermediation.

The banking sector has been used as an instrument of restructuring the economy--away from services and consumption toward production--in four ways. First, credit to the service sector, which constituted some 55 percent of the GDP (1984-85), has been drastically reduced to halt its expansion in the short-run and curtail its size in the medium-term. This policy went into effect during the second phase and has been continued

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1/ See Katouzian (1981).
2/ Bank Markazi Jomhouri Islami Iran (1984).
3/ See Behdad (1988).

in the later phase. Second, bank credit has been used to encourage the growth of the agriculture sector by using all available modes of Islamic finance to help farmers to improve and expand production. Coupled with substantial government subsidies for seed, fertilizer, machinery, and crop insurance, the credit policy of the banking system is aimed at reviving the agricultural sector. This policy was initiated during the first phase and strengthened in the later phases. Third, Islamic banking has been used to create incentives for the development of a cooperative sector spanning agriculture, industry, and trade. 1/ Cooperatives are given priority in credit allocation and in direct investment as well as in musharakah financing by the banking sector. At the present the Central Bank has devised a plan under which it will provide nearly all the needed finance, in the form of venture capital, for "innovative" industrial projects prepared by cooperatives. Priority for complete financing by the banking system is given to cooperative ventures with projects promising "domestication" of imported technology. Fourth, the banking system, in partnership with the government, undertakes to finance large industrial projects and investment in social overhead capital. 2/

The pattern of consumption and production in the economy has been affected by the banking system, not only through reduction of credit to the service sector and increased credit availability to the agriculture sector, but also through severe curtailment of credit to the producers and importers of luxury goods, while simultaneously expanding credit for the production and importing of necessary and intermediate products. 3/ The banking system also has been used as an instrument of income redistribution through provision of Qard al-Hasanah loans for the needy, financing the building of low-income housing, and provision of financing for small scale agro-business and industrial cooperatives often without stringent collateral requirements. Additionally, the banking system has financed government deficits, which obviously have distributional impacts. It is clear that with reduction of oil revenues from 27 percent of the GDP in 1977/78 to only 4 percent in 1986/87, the banking system has been a major source of finance for achieving many of the social and economic goals of the Islamic revolution. This active role of the banking system, moreover, is not likely to lose its importance in the medium term.

1/ See Mirakhor (1988).

2/ Examples are the Mubarakah Steel Project and the Tehran Metro System, which were financed jointly by the commercial banks and the government.

3/ The exchange rate system has also been another vehicle through which the importation and production of necessary and intermediate goods have been assisted; see Behdad (1988).

Given the extraordinary circumstances in which the Iranian economy has found itself since the revolution, the performance of Islamic banking since its implementation in 1984 has been remarkably smooth. To evaluate this performance the data for the first full three years of operation of Islamic banking, i.e., 1984-86, will next be considered.

Table 1 shows the various modes that facilitate financing of transactions in each line of economic activity. It must be mentioned that this Table is only suggestive in that a bank can finance a given economic project with any, or a combination, of the permissible modes. For example, the Bank of Industries and Mines, which is an investment bank, breaks down the total financing requirements of a particular project into its various components in accordance with the size of each required amount of financing and with the gestation period. The component is then matched with a particular mode of financing. The objective is to reduce the burden of financing on the profits of the firm. For instance, the working capital requirement of the project may be financed with salaf, machinery with lease-purchase, and production costs with musharakah.

Table 1

Islamic Republic of Iran: Modes of Permissible Transactions
Corresponding to Types of Economic Activity

Type of Activity	Permissible Mode
Production (industrial, mining agricultural)	Musharakah, lease-purchase, Salaf transactions, installment sales, direct investment, Muzara'ah, Musaqat, and Jo'alah
Commercial	Mudarabah, Musharakah, Jo'alah
Service	Lease-purchase, installment sales, Jo'alah
Housing	Lease-purchase, installment, Qard al-Hasanah, Jo'alah
Personal consumption	Installment sales, Qard al-Hasanah

Source: Bank Marakazi (Central Bank of Iran).

