

Islamic Republic of Iran: Selected Issues Paper

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ISLAMIC REPUBLIC OF IRAN

Staff Report for the 2011 Article IV Consultation

Selected Issues

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Approved by the Middle East and Central Asia Department

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IRAN'S FINANCIAL SYSTEM: THE STATE OF PLAY

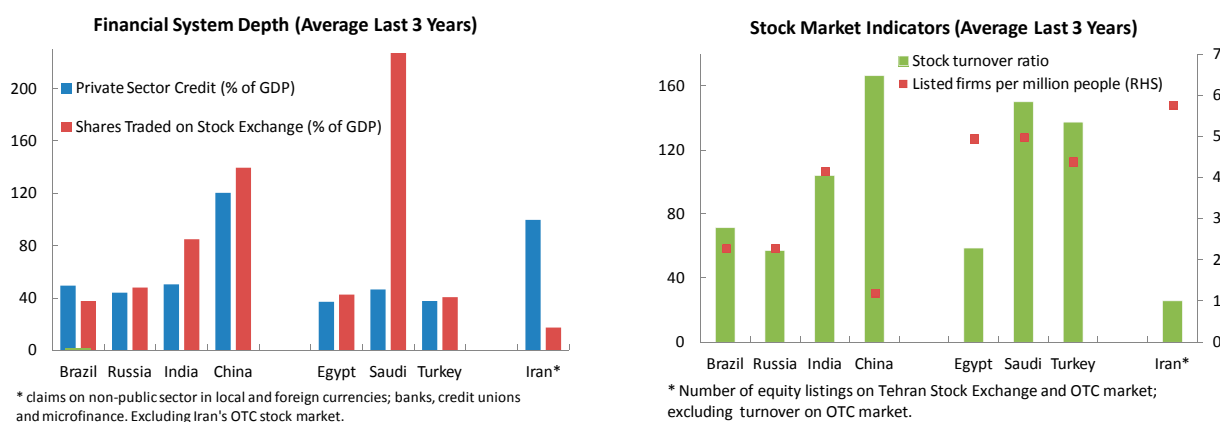
I. INTRODUCTION

1. **Iran's financial system, the largest Islamic financial system in the world, has undergone major transformations.** A significant deepening of bank intermediation occurred in the past decade, spurred by the licensing of private banks. Private bank assets have become the largest in the system following the privatization of large public commercial banks in 2008-09. Iran's equity markets have become viable channels of finance for the real economy. Mutual funds are gaining prominence as a means to encourage secondary market activity. The seven largest private banks are listed on the stock exchange and count among the most actively traded stocks. The performance of banking stocks is underpinned by the public's perception that banks are blue chip companies that pay reliable dividends and benefit from implicit government backing.
2. **The financial system has played a central role to support growth in a context of relative isolation.** To support the economy, the government has intervened in credit allocation and set low lending rates on selected facilities for labor-intensive sectors. While Iran's relative closeness and implicit guarantee from the government has insulated the system from potential crises, credit policies have led to a relative weakening of bank soundness.
3. **A number of important steps have been taken recently to strengthen the financial system.** The 5th Five-Year Development Plan (5th FYDP) in particular extends the Central Bank of Iran's (CBI) regulatory reach and strengthens its supervisory powers, especially over public banks. The launching of a centralized, real-time database with positive credit data in 2011 is a first step towards establishing a comprehensive early warning system. The planned deposit guarantee is an important part of a contingency preparedness framework.

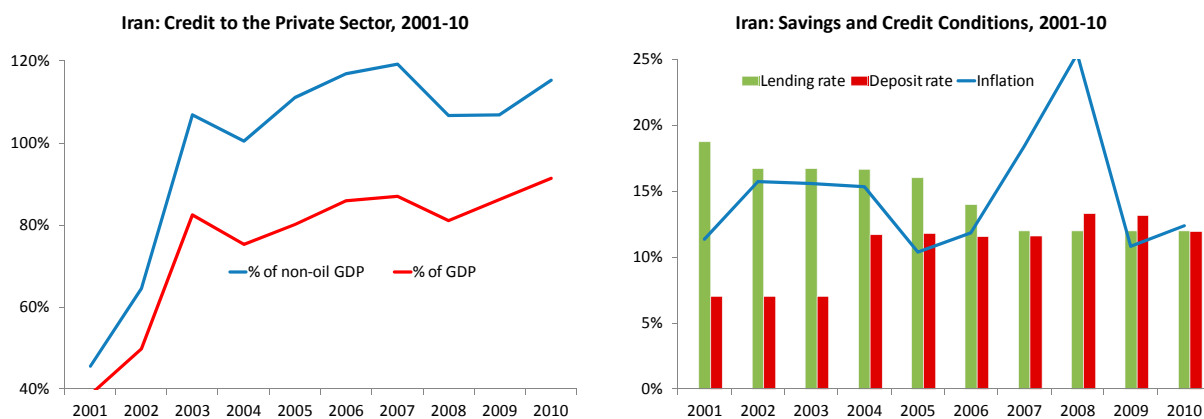
II. THE ROLE OF FINANCE IN IRAN'S ECONOMIC DEVELOPMENT STRATEGY

4. **The financial sector plays a central role in Iran's growth strategy.** In line with the 1983 Law on Usury (Interest) Free Banking, the banking system and the CBI support a broader set of goals and policies of the government, which aim at enhancing economic growth and job creation with low inflation. More recently, Iran's capital markets (Tehran Stock Exchange (TSE); OTC network; commodities exchange) have gained importance in the government's strategy of promoting a more market-oriented economy and mobilizing private capital for the financing of the economy. The strategy encompasses the 2010 subsidy reforms, as well as a wide-ranging privatization program in line with Principle 44 of the Constitution that affirms the primacy of private property in Iran's economic development. Finally, the 5th FYDP that lays out Iran's development strategy for the period 2010–15 contains an important chapter on strengthening and liberalizing the financial system (banks, capital markets, CBI; Box 1).

5. **Iran has a deep banking system and its equity market has developed considerably over the past few years.** The banking system's credit to GDP ratio, a standard indicator of the depth of bank intermediation, is the second highest among seven comparator emerging market countries considered in this study.¹ Iran's density of companies listed on the local stock exchanges is the highest among comparators. However, while the government's privatization program has helped boost market capitalization, trading remains subdued due to the still limited free-float and the absence of mutual funds until 2009.



