WALIA journal 31(S1): 1-5, 2015
Available online at www.Waliaj.com
ISSN 1026-3861

Banking legal challenges in Iran in the process of banking globalization

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Abstract: Banking systems operate as the beating heart in each country's economy. Subsequently the flaws and shortcomings existing in this system have a direct impact on the major sections of economy. In fact, the designers of the new banking system in Iran have started simulating the system of interest by creating a new synthetic contract which has led to numerous losses and downfall for the country's banking and economic system. The notable point in analyzing the problems in the current banking system is, knowing that the theoretical source of the current banking system is the act of interest-free banking approved in 1984. This act is by no means, the result of a philosophical view on Islamic economic law. Furthermore, there exists other challenges in this regard, some of which are executives ones due to the country's wrong-operating banking system. Other challenges are not related to Islamic banking and more or less, all banks in the world are faced with them.

Key words: *Banking; Globalization; Usury; Banking contracts*

1. Introduction

It has been said that globalization is the eminent and current phenomenon of our time, a phenomenon referring to deep considerable alterations in different thematic fields of social life on a world scale. It is a surging and complicated process in the international collective life which has influenced people all around the world despite existing differences and has successfully bought them together .It is fully expected that in near future, due to the globalization, the rivalry between conventional banks and Islamic banks may augment rapidly.

Globalization refers to the countries' increasing economic dependence on a global scale via adding to the number and diversity of the cross-border transactions, services and the flow of international fund, and also through the fast-growing spread of technology.

As a result of the given carte blanche, global markets are rapidly converting into a single market, and under such circumstances, there have been created a number of opportunities and challenges for both Iranian and Islamic banks.

On one hand, globalization has provided portfolio with abundant variety and as a result has decreased the present risk in profit-sharing methods. This matter will also provide Islamic banks with more opportunities to apply these methods.

On the other hand, Iranian banks need to be prepared for a much more severe competition with foreign banks. In order to take advantage of the opportunities created by globalization, it is highly required that Islamic banks endeavor for the betterment of their services and supply customers with consentaneous financial products. Here again, it is the customers who benefit from such rivalry.

Technological innovations have played a more distinctive role in financial integration and globalization in comparison with other factors. E-banking and the widespread use of computers have made banking undergo a plethora of modifications. This mater has made banking titans intervene on the grounds that applying modern technology requires further resources.

Recent merges in Western countries have led to the establishment of gargantuan banking and enormous finance institutes.

Liberation of currency markets has rigorously enhanced this process. Under such circumstances, banknotes have been substituted with plastic cards and e-documents have replaced financial statements. The revolution of communication through faxes, teletexts and e-mails has markedly reduced the cost of international communication.

Nowadays, a deposit account in one country can be transferred to other countries just via clicking computer mouse and customers in many countries can search through inter-bank internet, Investments Limited Companies (Ltd.), Limited Joint Investment Funds, Joint Investment Funds and even rival Trade Companies. Consequently, Iranian banks can no longer be indifferent towards recent developments. They are to diligently analyze the current advancement and accustom their strategies appertaining to them.

In furtherance of being active in global markets, they are obliged to escalate the amount of their activities and also form strategic settlement with

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other banks. Furthermore, creating a connection between present Islamic banks and those conventional banks interested in banking founded on Islamic regulations could be beneficial. Such strategic agreements can be advantageous for both sides.

2. A Comparison of Iranian Banking and Western Banking

2.1. Features of Western Banking:

Being grounded on the System of Interest

Since a long time ago different issues have altered human's life and inhibited people from achieving their survival requirements.

The thought of saving for the period of economic recession could possibly diminish parts of anxieties and apprehension to a certain degree, but this couldn't guarantee life satisfactorily.

After a while, loan attitude emerged out of people's interaction. Accordingly, the borrower could deal with his or her problems temporarily. But gradually, human being's covet led to a situation in which the phenomenon of borrowing was forcibly substituted with usury or interest.

Meanwhile, the circulation of coins and then banknotes, the saving of which was of little cost, added to the lenders' bargaining power in a way that they were not willing to lend unless accompanied with a high rate of interest.