Tables 2 and 3 provide information on the assets and liabilities of the banking system since the implementation of Islamic banking. Table 2 shows that the old interest-based deposits have been rapidly converted to the new Islamic modes. What must be noted in Table 2 is that the term "Qard al-Hasanah deposit" is used to denote demand deposits. This use of the term is unique and permits the banks to utilize these deposits as if they were the banks' own resources. They earn no return and are treated as if they are interest-free loans made by the depositors to the banks, with the understanding that the depositors are aware that the bank is using these deposits, but that the depositors can withdraw them at will. The size of deposits in Islamic modes doubled between 1985 and 1986. Both long-term and short-term investment deposits showed a much more rapid growth, with rates of 79 and 170 percent respectively, than the Qard al-Hasanah deposits which increased 21 percent over the same period. The growth of the deposits can be attributed to greater acceptance of Islamic banking by the population and the rapid expansion of banking in rural areas. According to the Central Bank 975 new branches opened in rural areas in 1986/87. 1/ These areas had no access to the banking system previously. Further expansion of the banking system into the rural areas is planned and the Central Bank hopes that much of the 60,000 existing villages can be provided with some banking facilities in the medium term. Table 2 also indicates that credit to the private sector using the new Islamic facilities increased from 754.7 billion Iranian Rials (IRls) to IRls 2,824.6 billion between March 1985 to March 1986; thus, nearly quadrupling its size in one year, while the old interest-based facilities declined by 22 percent over the same period.

Table 3 shows a more detailed picture of the asset side of the banking system. Earlier evaluation of operations of the banking system had raised concerns that profit-sharing modes such as civil partnerships, i.e., short-term and project-specific partnerships, and legal partnerships, i.e., long-term and firm-specific partnerships, were not used as major financing modes. This had led to fears about investment and capital formation because the other modes such as installment purchases are useful for financing primarily trade transactions. 2/ The 1985/86 data shows some improvement in the asset acquisition behavior of the banking system in that all profit-sharing modes, i.e., musharakah, mudarabah, and direct investment, have increased.

Despite these improvements, the trend toward greater utilization of profit-sharing arrangements can be expected to continue to be slow in the near term. Prominent among the reasons are, first, the environment of

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1/ Kayhan (Tehran: November 14, 1987).
2/ See Iqbal and Mirakhor (1987).

Table 2

Islamic Republic of Iran: Position of Banking System vis-à-vis Private Sector, March 1984-1986 1/

(In billions of Iranian rials)

	March 1984	March 1985	March 1986
Private sector deposits	5600.6	5918.3	7960.2
Sight	1955.8	2509	3168.6
Non-sight	3644.8	3409.3	4791.6
Old	3644.8	1087.9	258.3
Savings	2737.3	716.7	--
Time	907.5	371.2	--
New	--	2321.4	4533.3
Qard al-Hasanah	--	780.0	940.6
Term investments	--	1541.4	3592.7
Short-term	--	914.2	2477.0
Long-term	--	627.2	1115.7
Credit to private sector	4256.6	4500.7	5763.5
Loans and Credits (old)	4256.6	3746.0	2938.9
Commercial banks	2819.2	2288.4	1795.3
Specialized banks	1437.4	1457.6	1143.6
New Facilities	--	754.7	2824.6
Commercial banks	--	583.5	2068.6
Specialized banks	--	171.2	756.0

Source: Bank Markazi (Central Bank of Iran)

1/ March is the beginning of the Iranian year. (--) indicates zero.