6. **The significant deepening of bank intermediation that occurred in the past decade was spurred by the licensing of private banks.** The depth of banking increased by 50 percentage points for the ratio of credit to GDP, and by 60 percentage points for the credit to non-oil GDP ratio between 2001 and 2010. This growth occurred largely between 2001 and 2005, when private banks were licensed for the first time since 1979. The expansion of private banks coincided with relatively attractive bank intermediation spreads (the difference between lending and deposit rates). Intermediation spreads narrowed in the second half of the decade through greater competition, followed by government attempts to boost bank lending against the background of the increasing isolation of Iran's economy and dwindling access to foreign sources of capital. The narrower spreads of 2006-10 led to a pause in banking sector expansion.



¹ Depth is measured as the sum of credit to the non-public sector by all credit institutions relative to GDP. Comparator countries comprise Brazil, China, Egypt, India, Russia, Saudi Arabia, and Turkey.

**Box 1. Main Financial System Reforms of the 5th Five-Year
Development Plan (2010–15)**

Article 82. The Money and Credit Council (MCC) permits banks to borrow abroad for the financing of private sector and municipalities. Such borrowing has no sovereign guarantee. The MCC sets for each bank a ceiling on the ratio of its foreign liabilities and commitments to total assets.

Article 83. State-owned companies and municipalities can issue *sukuk* in foreign capital markets with prior approval of CBI and Ministry of Finance. Such instruments have no sovereign guarantee.

Article 86. The CBI should ensure that banks fully segregate within their accounting systems charitable deposits (GAH) from other types of interest-free resources. GAH funds must be entirely used for interest-free charity loans after deductions of margins, and prudential and required reserves.

Article 87 allows foreign investment in Iranian banks. The CBI reviews the investment proposals (fit and proper, etc.). Separate CBI regulations set the share of foreign participation.

Article 90 creates a system of borrower identification based on the government's civil registration databases. The CBI is mandated to operate a positive credit bureau based on this system.

Article 91 requires banks to develop an internal credit rating system following CBI instructions that support their assessment of credit risk and the level of exposure to a particular borrower.

Article 92. The MCC sets the remuneration of term deposits to yield no less than the average of the previous year's inflation and the CBI forecast for the current year.

Article 93 allows public banks to retain after-tax profits into tier 1 capital upon government approval. Until now, public banks had to remit after-tax profits to the budget.

Article 94 allows government-affiliated entities to keep deposits in banks instead of the central bank, and sets conditions for selecting proper banks.

Article 95 establishes a deposit guarantee scheme funded by premia levied on credit institutions operating as banks.

Article 96. (i) CBI is given power to disqualify directors and senior officers; (ii) government appointees as directors and senior officers of public banks require CBI approval; (iii) CBI to inflation-adjust statutory fines for noncompliance with regulations every three years; (iv) CBI to regulate all nonbank credit institutions (credit unions, microfinance charities, leasing).

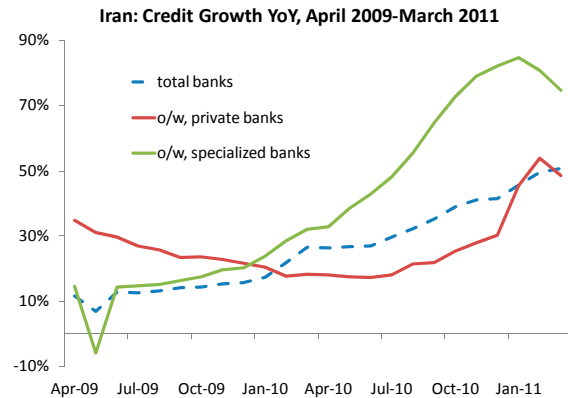
Article 97 creates restricted investment accounts and instructs the MCC to bring Iranian accounting standards in line with the spirit of interest-free banking.

Article 98 creates new *sukuk* (Islamic bond) structures: *istitna*; *morabeheh*; *tanzeel* (discounting of debts that finance real assets).

Article 99. All capital market securities must be registered with the Securities and Exchange Organization (SEO); trades outside SEO-regulated markets are null and void, unless the SEO gives special approval. All post-trade activities on registered securities must be on the SEO central depository system, with transparent audit trail. All directors and senior officers of entities that issue capital market securities must register with the SEO and their trades in capital market securities must have a transparent audit trail.

7. More recently, the government has intervened in the banks' credit allocation to support job creation as the economy's access to foreign capital became more restricted.

The sectoral credit allocation is set by the Money and Credit Council (MCC). In 2010-11, the MCC recommended that banks allocate 80 percent of their increase in deposits to priority sectors—37 percent to manufacturing and mining, 25 percent to agriculture, 20 percent to construction and housing, 10 percent to trade, and 8 percent to export. The remaining 20 percent of the increase in deposits could be used freely, although there are sub-limits on credit for consumer durables or home improvement.²



8. The government has also attempted to stimulate growth through cheaper credit on facilities for labor-intensive activities.³ Rates on selected facilities became negative after 2007 in real terms. More recently, the past 18 months saw strong credit expansion, as policies to boost credit for low income housing and labor-intensive small enterprises came into effect. The government has launched the *Maskan-mehr* housing program that aims to increase the stock of usable dwellings by 15 percent between 2010 and 2014. Credit growth has accelerated from 16 percent in 2009 to 51 percent year-on-year by March 2011, mainly from the housing bank. Private banks have also resumed credit expansion since the launch of subsidy reform in December 2010.

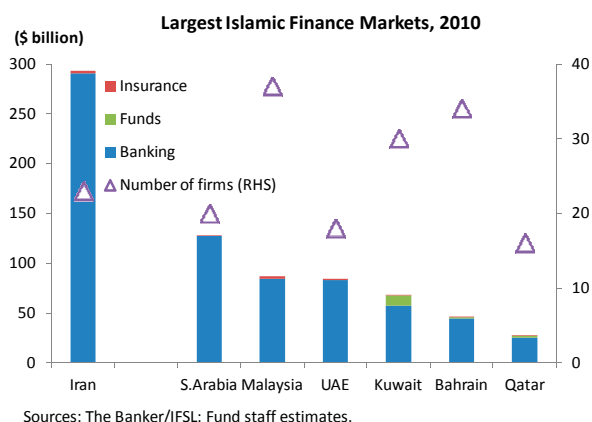
9. Government choices prompted by economic isolation have weakened bank soundness. Controls on rates of return undermine bank profitability and capital. The recent high credit growth could lead to new loan losses, adding further pressure on profits and capital adequacy. Regulatory forbearance could impact listed bank stocks, with potential spillovers on listed companies in other sectors of the market.