The improvement in production methods and the appearance of a place for a capital factor alongside a work factor, created a new era for loan attitude.

In the present time, the increment of consumerism and investment on one hand, the growth of cash capital owners' savings, the emergence of modern Finance Institutes and the innovations of various credit accounts on the other hand, added to the intricacies and complexities of "loan with interest" so that nowadays, different variations of credit banking operations and bonds based on the system of loan with interest, have been formed throughout the world and have organized the market of money and capital.

At the same time, another attitude under the title of the corporation of capital owners and the corporation of capital owners with economic career owners has stepped into human beings' life accompanying investing loans with usury .These loans have been provided with new gadgets including shares, bonds, and investing corporations (Akbarian and Rafiee, 2005)

Certainty of Interest

Bank interest is not a mere monetary phenomenon in modern economy, but remarkably influenced by capital scarcity.

In a widespread economy market, interest rate plays an important role in joining and regulating the relationship between the saving and investment. The real interest rate which is determined by market mechanism and is quite autonomous of individual or even government will, is literally an indicative of fund scarcity on one hand and ultimate capital return on the other hand.

The foremost role of interest in a banking system is leading savings, specifically small and average ones, towards investment. The fundamental economic difference between usury and interest rate time deposit roots in the delicate distinction between usury banking system and Islamic banking system. In Usury banking system, the depositor is certain of receiving extra money and its exact amount.

Conversely, in usury-free banking system, the depositor is not assured of receiving interest. In addition, the probable interest rate is not being clarified for him or her. In other words, the depositor in Islamic banking system, contrary to usury banking system, makes a perilous risk and that is jeopardizing his or her own deposit.

It should be taken into consideration that such risk is a part of existing risk in investment and business which is transferred to the depositor by Islamic banking system. Meanwhile, in usury banking system the presence of interest rate fully safeguards depositors against the perils related to his or her deposit banking operation.

In usury banking system, the depositor receives a legal guarantee to earn interest. Meaning that, the depositor has the legal right to complain to the court for not having received the deposit interest.

In the end of the deposit time, if the bank claims that the realized interest is less than the paid deposit time interest, the depositor possess no legal right to object (Karimi, 2000).

The emphasis on Credit Competence

In conventional banking, the mere notable issue for the bank is getting back the granted loan and its interest rate duly. Consequently, in giving loans, the prominent principle is the borrower's credit competence. While based on the code of sharing, bank receives financial return only if the project ends in success and is profitable. Therefore an Islamic bank's main concern is the project profitability, business competence, the employer's management competence; and not the ability to pay back.

This element of Islamic banking has critical application in credit distribution and also banking system stabilization. Conventional banking usually pays little attention to the moral consequences of their activities. In contrast, in Islamic system all economic agents are obliged to act according to Islamic moral values and banks are no exception. It means that they cannot finance those projects disaccording with Islamic moral values. For instance, they would not finance alcohol-making factories, casinos, night clubs or such activities prohibited in

Islam or anything recognized as pernicious for the society (Farahani, 1998).

2.2. Features of Iranian Banking

In any economic system, transferring cash from depositors to investors is crucial: since those who invest are not commonly capable of taking advantage of profitable investment opportunities. This economic duty, which is transferring cash from depositors to investors, is carried out either via directly financing bond or exchange market or through being a financial mediator in fiscal markets.

In order to highlight the significance of financial mediating, it would suffice to draw one's attention to the fact that in most countries, approximately two third of the recent investments are carried out through this channel.

Due to the fact that depositors do not customarily invest themselves but other sectors need such capital for the investment, consequently if these two groups-investors and depositors- aim to work directly and independent of financial mediators, they will certainly need a plethora of information on each other.

Acquiring such information is costly. So the process of transferring funds from depositors to investors will include the mediating costs. Due to the disharmonious information, not getting help from financial mediators may create problems in reverse choices and lead to moral perils. Financial mediators can take advantage of size economizing which means savings in costs due to the mass production. They could also diminish fund transferring costs from sections with surplus to sections with deficit.

Also, financial mediators are better capable of dealing with problems originated from disharmonious information. Similarly, the process of financial mediating may figure out the mismatches between depositors and investors in their preferences, interest time and the amount of funds.