Table 3

Islamic Republic of Iran: Breakdown of New Banking Facilities, March 1985-March 1986

(In billions of Iranian rials)

	March 1985	In Percent of Total	March 1986	In percent of Total
Lease Purchase	27.9	3.7	22.1	0.8
Installment sale	247.5	32.8	973.8	34.5
Civil Partnership	109.1	14.5	384.2	13.6
Mudarabah	134.6	17.8	508.3	18.0
Salaf transactions	26.8	3.6	99.8	3.5
Joalah	2.4	0.3	35.6	1.3
Legal partnership	37.0	4.9	182.3	6.5
Direct Investment	4.4	0.6	74.4	2.6
Other	1.6	0.2	46.2	1.6
Total trans. affec. profit of invest. deposit 1/	591.3	78.3	2326.7	82.4
Debt purchasing 2/	85.0	11.3	176.5	6.2
Qard al-Hasanah	78.4	10.4	321.4	11.4
Total transactions not affecting profit of investment deposits	163.4	21.7	497.9	17.6
Total transactions	754.7	100.0	2824.6	100.0

Source: Bank Markazi (Central Bank of Iran).

1/ This item indicates that investment deposits have been used in these transactions.

2/ This is the purchase of debt documents of less than 12-months maturity issued in the private sector against real commodities and discounted by the banking system.

uncertainty in the Iranian economy. This is mainly due to the war, but partly also because of government policy toward the private sector. The behavior of the private sector before and immediately after the revolution on the one hand, and expropriations and nationalization undertaken by the post-revolutionary government on the other, have created uncertainty and tension between the government and the private sector. The present policy-makers have on occasion questioned the motives of the private sector, and it was perhaps this apprehension that prompted the government to set up its own distribution centers shortly after the war began, and impose stringent price controls, despite the almost legendary distributional efficiency of the Iranian bazaars. On the other hand, the private sector has, for sometime now, been asking for clear-cut guidance and a legislative mandate specifying the role and scope of the private sector permissible under the constitution. Given the war and, at times, a hostile international economic environment, however, many of the government regulations and rulings affecting the private sector, e.g., price-quantity control regulations, import-export policies and exchange rate regulations, have had to be designed on short-term basis, thus appearing incoherent and at times contradictory to the private sector. This has led the private sector in turn, to initiate very short-term trade and commercial projects with quick payoffs. Although it has a constitutional mandate to do so, the legislature has been unable to forge a consensus on the rights and responsibilities of private property, as well as on the role of the private sector in the economy.

The second major reason for the slow growth of Islamic profit-sharing financing is embedded in the structure of the banking system in Iran. Currently there are six commercial banks and three specialized banks; i.e., the Bank of Industries and Mines, the Agriculture Bank, and the Housing Bank. The specialized banks are well-equipped for the task of project analysis and monitoring, which is a necessary requirement in Islamic banking. Of these, the Banks of Industries and Mines directly affects investment and capital formation in the non-agriculture productive sector and has a long history of financing long- and short-term industrial projects on profit-sharing basis. The law which implemented Islamic banking authorized the commercial banks to engage in profit-sharing financing as well. Although the personnel of these banks have all been trained in Islamic modes of finance, it will take a considerable time before they are able to develop the necessary expertise to engage in profit-sharing financing. In the meantime, however, only the commercial banks are allowed to attract private sector deposits, and the specialized banks receive their deposits from the Central Bank and the government. This has created an acute shortage of funds for the specialized banks, especially the Bank of Industries and Mines, since both agriculture and housing are given priority in credit allocation.

As can be seen from Table 2, in 1985 the specialized banks allocated about 23 percent of the total credit to the private sector. This amount increased by almost 4 percent in 1986. As there is evidence to suggest that there is excess liquidity in the commercial banks, 1/ the question arises as to why the commercial banks could not provide their excess liquidity to the specialized banks on profit-sharing basis for placement. One difficulty is that, contrary to the existing banking law, the commercial banks are allowed to lend their excess liquidity to one another on a fixed rate-of-return basis (6 percent as of September 1988) which establishes a floor for the commercial banks' expected rate-of-return, thus making them reluctant to provide their excess liquidity to the specialized banks on the basis of profit-sharing with an unknown rate of return.