² Banks cannot extend facilities for the purchase of property since 2009, only facilities for home improvement with a ceiling of 50 million rials (approx. \$45,000). The public housing bank is not subject to these limitations. 60 million Iranians live in homes that they own. Iran's housing stock is comprised of 21 million units, of which 17 million are deemed usable—meeting minimum requirements, located mostly in urban areas.

³ The Money and Credit Council (MCC) sets rates of return at the beginning of each Iranian year. The lending rate applies to so-called “nonparticipation” facilities (Islamic contracts that do not involve loss-sharing). The deposit rate is the weighted average rate across types of deposits, with the weights equal to the shares of such deposits in the total. The MCC also puts a ceiling on commissions the banks can charge when extending credit.

III. THE ROLE OF ISLAMIC FINANCE IN IRAN'S FINANCIAL SYSTEM

10. **Iran is the world's largest market for Islamic finance.**⁴ Iranian banking is unique in that all banking activities must follow *Shari'a* principles. Moreover, Islamic banking is regulated by a law,⁵ whereas other countries hosting Islamic banking have used the regulatory level to introduce provisions for the specific requirements of *Shari'a*, especially the prohibition of interest and of gambling/speculation.⁶ The TSE is developing plans for listing *sukuk*, a market which has not yet developed in Iran, as it has in Malaysia and GCC countries.



11. **The 5th FYDP provides the legal framework for issuing, trading, and structuring of *sukuk*.** Islamic bonds have existed in Iran since 1994 in the form of “participation bonds” (*sukuk musharekat*) issued by municipalities or large companies to finance projects. However, the participation bonds are redeemable on demand and at face value from the issuing agent and are therefore not suitable for secondary trading. As a result, issuance has been small (less than 1 percent of GDP per year) until 2009-10. In 2010-2011, issuance increased to 4 percent of GDP. From April 2011 onward, Islamic bonds will also take the form of asset-based *sukuk* that are not redeemable and must be listed on the TSE.

12. **Iran's legal framework for Islamic banking envisages four types of deposits:**⁷ demand deposits that are interest-free “loans” to the bank; savings accounts (*Gharz al hazaneh*); term deposits/investment accounts in which depositors share in the general profits of the banks; and since 2011, special-purpose investment accounts in which the investor/depositor restricts the use of funds to designated projects in which the bank is also an equity partner (generally used by specialized banks). Savings deposits receive some remuneration in the form of “bonuses” in cash or in kind through random drawing.⁸ The provisional remuneration of term deposits is set by the MCC each year with a view to ensuring reasonable funding costs. The final remuneration is known a year later, after the

⁴ The size of Iran's Islamic insurance market is less than 1 percent (premia/GDP).

⁵ The 1983 law on usury (interest) free banking.

⁶ See Wilson, R. (2011), “Approaches to Islamic Banking in the Gulf,” Gulf Research Center, Dubai.

⁷ See Appendix I. Main Islamic Financial Contracts Used in Iran.

⁸ Banks are required to distribute 2.5 percent of GAH deposits per year through random drawing.

bank's profits are certified by external auditors and profits apportioned to term depositors. In 2011, one-year deposits yield a provisional 12.5 percent and five-year deposits 15 percent. "Participation papers" (bank CDs or participation bonds) function in the same way, but pay a maximum of one percentage point more than equivalent term deposits that issuers can use to attract subscribers.

13. **Islamic credit contracts take two forms—participatory and nonparticipatory facilities.** Contracts are structured around the notion of rates of profits and in reference to the financing of real assets. Some contracts entitle the banks to a share of profits on the investment being financed (participatory facilities). Nonparticipatory facilities are similar to leasing structures, where the banks' remuneration is the rental rate of the equipment or consumer durable that the bank leases to the borrower or installment sales, where the bank's remuneration is a mark-up on the acquisition value of the good being financed. Housing facilities are structured as multi-year installment sales. For very short-term debt for working capital, the contracts are similar to swaps backed by a commodity trade, with the borrower paying back the advance at a higher future price. The difference between the future and today's price is the bank's remuneration. Overdraft or credit card lending are prohibited.

14. **The MCC sets rates of profit for credit contracts each year.** For nonparticipatory facilities the MCC specifies ceilings (11 to 14 percent in 2011). Participatory facilities are subject to a floor of 12 percent, given their greater risk. In 2011, the MCC introduced ceilings on participatory facilities as well, ranging from 14 to 17 percent depending on the term, or a maximum 300bp above nonparticipatory facilities of equivalent tenors. As for rates of profits on bank liabilities, the above ceilings are provisional, with the final rates of profits on bank assets being finalized a year later.

Iran: Rates of Profit on Bank Assets and Liabilities for 2011–12

| Resources (liabilities) | | Facilities (assets) | |
|-------------------------|---|--|---|
| | Ceiling | | Ceiling |
| CBI overdraft | 34 percent | Required reserves at CBI (in percent of deposit base): 16 percent average for banks; 10 percent for microfinance | 1 percent |
| Demand accounts | 0 percent | | |
| Saving accounts | Cash or in-kind prizes through random drawing | Nonparticipatory (depending on term) <i>Maskan-mehr</i> construction facility <i>Maskan-meht</i> purchase facility | 11–14 percent 11 percent 12 percent |
| Term deposits | 6 to 15 percent as a function of maturity (6 months to 5 years) | | |
| Participation paper | +100bp over term deposits | Participatory (e.g., <i>mosharekat</i> , <i>mozarebeh</i>) | 14–17 percent |

15. **Islamic banking does not pose particular issues to CBI surveillance of the financial sector.** However, Iran's unique position as the sole 100 percent Islamic banking jurisdiction complicates international comparisons, as mapping international standards for conventional banking into Islamic banking has given rise to issues of interpretation:

- The terms of participatory contracts that require sharing losses among the borrower, the bank, and the bank's depositors have not been tested on a large scale because of Iran's high inflation, as inflation eases borrowers' debt burdens;
- Provisioning for impaired assets. Provisions, as the difference between the asset's value at origination and its carrying value, are calculated using interest rates in conventional banking. Provisioning practices also depend on the value of collateral, i.e., less provisioning if the bank's rights to the collateral are ring-fenced from other claimants and if the collateral can be realized with limited price impact. Islamic banks in many countries often justify reporting lower provisions compared to conventional banks because their facilities are backed by real assets, although the market values of collateral assets can be hard to observe;
- Accounting rules that are critical in assessing financial soundness in conventional banking do not translate reliably to Islamic banking for equity-like exposures. Under participatory facilities, losses are shared with depositors, assessed ex-post, and only the installment in arrears is classified. In conventional banking, troubled loans are 100 percent classified, expected losses must be provisioned upfront and any loss is for the bank alone. The 2007 regulation on the classification and provisioning of credit facilities attempts to deal with this by requiring banks to classify 100 percent of an impaired facility (not just installments in arrears) if the borrower's financials and its sector of operation show diminished ability to pay.⁹

