

Overview of the Iranian Banking System

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This article sets out a high level review of the legislation governing the existing banking system in Iran and options available to international institutions looking to undertake financial activities in or with Iran.

The legal system in Iran is a civil law based system which incorporates, where applicable, the principles of Islamic laws and jurisprudence.

The Regulator

At present, there are no fully licensed foreign banks in Iran. Many banks in Iran are Iranian government owned, while the rest are private Iranian banks. The Monetary and Banking Law of Iran issued on 9 July 1972 provides that the Central Bank of Iran is responsible for the formulation and implementation of monetary and credit policies with due regard to the general economic policy of the country. Among other things, the Central Bank is responsible for the supervision of banks and credit institutions in accordance with the Monetary and Banking Law.

The Central Bank's scope of authority both in the Monetary and Banking Law and in the Banking and Monetary Act of Iran issued on 27 May 1960 is subject, in many cases, to the supervision and approval of the Currency and Credit Council. The Council's duties, amongst other things, are to:

- cooperate with the governor of the Central Bank in the general management of the Central Bank;
- direct and supervise all banking affairs, as provided in the Banking and Monetary Act;
- define what constitutes banking operations; and
- approve the granting of banking licences on a case by case basis.

In the discharge of its duties, the Council may demand any information from, or issue any directive to, banks operating in Iran. As per the Banking and Monetary Act, all banks operating in Iran are under the obligation to implement the Council's directives. There are, however, a few exceptions to this obligation, mostly in relation to the Council's competence to request personal information pertaining to customers.

As a general observation, there is an overlap between the scope of competence of the Central Bank and the Council in some areas. It is well established, however, that the Council is the highest policymaking body of the Central Bank.

Islamic Banking

The Law for Usury (Interest) Free Banking, as approved by the Council of Protectors in September 1983, includes a number of objectives and duties applicable to the banking system in Iran, including adherence to Islamic jurisprudence and interest free lending. This applies to all forms of lending, regardless of the currency in which the loan is made. The Regulations on Monetary and Banking Operations in Free Trade - Industrial Zone of the Islamic Republic of Iran contain an exception to this prohibition on interest, whereby foreign currency transactions conducted from within a free zone are exempt from implementing the Islamic banking system. It remains unclear, however, whether this exemption is consistently applied in practice.

The Law for Usury (Interest) Free Banking also empowers the Central Bank to intervene in, and supervise, the monetary and banking activities in Iran through the following mechanisms:

- Fixing a minimum or maximum ratio of profit for banks in their joint venture and Modarabah activities (these ratios may vary for different fields of activity).
- Designation of various fields for investment and partnership within the framework of the approved economic policies, and the fixing of a minimum prospective rate of profit for the various investment and partnership projects. The minimum prospective rate of profit may vary with respect to different branches of activity.
- Fixing a minimum and maximum margin of profit, proportionate to the cost price of the goods transacted, for banks in installment and hire-purchase transactions.
- Determination of the types, and the minimum and maximum amounts, of commissions for banking services and the fees charged for putting to use the deposits received by banks.
- Determination of the minimum and maximum ratios in joint venture, Modarabah, investment, hire-purchase, installment transactions, buying or selling on credit, forward deals, and customer deposits with respect to various fields of activity, and fixing the maximum facility that can be granted to each customer.

Licensing and Cross-border Lending

The Banking and Monetary Act provides that: “Engagement in banking operations is prohibited, except with the permission of the Currency and Credit Council. The articles of association of banks also must be approved by the Currency and Credit Council...”. The banking legislation in Iran is however silent about what constitutes “banking operations”, which can make it difficult to identify its scope and reach.

The legislation does however make it clear that, at the time of applying for a licence, an applicant foreign bank must formally include the proposed activities for its entity in Iran, which shall be assessed and decided on a case by case basis by the Council in line with the provisions of the Banking and Monetary Act. For the purposes of the Banking and Monetary Act, a bank shall be considered a “foreign bank” if more than 40% of its capital is owned by non-Iranian individuals or entities. Although the Banking and Monetary Act distinguishes between domestic and foreign banks based on the percentage of foreign or domestic ownership, the regime governing foreign and domestic banks under the Iranian banking legislation seems to be substantially similar. The Council is given absolute discretion to approve the permitted activities for each applicant bank on a case by case basis.

All financial institutions in Iran, including foreign banks established in Iran, branches, and representative offices, may not engage in any banking activities or ancillary services (including marketing and cross-border marketing activities) without express approval and licences from the Council and the Central Bank, respectively. Contacting a customer for general relationship management purposes including socialising, discussing general economic trends, general education about financial services, and generally responding to customers, including other modes of marketing, also requires the approval of the Council and the Central Bank. It should be noted that the establishment and permitted activities of a foreign financial institution registered within any of Iran’s free zones would also be subject to the relevant laws and regulations governing the operations of entities in the relevant free zone.

In terms of the different forms of on ground presence available in Iran, the Monetary and Banking Law provides that domestic and foreign banks (as defined above) may only take the form of public joint stock companies. With regard to the establishment of a branch in Iran, the Procedural Regulations for the Establishment, Operation, Supervision, and Winding Up Of Branches of Foreign Banks in Iran issued in July 2011 permits the establishment of branches. As for the establishment of a representative offices or any other alternative form of presence, the Monetary and Banking Law is silent and, in essence, provides the Council with an absolute discretion to approve any proposal or application submitted to it. All activities to

be undertaken by such entities (including branches and representative offices) must be disclosed to the Council at the time of submission of application for licensing and the Council has discretion to consider and grant the right on a case by case basis.

Iranian banking legislation is silent with regard to cross-border lending, i.e. lending to Iranian companies from outside Iran. It is also silent on the permissibility of a bank taking security in Iran without establishing a presence in Iran. To date, it is our understanding that Iranian applicants wishing to avail a loan from outside Iran are required to declare the loan to the Ministry of Finance in Iran, which assesses the reasons for the loan and grants its approval accordingly. Failure to obtain such approval may lead to sanctions by the relevant authorities, which may include freezing of the borrower's account and restrictions on remitting the repayment instalments outside of Iran. In terms of security agency arrangements, cross-border loans were commonly secured through the issuance of an Iranian bank guarantee issued at the request of the Iranian loan applicant and presented to the lending bank as a "security" for the cross-border loan. We understand that this practice has been banned by the Central Bank for some time.

It is too early to assess the degree to which Iran will reform, or the speed at which it will reform, its banking and finance related legislation and framework following years of isolation. Issues of sanctions and limitations on US dollar transactions will also continue to be inhibiting factors to some financial institutions. However, progress has started with the recent reconnection of Iranian banks to SWIFT. Also, with an economy full of opportunities and as one of the world's largest Islamic financial systems, Iran is clearly a jurisdiction which many financial institutions will be eager to explore, whether through establishing an on the ground presence or on a cross-border basis.