2. Pakistan

The gradual process of implementation of Islamic banking in Pakistan began in February 1979, after several years of study and preparation by the government-appointed Council of Islamic Ideology (CII), 2/ when the President of Pakistan announced that interest was to be removed from the economy within a period of three years. Three of the specialized credit institutions--the House Building Corporation, National Investment Trust, and Mutual Funds of Investment Corporation of Pakistan--were to remove interest from their financing operations immediately.

The House Building Finance Corporation Ordinance of 1979 provided the rules under which the operations of the Corporation were transformed to non-interest basis. This ordinance specified a scheme under which housing finance was to be made available on "rent-sharing" basis, according to which the client is to pay the Corporation an imputed rental income for a maximum period of fifteen years. 3/ The National Investment Trust, which previously had mixed bond and stock portfolios, terminated investment in fixed rate-of-return securities in July 1979. The Investment Corporation of Pakistan, whose purpose is to broaden the equity base of the private sector and induce the growth of capital markets, converted its assets and liabilities into profit- and loss-sharing (PLS) modes in October 1980. By 1981 all the main specialized credit institutions in Pakistan had converted their operations to PLS-type financing modes.

1/ See Iqbal and Mirakhor (1987).

2/ See Council of Islamic Ideology (1980).

3/ The client is not required to make any payments during the construction phase of the project. The rental income is determined on the basis of market sample survey conducted during the three months preceding the client's request for housing finance.

The task of eliminating interest from the commercial banks, however, has proved difficult and complicated. The Council of Islamic Ideology, which provided the detailed blueprint for the Islamization process, did not recommend any changes in the institutional structure of the banking and financial system. The central bank, the commercial banks, and the specialized credit institutions would remain intact; only their financing operations would be based on an unknown rate of return derived from PLS rather than interest-based transactions. Clearly the plan saw the major functions of the banking system as intermediation based on rate of return signals emitted from the real sector. The report also envisioned that the Islamization process would be undertaken in phases, allowing a deliberate and cautious move on the part of the policymakers and bankers toward full Islamization.

In accordance with a government directive issued in January 1981, separate counters were set up in the commercial banks for accepting deposits on a PLS basis. The commercial banks were not to utilize PLS deposits in their interest-based operations and their accounts were to be maintained separately. A series of directives issued in 1981 by the State Bank of Pakistan (the central bank) permitted the commercial banks to issue these deposits to acquire non-interest based securities offered by the specialized credit institutions, to finance exports and imports of commodities, and to provide financing for trading operations and housing. During the period of 1980-82 new non-interest based financial instruments, such as Participation Term Certificates (PTCs)--a transferable corporate instrument with maximum maturity of fifteen years and a profit-sharing provision and intended to replace long and medium-term private investment debentures--were devised to mobilize resources.

In June 1984 the government announced that the dual window operations of the banking system would be discontinued within one year. As of July 1, 1985, all financial operations of the banking and financial system, except the foreign currency deposits which continue to earn fixed interest, were brought under the non-interest based modes of financing.

Contending that the existing legal framework in the country could not adequately protect the banks against undue delays and defaults, the government enacted a law called the Banking Tribunal Ordinance in 1984. According to this ordinance 12 banking tribunals with specific territorial jurisdictons, and each headed by a high-ranking judge to be appointed by the government and required to dispose of all cases within 90 days of the filing of the complaint, were to be set up. The law also provided for an appeal procedure under which the verdicts of a tribunal could be appealed to the High Courts within 30 days.

Just as was the case in Iran, the liability side of the banking system quickly converted to Islamic modes. The revealed preference of the depositors is more meaningful in Pakistan because, unlike Iran, the depositors had a choice between interest and non-interest based deposits until July 1985. Table 4 shows that the ratio of Islamic deposits to total deposits more than tripled between 1981 and July-1985 when the interest-based deposit windows of the commercial banks were closed.