Iran: Classification of Loans and Provisioning, 2007 Regulation

| Classes | Time in Arrears* | Provisioning Rate |
|--|-------------------------|---------------------------------------|
| 1. Current | < 2 months | 1.5 percent (general reserve) |
| 2. Overdue | 2-6 months | 10 percent (specific reserves) |
| 3. Arrears | 6-18 months overdue | 20 percent (specific reserves) |
| 4. Doubtful | > 18 months overdue | 50 to 100 percent (specific reserves) |
| *Instalments in classes 2-4 require provisioning. The rest of the facility stays current unless the borrower's financials or sector of operation show diminished ability to pay. | | |

⁹ Benchmark regulatory practices tend to require higher provision rates and prompter classification than in the case of Iran, as well as on total exposure.

IV. IRAN'S FINANCIAL SYSTEM: STRUCTURE AND GOVERNANCE ASPECTS

Equity Finance

16. **Although banking remains the backbone of the financial system, Iran's equity markets have become viable, though still small, channels of finance for the real economy.** Market capitalization has doubled in dollar terms between 2006 and 2010, as a result of more listings, significant IPOs under the government's privatization plans, as well as sharp increases in prices in 2009-10. Iran has two venues for listing and trading shares: the Stock TSE, and an OTC exchange for small and medium-sized enterprises. The two venues list some 500 companies. The TSE hosts a main board for the more liquid share and stronger companies, and a secondary board for less liquid shares. The OTC exchange lists companies with less of a track record. The 5th FYDP provides that companies which have issued shares under public placements must be listed on the OTC exchange, regardless of their performance. As a result, another 1,500 companies will be listed by 2012 and therefore comply with minimum requirements of transparency and governance.¹⁰

17. **The Iran Mercantile Exchange (IME) actively trades spot contracts of agricultural commodities, metals, gold and petrochemicals.** The IME is planning to launch a crude oil contract, as well as futures. Nonresidents are able to trade the contracts in the offshore center of Kish Island in the Persian Gulf. The government plans to use IME prices as benchmarks to adjust domestic prices when the subsidy reform will be completed. IME prices are thought more suitable given that the specifications of the underlying commodities match the Iranian market more closely than international prices, thus avoiding basis risk.

18. **The capital market regulator has developed a comprehensive approach to market integrity with a strong focus on transparency and enforcement.** Companies use the regulator's electronic network to file and disclose quarterly statements within 30 days of quarter end, of which the mid-year and end-year must be audited. Companies are required to post annual audited financials within 60 days of year-end, and to provide quarterly earnings guidance. Material developments of a financial or corporate control nature must be immediately disclosed to the market. As concerns enforcement, the Securities and Exchange Organization (SEO) requires that all company insiders (directors and senior officers) be registered and their trades individually traceable (audit trail) on its central depository system, which handles all post-trade requirements of Iran's capital markets. The SEO supervises the audit profession and retains its own auditors to verify that financial statements fairly

¹⁰ The OTC exchange has traded participation bonds since 1988. The current outstanding is \$500 million, but liquidity is low because the bonds are redeemable at face value on demand from the issuing agent.

represent management's current knowledge. Iran has a dedicated court with judges specialized in capital market issues to prosecute market abuse and manipulation. This framework incorporates the lessons of several scandals that marred Iranian equity markets in the 1980s.

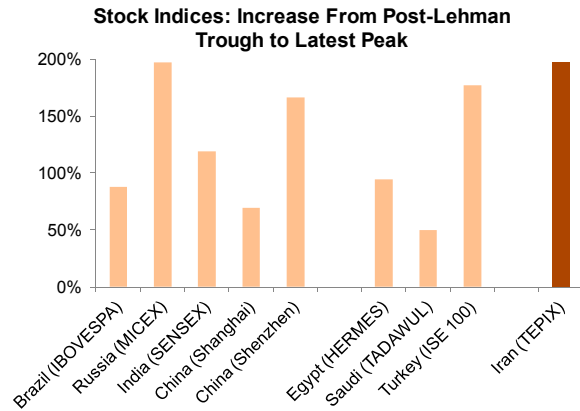
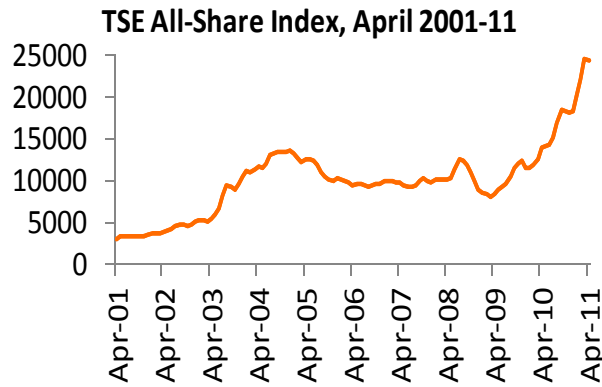
19. **The regulator has recently licensed mutual funds as a means to encourage market turnover.** Open-ended mutual funds did not exist before 2009. Some 50 funds are currently marketed by asset managers, brokerages, or investment banks. The aim is to attract indirect retail investors and thereby increase market activity. Direct retail accounts on the TSE number 4 million, of which 2 million are active. These investors represent half of the market turnover, though they only hold 21 percent of the market capitalization. The remainder is locked up in accounts of largely buy-and-hold investors: closed-end investment companies (25 percent); pension funds (17 percent); government-affiliated investment companies (16 percent); banks (5 percent); and "justice shares" (16 percent).

20. **The government has distributed free shares to households under its privatization program.** IPOs of state companies must allocate 40 percent of the offering to the justice shares scheme, 40 percent to institutional investors, and 20 percent as free float to retail investors. The justice shares scheme aims to develop a shareholding culture, with 40 million Iranians owning justice shares in state-controlled investment vehicles (one per province) that hold and service a uniform portfolio of underlying company stocks. Justice shares cannot be sold for ten years, unless holders buy them from the government. Developing the shareholding culture rests partly on the investment vehicles paying dividends on justice shares. As a result, some companies may not retain sufficient earnings to contain leverage.

