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Islamic Banking in Iran and Pakistan: A Comparative Study*

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In recent years, several Muslim countries have made ambitious attempts to practise Islamic banking. Iran and Pakistan appear to be particularly active in transforming their banking and financial sectors completely in line with the dictates of *shariah* [Naqvi (1981)]. The present study aims to contribute to the understanding of the process of Islamisation of banking in these countries. This kind of understanding, it is believed, is important for policy-makers guiding the Islamisation process anywhere in the world.

The study tracks, over a period of a decade, the routes Iran and Pakistan have taken to attain their avowed objective, and focusses on the common concerns they share in their respective pursuits. The study also discusses the diverging sets of problems faced by these countries.

The limited amount of empirical research in the area of Islamic banking has left many policy-related questions unanswered. One reason for the scarcity of studies on the subject has been the lack of suitable information. However, with the availability of some patchy but useful data at hand it is now possible to arrive at some interesting conclusions in a systematic fashion.

The study is organised as follows: Section I highlights salient features of the Islamisation of the banking process in Iran and Pakistan. Section II takes up for discussion and analysis some of the pertinent practices and issues related to Islamic banking in these countries. In the final section the main conclusions of the study are presented and some useful recommendations are made.

I. ISLAMISATION OF BANKING IN IRAN AND PAKISTAN

Iran and Pakistan are committed to establish Islamic justice known as *Adl wa Ihsan* [Naqvi (1981)] through the Islamisation of their social, political, and

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economic institutions. Both countries share the conviction that the ultimate solution to their economic problems lies in a functioning Islamic economic system. In this context, prime importance is laid on the abolition of *riba* (interest) from their banking systems.

Pakistan's banks, nationalised in 1973, were functioning rather smoothly when the Zia regime initiated Islamisation of banking in 1979, primarily to seek political support of the Islamic activists. In contrast, Iran went through a basic overhaul of all her economic and social structures in the wake of the Islamic revolution in 1979. By then, an economic crisis in the form of stagflation, augmented by strikes, had led to a total disruption of the economy. Most banks were plagued by heavy withdrawals and people's confidence in the banking system was shattered threatening bank closures and bankruptcies. Therefore, Iran decided upon nationalisation of banks on 7 june 1979, and the country's 34 banks were merged into 9 banks comprising 6 commercial and 3 specialised banks, and the branches of Bank Saderat (Bank of Exports) were formed into 22 local (provincial) banks [Mahdavi (1991)].

In Iran, the abolition of interest began with the substitution of "interest" by "maximum service charge" and "guaranteed minimum profit". Thus, interest on all assets was replaced by a 4 percent maximum service charge and a 4–8 percent minimum profit rate, depending on the type of economic activity.

Interest on the deposits was also converted into a "guaranteed minimum profit". [Hedayati (1991)].

These steps, however, could not bring about a fundamental change in the banking system. Hence, although the country was engaged in the war with Iraq and also practically with the rest of the world including the West and the Middle East during 1980–1988, yet the religious and economic authorities were able to design elaborate laws and regulations for conducting the banking business along Islamic lines. Thus, the "Law for the Usury-Free Banking" came into force on March 21, 1984. Modes of financing allowed in the Law include *qard al-hasan*, *mudharabah,* civil partnership, legal partnership, hire- purchase, instalment transactions, *muzara'ah*, *mosaqaat*, direct investment, forward deals, *joa'lah*, and debt-purchase [Bank Markazi Jomhori: Islami Iran (1983)].

On the other hand, Pakistan opted for a gradual transition to an interest-free (called profit-loss sharing or PLS) banking system. Each step was taken after making sure that the existing system would undergo minimum disruption as a result of new banking rules and regulations. According to Ghulam Ishaq Khan, the then Finance Minister, the "gradualism" approach was adopted in order to base new laws, institutions, concepts and practices on sound intellectual foundations;

develop a broad consensus and wide acceptance of the new measures and allow flexibility to accommodate difference on minor *fiqhi* details [Khan (1984)].

Thus, during 1979-80, some specialised banks and investment companies transformed their banking business operations into the PLS modes of financing. In January 1981, all five nationalised banks and their 6,600 branches started special PLS counters. In mid-1984 the central bank announced twelve "Islamic" modes of finance comprising mark-up, mark-down, buy-back, leasing, hire-purchase, development charge, *musharikah*, equity, participation term certificates, rent-sharing, *qard al-hasan*, and service charge. All accounts with interest-bearing deposits were converted into PLS accounts, and transition to PLS banking was complete by mid-1985 [Nienhaus (1988)]. In Pakistan foreign banks could also adjust to the PLS banking system while Iran had to close down all foreign banks.

II. BANKING PRACTICES AND ISSUES

Notwithstanding their different approaches, Iran and Pakistan have a number of common concerns. For instance, bank lending has been concentrated on short-term financing; government borrowings are met effectively on the basis of interest; difficulties are encountered in financing small-scale enterprises; and instruments available for asset diversification are certainly insufficient.