The asset side of the banking system, however, has shown a far slower tendency toward PLS financing. As was stated earlier, when the nature of the transaction is such that it does not lend itself to profit-sharing modes, Islamic law provides for alternative modes. One such a procedure is what is referred to as markup, according to which the seller is allowed to charge a markup over and above his costs. This was a method which the report of the Council on Economic Ideology had suggested among permissible non-interest based modes of trade financing. The deliberations of the Council itself, as well as the critiques of the report, show an awareness of the possibility that markup may "open a back door" to interest. 1/ The data on the asset acquisition behavior of the banking system reveals that, indeed, the banking system has shown a strong tendency to substitute markup for interest (Table 6).

Table 5 shows various methods of financing envisaged for each line of activity, and Table 6 provides the most recent available data on the asset portfolio of the commercial banks. Table 6 indicates that in 1984 short-term assets constituted over 80 percent of bank portfolios. There is no indication that this bias toward short-term trade financing on a markup basis has been reduced.

It has been suggested that the bias in the asset acquisition of the banking system toward short-term trade financing is the result of the risk-averse posture of the policymakers and bankers in the Islamization process. 2/ As the banking system continues to shun profit-sharing modes, and finances mostly short-term commercial and trade-related projects, longer-term investment opportunities have to look elsewhere for funding. Given the shallow nature of the capital markets, this means either disintermediation or capital starvation for industrial projects. Professional bankers believe that so long as the business community does not adopt Islamic ethical norms in their operations, the monitoring costs of profit-sharing projects will be excessively high due to moral hazard. 3/ In fact, at the present, there exists a basic inconsistency within the system. On

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1/ See the discussion of the CII report in Ariff (1982).
2/ See Mirakhor (1987b)
3/ See Iqbal and Mirakhor (1987).

Table 4

Pakistan: Profit-and-Loss Sharing Deposits, 1981-85

(In billions of rupees)

	End-December					End-June	
	1981	1982	1983	1984	1985	1984	1985
Total deposits	70.0	82.8	106.9	111.7	130.6	117.9	138.0
Return-bearing deposits	54.7	66.4	86.3	91.0	...	98.0	...
PLS deposits	6.5	12.9	19.9	29.7	80.5	22.1	38.1
PLS deposits/total deposits (in percent)	9.2	15.4	18.6	26.3	61.6	18.7	27.6
PLS deposits/return bearing deposits (in percent)	11.9	19.4	23.1	32.3	...	22.6	...

Source: Data supplied by the authorities; State Bank of Pakistan, Monthly Bulletin (November 1985); and State Bank of Pakistan, Annual Report, 1984/85.

Table 5

Pakistan: Possible Modes of Financing for Various Transactions

Type of Activity	Basis of Financing
1. Trade and commerce	
Commodity operations	Markup
Trade, domestic, foreign	Markup and markdown, service charge
Other	PTC, equity participation, leasing hire/purchase, markup
2. Industry	
Fixed investment	Equity participation, PTC, Madarabah, leasing, hire/purchase, markup
Working capital	PLS, markup
3. Agriculture and fisheries	
Short-term	Markup, service charge
Medium- and long-term	Leasing, hire/purchase, PLS, markup
4. Housing	Rent-sharing, markup
5. Personal advances	
Consumer durables	Hire/purchase
Consumption	Buy back arrangement

Source: State Bank of Pakistan, BCD Circular #13, June 20, 1984.

Table 6

Pakistan: Investment of Profit-and-Loss-Sharing Funds by Commercial Banks, 1984 1/

Financing Technique	June 1984 Value	June 1984 Share	December 1984 Value	December 1984 Share
	(In millions of rupees)	(In percent)	In millions of rupees)	(In percent)
Markup and markdown	17,318	86.7	16,263	83.0
Commodity operations	14,687	73.6	11,426	58.3
Trading operations	727	3.6	2,755	14.1
Documentary inland bills	298	1.5	377	1.9
Export bills	705	3.5	953	4.9
Import bills	901	4.5	613	3.2
Others	--	--	139	0.7
Musharakah	617	3.1	777	4.0
Hire purchase	132	0.7	130	0.7
Rent sharing (housing loans)	130	0.6	198	1.0
Investment (equity participation)	1,593	8.0	1,970	10.1
Others	176	0.9	249	1.3
Total	19,967	100.0	19,587	100.0
Memorandum items				
Total PLS deposits	22,088		29,684	
PLS financing/PLS deposits (in percent)	90.4		66.0	
Total bank credit and investment	140,206		147,928	
PLS financing/total bank credit and investments (in percent)	14.2		13.2	

Sources: Data supplied by the authorities; Government of Pakistan, Annual Economic Survey (1984-85); and the State Bank of Pakistan, Monthly Bulletin (November 1985).