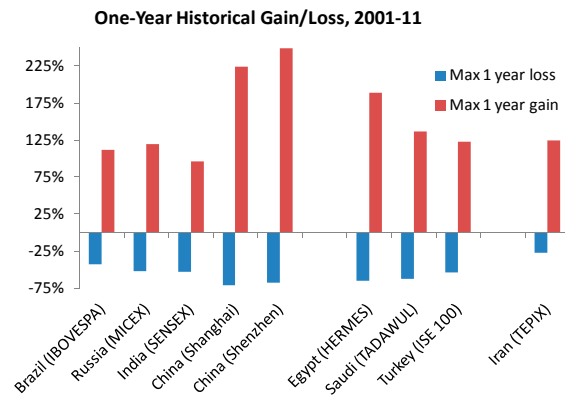
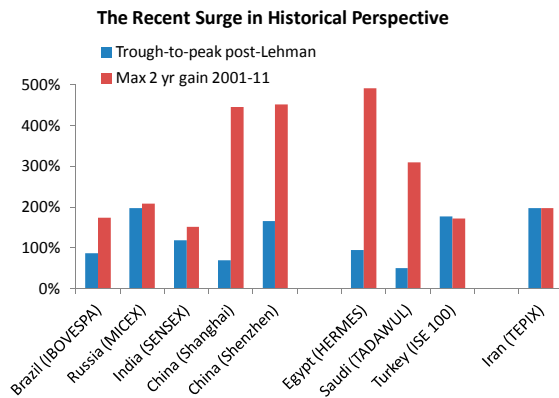
21. **While the surge of equity prices since 2009 has been large, it has not reached bubble proportions because of several supportive factors** (Box 2). The TSE posted large persistent negative returns in real terms between the third quarter of 2004 and the first quarter of 2009, after a brief bubble-like episode that started in the second quarter of 2003. After a long bear market, investors were again attracted to equities partly because of negative real rates on bank deposits, with inflation reaching 25 percent in 2008. At the same time, the government launched large privatization IPOs that were attractively priced. After the recent peak in April 2011, stock prices have largely stagnated or declined against a background of moderating international commodity prices, subsidy reform that has clouded the earnings outlook for energy-intensive sectors (e.g., cement), growing uncertainty in the run-up to the 2012 parliamentary elections, and sanctions that have hurt the supply chain (e.g., light manufacturing/assembly).

Box 2. The Tehran Stock Exchange: Bubble or Fundamentals?

By April 2011, the Tehran Stock Exchange (TSE) all-share index (TEPIX) had increased 200 percent from its April 2009 low, raising concerns about a bubble. Russia and Turkey have had comparable increases in the region. The TEPIX growth was broad-based across sectors and coincided with a number of IPOs. Iran’s mass privatization program allows for 80 percent of state assets to be sold: 40 percent via the distribution of shares to low-income households; 40 percent via IPOs. The market has considerably grown in size from large IPOs of state companies since 2008.

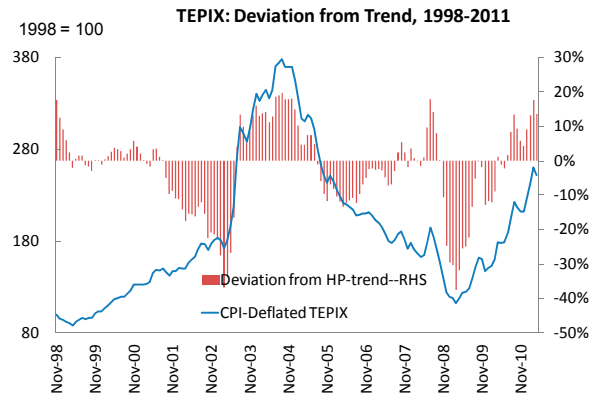
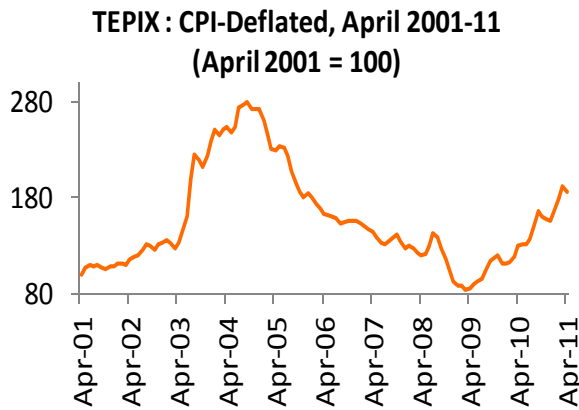


The TSE is not an outlier on a cross-country basis, although the price surge between early 2009 and April 2011 has been the largest in any 2-year window over its past ten years. China, Egypt, and Saudi Arabia have had price surges up to twice as large as Iran during this time. Moreover, Iran’s episodes of stock market corrections since 2001 have been the smallest among the comparator countries considered here (27 percent versus China’s 70 percent). Even if the TSE dropped to the extent of China’s peak correction, it would still post gains of 40 percent at the one-year horizon.

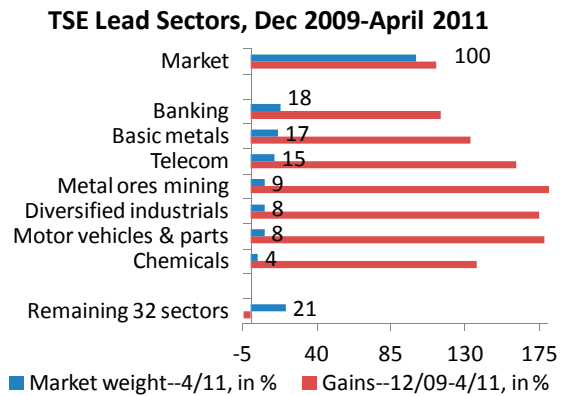
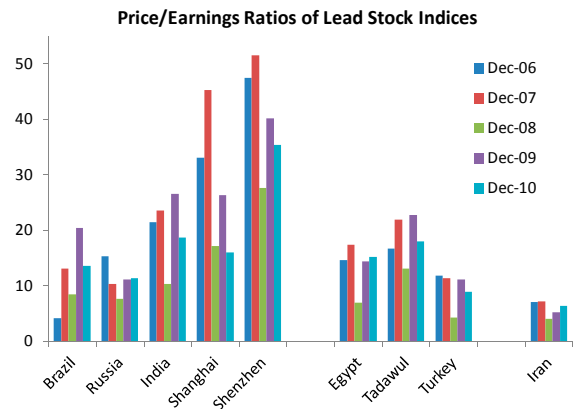


Box 2. The Tehran Stock Exchange: Bubble or Fundamentals? (concluded)