In economy, Sections with surplus capital are normally small families that save rather small amount of money. In contrast, sections with deficit are big agencies which need abundant amount of funds. Financial mediators eliminate such mismatches between the little supply of fund and the high demand of fund via collecting small amounts of money and putting them all together appropriate to the need of fund demanders.

In addition, investors customarily need money for a relatively long time which is not satisfactory for the minor providers. This causes a kind of mismatch in interest time and cash preferences between minor depositors and investors. Mediators solve the conflict by gathering small amounts of funds.

Along with the above-mentioned distinction, the minor suppliers' preferences and those of major investors are at great inequality. It is quite common that minor depositors are risk-avoidant and prefer low-risk situations whereas investors use those funds in risky projects. Therefore money cannot be supplied directly and subsequently the role of mediating is highlighted here again. Financial mediators can scale down the existing risk considerably through diversifying the portfolio.

Furthermore, minor depositors cannot gather all the required information or investment opportunities sufficiently, while financial mediators are at better position to get such information essential for investments. Therefore, financial mediators lessen the risk via accumulating essential information (Mousavian, 2002).

The duties of Islamic banks and other Islamic Finance Institutes resemble those of conventional banks and finance institutes. Theoretical studies in Islamic economy have taken advantage of Islamic substitute methods in finance in order to make patterns, based on which, banking operations could be handled.

Some studies have shown that Islamic patterns can excellently wrestle with mentioned banking duties. Some of those patterns are as follows:

3. Second Type Pattern of Banking Partnership

The main feature of this pattern is substituting interest rate with interest share in both assets and liabilities. I would like to draw your attention to the fact that from Islamic economy point of view, the principal duty of a bank is gathering money from society on the grounds of banking partnership code and also providing merchants and businessmen with funds based on this code (Karimi, 2000).

Among various types of bank accounts, it could be said that a bank is authorized to have interminable deposit amounts or limited deposit accounts in which depositing is conditioned to investing the money in special business projects. And then there are current accounts in which deposits could be withdrawn at any time. These accounts are not granted with interest but people are permitted to use these deposits profitably while accepting probable risks.

4. First Type Pattern of Banking Operation integrated with multi- faceted investment tools.

The primary works and literature on Islamic banking were founded on the traditional patterns of Islamic financial methods such as partnership contracts and cooperation. But practically, Islamic banks faced severe troubles applying these methods.

The earlier writings and experiences in Islamic banking played a significant role in the development of new versions of Islamic finance institutes and also in expanding the concept of methods and Islamic financial tools.

Islamic banks have also created various types of sales with price deferred and sales with deferred objects. For instance, short-term Murabaha (which is financing based on cost plus interest), installment sales (ling-term and mid-term Murabaha), prepayment or manufacturing order with price deferred (Astasna) and rentals with prepayment or rentals with deferred rent (leases).

These advancements have led to the emergence of different Islamic banking patterns. Banks, in their relation with employers, apply other religiously permissible financing methods which do not include interest. Among these financing methods, the prominent ones are as follows:

- Partnership
- Murabaha cooperation
- Rentals,
- Salm (prepayment)
- Astasna (prepaid construction/manufacturing)
- Charge-based loans (which means compensating the real charges made through the process of gathering funds)

In any of these methods, a category of Islamic financing tools have been created via altering the payment and delivery options (Mazaheri, 2003).

5. The Pattern of Advocacy, Islamic Bank as an Advocate

It could also be claimed that Islamic banking is organized on the basis of advocacy. Meaning that Islamic banks manage the money based ona fixed charge on behalf of their customers. The regulations and conditions of contracting the advocacy need to be specified by both sides' agreement.

6. Exclusive Features of Islamic Banking

Although Islamic banks often act as conventional banks, they possess their own exclusive features as follows:

6.1. Risk sharing

The most significant peculiarity of Islamic banking is sharing risks between money suppliers (depositors) on one hand and both financial mediator (the bank) and money consumers (the employers) on the other hand.