1/ These data cover only nationalized banks, which account for over 90 percent of the total banking sector's assets and liabilities.

the one hand there are the depositors, motivated by religious preference, who place their funds within the banking system run the risk that their funds will not be utilized in strictly PLS projects. On the other hand, the banking system has the perception that it runs a risk of bankruptcy should it place a large portion of its asset portfolio in musharakah and mudarabah financing.

It is argued that the existence of a multiple books of account in the business community, motivated by tax avoidance, does not allow efficient monitoring of an enterpreneur's operation, thus discouraging partnership financing by the commercial banks. One suggested remedy is the adoption of the Islamic Law of Contracts by the legal system, which will then permit contracts between banks and their clients to be representable in the courts as legal documents, just as they are in Iran. Although, as was stated earlier, there are plans to establish tribunals to handle banking disputes, the assessment is that neither the numbers nor the perceived functions of these courts will allow for speedy settlement, thus placing a premium on noncompliance and default.

There is yet a further danger of disintermediation as it relates to the rate of return structure within the banking system. In an Islamic banking system the rate of return in the real sector becomes the instrument of financial resource allocation in the economy. The implication here is that if an Islamic banking system is looked upon as a pure intermediary, then the assets and liabilities of the banking system are acquired such as to reflect the existing structure of real rates of return in various sectors of the economy, and that the rate of return to deposits reflects the profit-earning capacity of the banking system. If for any reason this does not occur, the absence of the latter will lead to disintermediation, and of the former to misallocation of resources.

Perhaps a tentative hypothesis regarding the efficiency of the intermediation role of Islamic banking is that in the long run the rate of return to the banking system is the same as that to the depositors plus the cost of intermediation, and that once Islamic banking has been implemented these two rates should approach one another asymptomatically through time. It is a fair argument that existing constraints will not allow the convergence of these two rates in the short run. Moreover, detailed data on the rates of return on all modes of assets and liabilities acquisition are unavailable. Nonetheless, Tables 7 and 8 provide information on the rates of return on equity and on PLS saving deposits of five of the major commercial banks and can be used as proxies for the rate of return to the banks and to depositors in order to allow an assessment, albeit incomplete, of the present and future prospects of the intermediation role of the banking system in Pakistan.

Table 7

Rates of Return on PLS Saving Deposits of the Nationalized Commercial Banks in Pakistan 1981-1986 1/

Bank	1981	1982	1983	1984	1985	1986
Allied Bank	8.50	8.00	7.00	8.55	7.00	7.10
Habib Bank	9.00	8.50	8.50	7.25	7.80	7.30
Muslim Commercial Bank	9.00	8.50	7.25	8.15	7.70	7.10
National Bank	8.50	8.00	7.25	9.00	7.80	7.30
United Bank	8.50	8.00	8.50	7.10	7.00	6.50
Average	8.70	8.20	7.70	8.01	7.46	7.06

Source: Zaidi (1987).
1/ December.

Table 8

Rates of Return on Equity of the Nationalized Commercial Banks in Pakistan 1981-1986 1/

Bank	1981	1982	1983	1984	1985	1986
Allied Bank	10.40	12.92	14.75	14.79	15.34	17.92
Habib Bank	43.79	44.80	39.60	37.79	30.01	26.71
Muslim Commercial Bank	26.46	32.29	28.13	24.95	19.82	18.27
National Bank	14.23	17.75	19.18	20.14	20.51	18.43
United Bank	15.90	17.82	19.14	28.95	15.54	14.13
Average	22.16	25.12	24.16	25.32	20.24	19.09

Source: Zaidi (1987).
1/ December.