The TSE is also not an outlier when looking at the magnitudes of stock price changes in real terms (CPI-adjusted): real stock prices in April 2011 were still 30 percent below their 2004 peak. A more formal assessment of potential price bubble involves comparing real prices to trend. In the recent past, real prices were up to 18 percent above trend, quite below threshold values of 40-50 percent that help predict financial crises at one- to two-year horizons.¹¹



There is also no evidence of a bubble form looking at valuations. TSE price/earnings (P/E) ratios have been consistently low. Between 2007 and 2010, TSE P/E ratios ranged between 25 and 44 percent of the median of other markets. Low P/Es could reflect frontier market status and the impact of sanctions. A sectoral analysis of the TSE suggests that sanctions may have boosted earnings of diversified industrials and motor vehicles and parts through import substitution, including through government procurement channeled to domestic producers. It is also the case that the fundamentals of basic metals, mining, or petrochemicals have benefited from the surge in global commodity prices. Under-pricing of large government IPOs (Iran Telecom, banks) in the context of the privatization program has also been a supportive factor.



¹¹ Borio and Lowe (2002), Asset Prices, Financial and Monetary Stability” Exploring the Nexus, BIS.

22. **The seven largest private banks are listed on the TSE and count among the most actively traded stocks.** At end-2010, the TSE sub-sector “Monetary Intermediation” had the largest capitalization of the TSE’s 39 sectors (18 percent of the market), with four banks being in the top ten listings by market cap. The sector also accounts for more than half of total market turnover, because of its higher free float relative to other market sectors. CBI regulations encourage bank shares to be widely held. A 2007 regulation prohibits an individual from holding more than 5 percent of a private bank’s equity and 10 percent for a legal entity. The thresholds are assessed on an ultimate beneficiary basis, after factoring in nominee shareholders. These limits do not apply to foreign investors, the CBI having discretion in approving larger foreign participation.

23. **The performance of banking stocks is underpinned by the public’s perception that banks are blue-chip companies, which pay reliable dividends and are assumed to have implicit government support.** No bank has ever failed and the government has a record of supporting banks in case of trouble. Although the large private banks are listed, bank transparency and governance are novel concepts—as in most countries in the region. The CBI intends to standardize bank public reporting, by introducing minimum requirements to disclose core financial soundness indicators and qualitative information on bank governance, which are not yet included in SEO disclosure requirements.

The banking sector

24. **The banking sector is comprised of 26 institutions grouped in four segments:** (i) four public commercial banks; (ii) four public specialized banks (agriculture, housing, export, mining, and industry); (iii) sixteen relatively small private banks; (iv) four large recently privatized public banks. Private banks have been allowed in the system since 2000, with six licenses being granted initially, and ten more since then. These private banks had a limited market share (10-15 percent) until the recent privatizations. There are also several hundred credit unions and microfinance institutions; the credit union sector is going through an intense phase of restructuring following recent abuses (Box 3).

Box 3. NonBank Credit Institutions

Iran has some 7,000 registered nonbank credit institutions, of which 5,000 are active (3,500 microfinance entities; 1,500 credit unions), with total assets in 2010 of \$60 billion (>15 percent of GDP). The sector was until recently neither licensed nor supervised by the CBI.

Microfinance charities

Six entities account for 90 percent of the sector's assets of \$40 billion. The entities' funding consists of charitable donations supplemented by nonremunerated deposits that the public entrusts to them given that the funds are lent interest-free to borrowers. Their license allows them to charge a 4 percent commission on lending. However, unless a minimum scale is reached, 4 percent is not sufficient to cover operating costs in times of higher inflation. As a result, sub-optimal entities started to take on credit risk by granting non-interest free facilities. Losses led to a run on a microfinance charity in Isfahan in 2003. The panic brought to light the risk posed to social stability by chronically loss-making microfinance institutions that also collect deposits. The 2007 "law on the regulation of nonbank money markets" imposed limits on charities' operations: deposits became subject to CBI reserve requirement; lending was restricted to interest-free loans.

Credit unions

90 percent of the sector's total assets of \$20 billion are also accounted for by six entities. Credit unions were licensed by the Ministry of Cooperatives, but not supervised effectively. While the vast majority of institutions provided banking services purely to their members, some progressively engaged in regular banking in violation of the license. To attract deposits away from established banks, some institutions promised to remunerate term deposits much above the CBI-regulated rates offered by banks. Paying high deposit rates required credit unions to engage in riskier lending and, in 2010, one million depositors were affected by the bankruptcy of two medium-sized credit unions. The run stopped when the CBI provided a credit line to a bank that agreed to absorb the failed institutions.

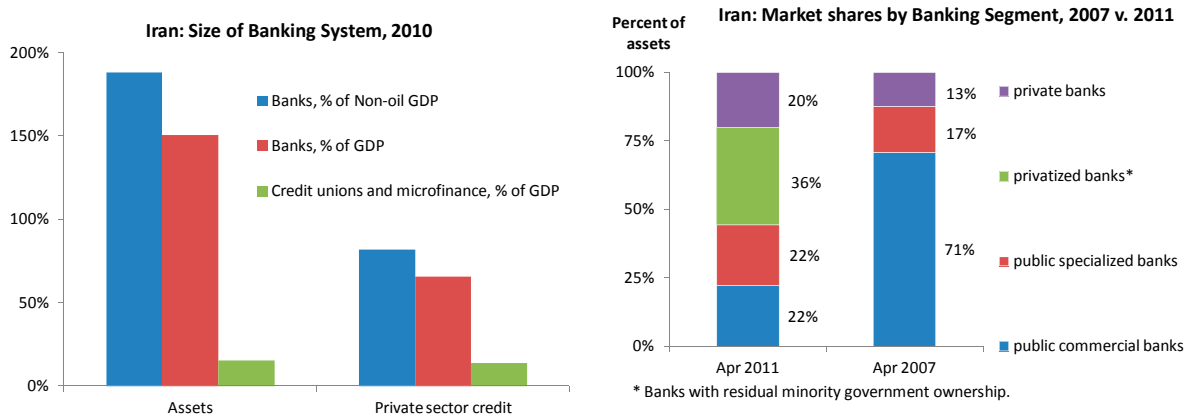
New regulatory framework for credit unions

The 5th FYDP of 2010 (article 96) makes the CBI solely responsible for licensing and supervising nonbank credit institutions. Since then, 900 credit unions have applied for a CBI bank license and the many small and medium-sized ones will operate under the umbrella of a new Cooperative Bank of Iran. The CBI closed 50 credit unions and merged the remainder into six new entities. The consolidation is therefore expected to result in 12 new banks and the Cooperative Bank of Iran.