In Iran, people were initially hesitant to make investment deposits, but gradually the volume of term investment deposits increased. In 1990-91 these deposits were 6.3 times more than in 1984-85. Interestingly, the growth of long-term investment deposits has exceeded that of short term deposits (157.1 percent against 92.5 percent) during 1988–90. Similarly, the volume of new facilities has increased by 15 times since 1984-85 amounting to 11241 billion rials in 1990-91 [Sheybani (1991)].

Data presented in Tables 1 and 2 clearly indicate that the bulk of the financing business of the banks in both countries is short term (Instalment sales and *mudarabah* in Iran and mark-up in Pakistan) whereas partnership type long-term finance has been advocated as the real Islamic alternative to the conventional banking system. In reality, the share of the long-term and the medium-term financing in total banking finance is, however, generally very low. Therefore both countries need to devise and implement long-term instruments of finance.

Neither Iran nor Pakistan has made appreciable headway in improving income and wealth distribution patterns. For instance, according to a recent study on Pakistan, 97 percent of bank deposits (19.16 million out of total of

Table 1

Breakdown of New Banking Facilities in Iran
(% of Total Facility)

Financing Mode	1984-85	1985-86	1986-87	1987-88	1990-91
Instalment Sale	33.3	32.3	34.4	42.1	48.0
Mudharabah(Short Term)	18.1	15.7	17.6	12.5	20.2
Civil Partnership	14.7	13.0	13.3	13.7	14.4
Qard al-Hasan	10.5	10.6	11.1	1.6	5.7
Hire Purchase	3.8	2.0	1.8	2.1	–
Legal Partnership	3.5	7.3	6.3	3.1	–
Direct Investment	0.6	3.5	2.6	1.8	–
Jo'ala	0.3	1.4	1.3	1.8	–
Debt Purchasing	11.4	9.9	6.2	10.5	–
Other	0.2	1.2	1.6	7.0	–

Source: Research Department of the Central Bank of Iran Courtesy of S. A. A. Hedayati (1991) and E. Sheybani (1991).

Table 2

Breakdown of New Banking Facilities in Pakistan
(% of Total Facility)

Financing Mode	June 1984	December 1984	June 1988
Mark-up and Mark-Down	86.7	83.0	33.10
Musharakah	3.1	4.0	18.25
Hire Purchase	0.7	0.7	0.05
Rent Sharing	0.6	1.0	0.08
Equity Participation	8.0	10.1	0.76
Qard al-Hasan			2.32
Purchase of Trade Bills			4.22
Participation Term Cert			6.00
Others	0.9	1.3	0.04
Total Non-Interest Fin			65.00

Source: Economic Survey (1984-85) and State Bank of Pakistan Courtesy of Z. Iqbal and A. Mirakhor (1987) and N. A. Zaidi (1988).

19.38 million deposit accounts) stood in the name of small deposits of Rs 20,000 or less on 31 March 1984. Such accounts totalled Rs 65 billion, or 54 percent of the entire deposits of Rs 120 billions. On the other hand, advances made to small

account holders, amounting to Rs 5.4 billion, constituted only 5.7 percent of the total advances of Rs 94 billion. As many of the depositors belong to low-income or middle classes while the credit benefits the upper classes, this situation perpetuates the uneven distribution of wealth and income moving away from the Islamic principles of economic and social justice [Manzoor (1986)].

In Iran, however, collaboration and coordination of the credit policies of banks with the economic policies of the government in various spheres have been strengthend. For instance, investment plans of banks in productive and development projects are submitted in the country's budget bill for approval by the Islamic Consultative Council. Plans for the construction of low-price housing are drawn up by the central bank and notified to the banks. Regulations on minimum and maximum rates of return on various facilities, duration and manner of credits are strictly followed by the banks. The banks are barred, by law, to invest in the production of luxury and non-essential consumer goods. Priority is given to legally formed cooperatives in the grant of *mudharabah*. All banks are obligated to grant a part of their resources in *qard al-hasan.*

Qard al-hasan is granted to production and service cooperatives, to small farmers and craftsmen, and for personal needs such as matrimonial costs, procurement of dowry, medical costs, house repairs, and educational aid [Shirazi (1988)].

In a nutshell, banking activities in Iran are integrated with the country's development plans but, in Pakistan, banking functions are not geared towards the achievement of plan targets. In fact, the Pakistan government is competing with the banks for funds by borrowing directly from the public at a rate much higher than the public can obtain from the commercial banks.

In the wake of Islamisation, both countries wish to provide all modern banking facilities and services normally offered by interests-bearing banks, but, using interest-free methods of financing. Therefore banks in both countries practically function as "intermediaries" between the savers and the investors. In Iran, banks are barred from indulging in commercial and trade activities, although their methods of intermediation are different from the conventional banks [Mahdavi (1986)].

In Pakistan, banks are criticised for their reluctance to assume an investment role in place of intermediation. Acting as intermediaries, the banks cannot trade on their own account despite the fact that even in *murabaha* transactions, the bank has to purchase and sell the goods at its own account. In fact, Islamic banks deal in documents and not in goods. This is clearly in contradiction with the distinction drawn between conventional banking and Islamic banking on the basis of the Qur'anic verse "Allah has permitted trade and forbidden riba" (Al-Baqarah:275).