As can be observed from Tables 7 and 8, the trends in the average rates of return seem to correspond to one another but there are some features worth noting. First, the large variation which exists among the rates of profits of the banks (Table 8) is not reflected in the rates of return on PLS deposits (Table 7). Under normal circumstances, if the banks would be allowed to pay rates of return to depositors commensurate with their own profits, deposits would shift from low-rate banks to high-rate banks. The only condition would be that the rate differentials should be high enough to cover search and other costs of switching deposits from one bank to another. The regulation of the banking system in Pakistan has been designed to preempt large shifts of deposits within the banking system in order to maintain stability. Thus, the competitive edge among the banks in attracting deposits does not hinge on the economic performance of the banks in the short or medium term.

The second noticeable feature of Tables 7 and 8 is the fact that the trends in the profit rates of the individual banks are generally not reflected in the rates of return to their depositors. The profit rates of Allied Bank, for example, show an increasing trend while the rate of return to its depositors shows the reverse. Perhaps a positive feature of the rate-of-return regulation seems to be that it has ameliorated the potential fluctuations in the rate of return to depositors. The profit rates of the Habib Bank, for example, show a decline of about 17 percentage points between 1981 and 1986 while the rate of return to its depositors reveals a decline of only 2 percentage points. Nevertheless, if a salient feature of an Islamic banking system is that the rate of return to depositors is an efficient signalling device for the rate of return to the real sector as well as the productivity and efficiency of individual banks, as of now, this is not reflected in the performance of the banking system.

If the rate of return on equity (Table 8) of the banks is taken as a proxy for the rate of return to the economy as a whole, then the performance of the banking system thus far indicates that if Islamic banking is allowed to operate properly and the depositors are permitted to share in the profits of the banks as partners, there is sufficient incentive for the expansion of the banking system as well as enhancement of its intermediation role. The tightly-regulated environment at the present, however, does not allow the market realities to be reflected in the rates of return, in that both the rates of return to the banking system and to the depositors are heavily influenced by regulation rather than market information. Given this reality, it is a rational reaction on the part of the bankers to choose minimum-risk modes of financing that may not be effective in promoting efficient resource allocation and economic development and, in the long run, Islamic banking. It has been suggested that the present situation can be improved upon by the revision of profit-sharing formulas and the weighting system that regulate the rate of return to the banks and their depositors. Perhaps a further step could be to allow the formulas to become more sensitive to interbank competition and market factors by introducing into them a weighted index of banks' profit performance.

Although improvements in the existing formulas may make the functioning of rates of return in the real sector as a resource allocation mechanism more efficient, the most serious challenge to the intermediation role of Islamic banking in Pakistan is government borrowing. At the present, the government borrows directly from the public at predetermined rates higher than the banks pay on their PLS deposits. Moreover, lending to the government is perceived to be less risky. For these reasons disintermediation is a likely outcome threatening the proper functioning of Islamic banking.

IV. Conclusions

Despite their similarities, the models of banking followed in Iran and Pakistan have features which make the paths of progress of the two systems quite distinct. This difference can be mostly attributed to the role of government and central banking in the two countries. In Pakistan, Islamic banking was adopted and implemented in a manner so as to leave the intermediation role of the banking system undisturbed. In Iran, on the other hand, the banking system is looked upon as an instrument for achieving the goals and objectives of the Islamic revolution.

The progress of Islamic banking in Pakistan has been constrained by an interrelated network of regulations, the roots of which, it is argued, are in the lack of operating Islamic ethical norms in the business environment. If Islamic banking is adopted solely to play an intermediation role, then the only effective instrument available to it to perform this function efficiently is the structure of the rates of return signals in the economy. It follows that the financial sector must be allowed reasonably free and efficient access to the market so that it can receive proper expected rate of return signals. Similarly, the banking system must be allowed a relatively unconstrained opportunity to translate these signals into rates of return for its depositors.