Other nonbank financial institutions

- 2 investment banks, 110 brokerages, and 48 investment companies regulated by the Security and Exchange Organization
- 100 active leasing companies regulated by the CBI
- 1,000-1,500 money transfer operations

25. **Private bank assets have become the largest in the system following the privatization of large public commercial banks in 2008–09.**¹² The four privatizations boosted the private banks' market share from 13 percent in 2007 to 56 percent in 2011. The CBI also issued eight new licenses between April 2010 and April 2011 and several hundred credit unions were brought under the supervision of the CBI. Some of the original private banks are financial arms of broader commercial/industrial groups, a common phenomenon in the region. The CBI aims to reduce cross-shareholdings, but a clearer separation of banking and commercial interests has been delayed by international sanctions.¹³

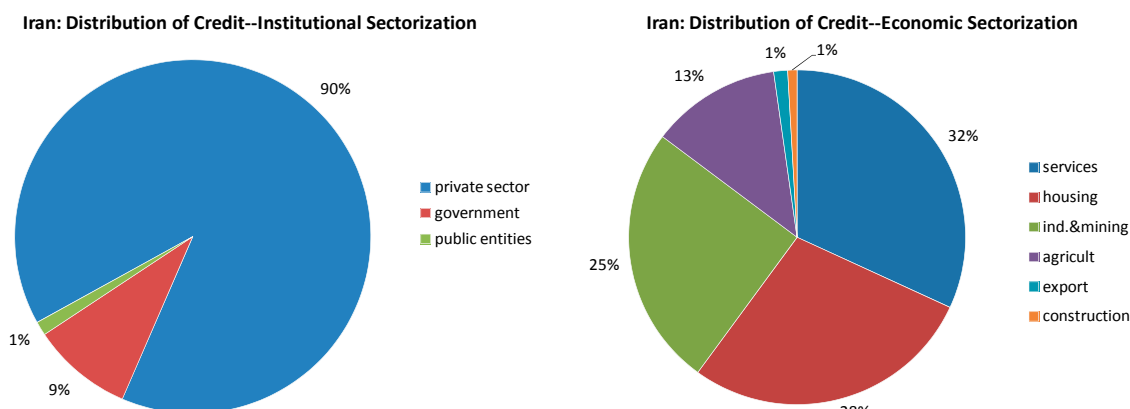


26. **Iranian banks have straightforward balance sheets.** With the exception of the four specialized banks, funding consists of domestic deposit-type liabilities and some Islamic bank bonds, Public commercial banks used to have some excess liquidity in the form of deposits at the central bank, but these had largely disappeared by the end of 2010. The four specialized banks depend on central bank refinancing, as they are called upon to implement large directed credit programs, such as the *Maskan-mehr* National Housing Program. At end-2010, the CBI lent out to specialized banks about half of the deposits of private banks at the CBI. Interbank borrowing is still underdeveloped. The asset side of banks' balance sheets is

¹² Bank Mellat (2008), Bank Refah (2008), Bank Tejarat (May 2009), Bank Saaderat (June 2009).

¹³ As of May 18, 2011, and under United Nations Security Council Resolution 1929 authorizing sanctions targeting Iran's nuclear and missile proliferation, the European Union had prohibited 18 Iranian banks from conducting transactions in Europe. In addition to the 18, the U.S. Treasury has sanctioned three more banks pursuant to US Executive Order 13382. The U.S. alleges that Iran has a practice of migrating illicit financial activities from one bank to another to facilitate transactions for sanctioned banks. E.O. 13382 is aimed at freezing the assets of proliferators and their supporters, and isolating them from the U.S. financial and commercial systems.

dominated by credit to nongovernment entities.¹⁴ Three-fourth of credit to the nonpublic sector goes to services, housing, and industry and mining.



27. **Some credit facilities benefit from government guarantees.** These include national credit programs (e.g., housing, agriculture, small manufacturing workshops), and facilities extended under ad-hoc injunctions, such as imports of essential goods or various packages designed to cushion the impact of subsidy reforms on enterprises. Guarantees are concentrated in public banks and have been utilized to comply with large exposure limits for borrowers benefiting from national credit programs.¹⁵

28. **The private banks have concentrated their lending on participatory facilities.** The original private banks account for less than 3 percent of systemwide nonparticipatory facilities. Banks charge higher rates for participatory facilities, to compensate for the greater market risk due to their profit-sharing features. Private banks have experienced significantly higher NPLs than privatized banks or public commercial banks.

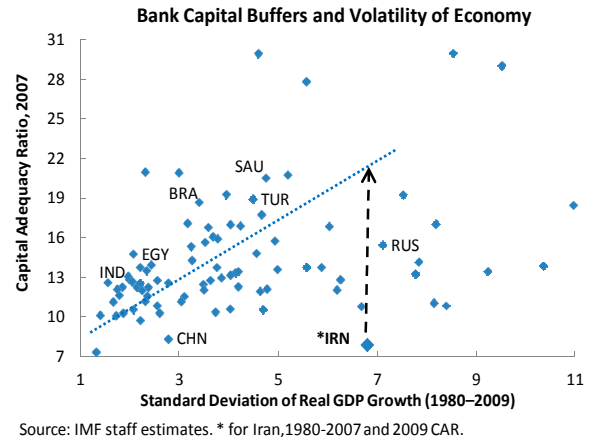
29. **Negative real deposit rates since 2007 have spurred other forms of savings, such as real estate, stock market, gold, and foreign exchange.** It is generally believed that retail deposits in Islamic systems have limited sensitivity to their remuneration, because of Islam's expectation that depositors should fund charitable causes interest-free. . Nevertheless, the share of interest-free deposits dropped from 40 percent a decade ago to 20 percent currently and the share of interest-free deposits in private banks has been stable at around 4 percent. These banks' business model is focused on term deposits to fund term banking facilities.

¹⁴ Oil revenues ensure that net credit to government is negative.