Achievement of Islamic goals, however, requires structural changes. For example, financing of new ventures is a crucial precondition for unfolding entrepreneural potential, and for this, independence from well-established conglomerates and vested business interests is essential. Similarly, the adoption of the PLS system would require banks not only to have a critical look at project feasibility but also to do proper monitoring after its implementation. Thus, the bank's main concern would shift from adequacy of security to appraisal and feasibility of the projects. This, in turn, calls for trained manpower to do a satisfactory job. In Iran, consistent efforts have been made to train the banking staff and educate the public on Islamic modes of financing while no such effort has been made in Pakistan. In fact, banks continue to follow the conventional practices by charging interest in the name of profit in Pakistan; hence the Federal Shariah Court's ruling called for basic changes in the banking operations.

The malpractice of maintaining different sets of books is resorted to by business establishments in Pakistan. They show profits to the extent of rate acceptable to the banks for obtaining PLS financing. Tax system is at variance with the requirements of envisaged banking practices, leading to enhanced misreporting and tax-evasion in Pakistan. Tax evasion is merely one form of widespread corruption and this is certainly a major hurdle in the way of Islamicising banking in Pakistan. The Shariah authorities in Pakistan are conservative in their recommendations of permissible modes of financing, perhaps, because of their lack of understanding of the banking realities. In contrast, the Iranian Shariah authorities are flexible and pragmatic in approving financial measures necessary to check anticipated evasions, frauds and problems associated with moral hazard. In Iran, for instance, banks are considered part of the government, and the payment and receipt of extra amount in excess of the principal on government borrowings is not considered "riba". Acceptance of the rate of interest upto the rate of inflation, as not being "riba" is being debated which is likely to be granted in Iran. The banks are allowed to insert a penalty clause into the loan contracts under which the borrowed would agree to pay the banks 12 percent a year of the unpaid portion of the loan [Mahdavi (1991a)].

In Pakistan, on the other hand, Shariah authorities object to the extra charge included on daily product basis in the contracts, which is rebatable if repayment is made on time. Financial sanctions comparable to the penal interest rates are imposed by the courts, rather than banks, established under the Banking Tribunal Ordinance.

Guarantee of deposits plus disbursement of prizes to the holders of *qard al-hasan* deposits is approved by the religious authorities in Iran, while guarantee

of deposits is considered unislamic in Pakistan. In Iran, service charge at the rate of 2 percent is permitted while, in Pakistan, service charge on percent basis is considered *riba* and, therefore, the banks are supposed to charge the actual cost of processing each transaction. Besides practices of buy-back arrangement, sale of goods by banks without having the possession there of, and method of giving rebate are also objected to by the Shariah experts [Cunningham (1990)].

Iranian regulation provide for settling existing unislamic contracts while Pakistan 's regulations assumed silence regarding those contracts which instigated the ruling of the Federal Shariah Courts that has, in turn, made the future of banking uncertain. On 14 November 1991 a set of 22 laws governing a wide range of interest-based activities including banking, insurance and savings were declared "repugnant" to Islam by the Shariah Court in Pakistan and the authorities were asked to bring the relevant provisions in conformity with the injunctions of Islam by 30 June 1992 [Khan (1991)].

III. CONCLUSIONS AND RECOMMENDATIONS

The desire to practise the Islamic faith seems relatively stronger in Iran than in Pakistan, as reflected in the extent of efforts made by each country towards Islamisation of banking. Both financial systems are basically interest-free although the Iranian banking system is certainly more closer to Islamic norms since the basics of Islamic banking are closely pursued. Both Iran and Pakistan are facing difficulties, though of different sorts.

The banking community in Pakistan has failed to devise innovative financial modes consistent with the Islamic financial norms. People in Pakistan are frankly reluctant to adopt Shariah means, especially if they find them materially less advantageous compared with the existing conventional financial practices. Hence, despite great pressure from the religious quarters, the government, banks and the business community are all reluctant to shun existing banking practices because these practices are more compatible with their acquisitive attitude. The recent ruling of the Federal Shariah Court is bound to cause a crisis since permissible modes of financing must be designed and implemented in a limited time. It is recommended that the government must seek more time to devise permissible modes and to ensure minimum disturbance in the system. Moreover, the existing contracts must be allowed to liquidate in conformity with the terms and conditions set out in the debt contracts in order to prevent a complete breakdown of the financial system due to non-payment of interest accrued on outstanding loans.

Privatisation of banking in Pakistan is likely to complicate compatibility of contracts with the Shariah. It would certainly be helpful if the banks are put

under the direct supervision of a Banking Shariah Board comprising respected *ulema* representing all sects in Pakistan, assisted by an Experts Council comprising eminent economists, bankers, lawyers, and businessmen.

Finally, in order to standardise Islamic banking practices in the two neighbouring countries which have launched Islamisation of banking, close cooperation between them is essential.

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