Meanwhile, conventional banks act conversely which means that the depositor is certain of receiving a pre-determined interest rate. Due to the incertitude nature of our world, the result of projects cannot be determined with certain anticipation. Therefore there would always be a certain amount of risk. In conventional banks, this risk is on the side of the entrepreneur. Whether the project is efficacious and exuberant or ends in failure, the owner of capital will receive his or her pre-determined profit.

But in Islam such unfair risk distribution is inadmissible; therefore in Islamic banking both depositors and employer collaborate in the project results based on the capital supply and demand. If projects are profitable, both sides will be beneficiaries according to the pre-determined proportion and if the projects end in forfeiture, all financial losses will be on the side of the depositor and the employer will receive nothing for his/her job. It means that the employer's loss is not receiving profit for what has been done (Bakhshi dastjerdi, 2005).

6.2. An Emphasis on the Profitability VS. An Emphasis on the Credit Competence

In Conventional banking, the mere noteworthy issue for bank is the duly return of the loan and its interest rate. Therefore in granting loans, the foremost principle is the borrower's credit competence while , based on the code of sharing benefit and loss, banks only receive profit in case of the projects success and profitability. Consequently, the major concern of an Islamic bank is the project suitability, business efficiency, the employer's management competence; and not the capability to pay the loan back.

This aspect of Islamic banking is well-applied in credit distribution and also the stabilization of banking system. Some of these functions will be mentioned later in this paper. It is even applied in non-sharing methods such as Murabaha, financing a good or asset which guarantees using assets in profitable activities and also minimizes the extravagant use of capital (Esfahani, 2009).

6.3. Moral Aspects

Conventional banks normally pay little attention to the moral results of their activities in financing.

In contrast, In Islamic system, all economic factors should act upon Islamic moral values and Islamic banks are no exceptions. Meaning that, they are prohibited to finance those projects contrasting the system of Islamic moral values. For instance, they are not permitted to finance alcohol-making factories, casinos, night clubs or any other activity banned in Islam or anything which is considered pernicious to the society (Esfahani, 2009).

7. Conclusion

As in the birth of Islam, usury was gradually introduced as a forbidden act and ultimately announced prohibited and Islamically unlawful. Similarly we had some subjects in our constitutions which were not performed in the early years but were implemented after a relatively long time such as the amendment of Islamic councils' formation which were formed in 2000 for the first time.

The reason behind the delay in the Islamic council's formation was special political and social conditions. It was the time of Islamic revolution in Iran and the democracy was given prominence. The Islamic government needed sufficient authority for reformation, truly altering the nature of the ex-government and forming an Islamic system.

Therefore at first, the power was centered in government. On the other hand, the people who were literally and not figuratively introduced to the concept of democracy were supposed to take advantage of such capacity in order to be prepared to use such opportunity rightfully and realistically.

While discussing usury- free banking system, social issues are also of high concern; since Islamic revolution has newly achieved victory and aims to reform its banking system which is the heart of economy and one of the most prominent sections of the society. It certainly plays a foremost role in the destiny of such a plan. Usury-free banks indicate a banking system in which no extra charge should be paid as interest if loans are granted upon people in the format of borrowing; and also if loans are used for investments or economic activities, which are mostly in this regard.

Here, the bank has no right to determine specified interest rate before the activity's profit or loss is being clarified. It is allowed to withdraw from probable disadvantageous economic activities. Under the circumstances of a newly victorious revolution, people are impressed by the revolution and the new government and possess no experience in investment and economic activities. Granting loans and facilities to people and banking partnership in profit and loss, bearing loss in case of project or economic activities' failure due to the non-existing mutual trust between the bank and people, may create such mentality for people that they have no commitment to nurture the project. If projects are not profitable, the loss is for the banks or financial institutes. Since banks finance the projects, if they end in failure, people have no responsibility to return the capital. This gradually turns out to be an irrevocable pattern of habit for people.

But, if people are granted loans as the current model, their sense of responsibility in economic activities will be escalated and their viewpoint towards investment and partnership will be formed rightfully. If people's economic activities fail under present conditions, in fact they themselves will be at loss.

Therefore such culture and mentality will appear in society indicating that, when an individual steps into the field of investment he or she will be required to pursue the success and the profitability of the project conscientiously.

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