The posture of the policymakers toward Islamic banking in Pakistan has been marked by a great deal of caution. The banking community has also shown a reluctance to engage in medium- or long-term industrial financing on a profit-sharing basis. Islamic banking in Pakistan appears to be at a crucial crossroads, and if there is to be further progress the regulatory and legal conditions must be such that the system will have a fair chance to perform as expected. If the only modes of Islamic financing continue to remain short-term trade transactions, e.g., via markup, then the rates of return to the banks and the depositors may begin to show a downward trend, mainly because of the diminishing marginal productivity in short-term trade markets as they slowly become saturated with financing. Moreover, emphasis on short-term financing will undoubtedly have inimical effects on investment, capital formation, and economic development.

In Iran the adoption of Islamic banking has had both a different set of objectives and different course of progress than that in Pakistan. Three distinct phases of this progress have been identified. Each phase has meant a significant jump in utilization of the banking system to achieve the economic goals of the revolution and each phase has been prompted by impatience of the government authorities with the pace of Islamization. It seems, for example, that in the second phase government policymakers became dissatisfied with the semi-autonomous and quasi-independent status of the banking system. Thus, in the third phase it appears that the line of demarcation establishing the previous status for the banking system has become quite blurred and the banking system is being rapidly integrated with the rest of the government. As such, the banking system is being perceived not only as the major source of financial resources to underwrite the government's fiscal deficits, but also as an effective tool in pursuance of Islamic economic objectives, such as the modifications and shifts in the pattern of consumption, investment, and production behavior in the economy as well as restructuring and income redistribution.

An implication of the above is that in Iran the government believes that market rates of return are not strong imperatives in providing resource allocation signals for the banking system. Perhaps for this reason the rates of return to the deposits are determined arbitrarily, and do not necessarily reflect the actual rates of return in the economy. However, since financial resources are allocated to projects whose long-run social benefits outweigh their shorter run and purely economic marginal productivity, e.g., expanded credit availability to the agricultural sector, government cooperatives, and social overhead capital, the rates of return to the depositors will have to be less than if resources were allocated to projects with higher and more immediate rates of return. Hence, private sector deposits, in effect, subsidize projects that in the policymakers' view have important social benefits. Clearly, if the policymakers could identify and prioritize projects which in their view need to be financed, and then allow the banking system to allocate its remaining resources according to the rate of return prevailing in the real sector, this would reduce the implicit subsidy paid by depositors.

One problem which both the Islamic Republic of Iran and Pakistan share in common, and which has significantly influenced the performance of Islamic banking so far, is the intractable question of financing of government deficits through the financial system. In Iran the government borrows directly from the banking system at a zero rate of return at the present (it is argued that since all banks are nationalized it does not make much sense for the government to pay itself for the money it borrows), while banks lend to each other at a fixed rate of return. In Pakistan on the other hand, the government borrows directly from the public at rates higher than that paid on PLS deposits of the banks. The risk-adjusted differential in the two rates is high enough to attract deposits away from the banking system, thus leading to disintermediation. Recalling that in Pakistan, Islamization of banking was meant to strengthen its intermediation role, this government policy is clearly harmful to the process. In both countries the resultant fixed rate of return within the financial sector establishes a floor and a point of reference against which all expected rates of return return are measured.

The general conclusion which can be derived from this study of the experiences of Iran and Pakistan is that the adoption of Islamic banking has not led to the collapse or decline of the financial system. There has been a rapid growth of private sector deposits in Islamic modes in both countries, demonstrating that the system can be effective in mobilizing resources. But at the same time, because government policies in Iran and Pakistan strongly influence the asset acquisition behavior of the banking system, it is far more difficult to judge the efficiency of Islamic banking in allocating the mobilized resources based on the performance thus far of the systems operating in these two countries. How the system would work in the absence of government intervention is still an open question, and one could argue that as yet one has not seen a fair demonstration of Islamic banking.

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