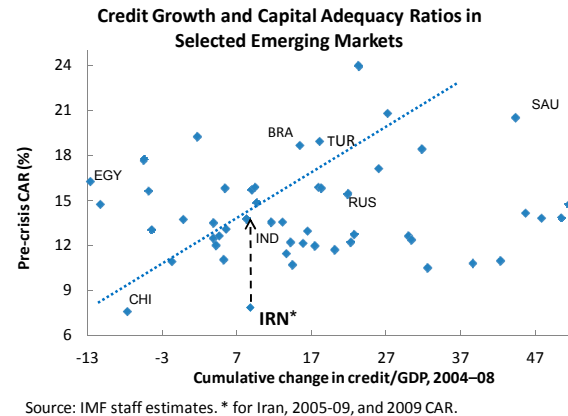
¹⁵ Large exposure limits are set by the MCC as part of yearly supervisory policy packages. [www.cbi.ir]

V. IRAN'S BANKS: PERFORMANCE AND SOUNDNESS

30. **The banking system's aggregate capital adequacy ratio is low.** In March 2011, the aggregate ratio stood at 7.5 percent of risk-weighted assets.¹⁶ This is low in relation to the volatility of the economy, which is used here as a proxy for intrinsic risk of doing banking in a particular economy. For example, Chinese banks operate with a capital adequacy comparable to that of Iranian banks (in the aggregate), although China's economy is 40 percent less volatile than Iran's. The cross-country evidence on the capital needed in a volatile environment suggests that Iranian banks should target a capital ratio well above 15 percent. The presumption of state support and the ability of the government to credibly provide support also play a role in deciding a target for capital.

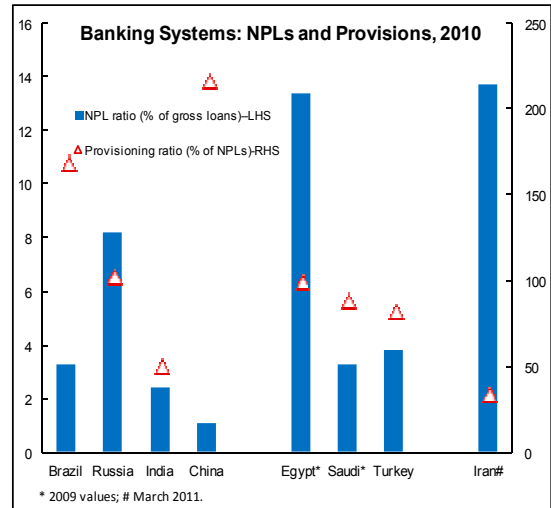


31. **The capital ratio is not in line with recent credit growth.** In other countries, excessive credit growth/credit bubbles have often been associated with high loan losses a couple of years later. High provisions on nonperforming loans translate into losses that are deducted from capital. Sound banking requires that the capital buffer should be built up during the credit bubble in anticipation of such losses. On this measure, Iran's 2009 capital adequacy ratio was also much below other countries. The recent credit growth suggests a target for the capital ratio on the order of at least 13 percent.



¹⁶ Risk-weighted assets (RWA) are calculated under the Basel I set of weights. In March 2011, the ratio of RWA/total assets ranged between 54 percent (specialized banks) and 63 percent (private banks).

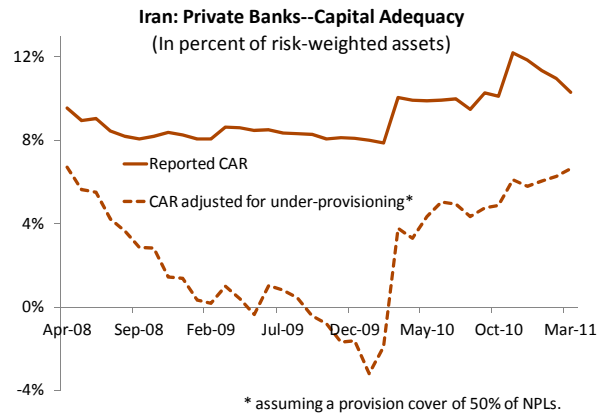
32. **In addition to being under-capitalized, the banking system is under-provisioned.** The aggregate NPL ratio reached 23 percent of the loan portfolio in early 2010, with a provision cover of 12 percent of nonperforming loans. Sustained collection efforts supported by special government measures helped lower the NPL ratio to 16 percent by February 2011 and raise the provision cover to 32 percent.¹⁷ Nevertheless, among comparator countries, the Iranian system has very low provision cover. Egypt's NPL ratio is comparable to Iran's, but impaired loans are fully covered by provisions. Moreover, Egypt's credit/GDP ratio shrank in the past few years as newly privatized banks actively repaired their balance sheets.



33. **Under-provisioning implies that reported profits and capital could be overstated especially for banks with below-average provision cover.** Shortfalls resulting from under-provisioning should be deducted from capital to get a better picture of bank soundness. The marked propensity of Iranian banks to under-provision is a sign of weak earnings given the amount of risk taken. Under-provisioning also reflects pressure to distribute dividends.

34. **The system-wide average soundness indicators hide the fact that some banks perform worse than others** (Box 4).

Although the private banks report a capital adequacy ratio of 11 percent, they also have the highest NPL ratio (23 percent in February 2011) and the lowest provision cover (18 percent). Under mild assumptions, their capital adjusted for under-provisioning would be 6 percent of RWA, instead of the reported 11 percent. Over the period April 2008 to March 2011, the private banks' capital adjusted for under-



¹⁷ The government encouraged banks to waive the standard 6 percent penalty on overdue loan installments if borrowers agreed to pay within a short time window. It mobilized the judiciary to put pressure on delinquent borrowers. It helped public companies settle their loan arrears. The banks were allowed to count nonperforming claims with government guarantees as current. The banks beefed up loan collection operations, with some private banks creating asset management subsidiaries dedicated to loan collection.

provisioning was on average 6.5 percentage points below their reported average capital of 9.1 percent.¹⁸ Adjusted capital was actually negative between September 2009 and February 2010, just before the annual financial statements for 2009-10 were released. The performance of these bank stocks on the TSE does not reflect these trends, as investors put more weight on dividends in the short term and government implicit guarantees than on the soundness factors that would help sustain dividends in the long run.

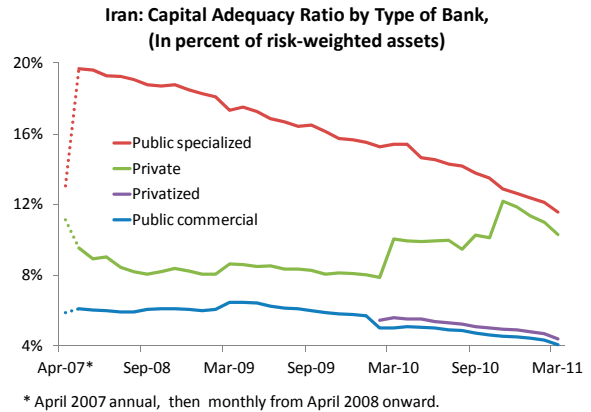
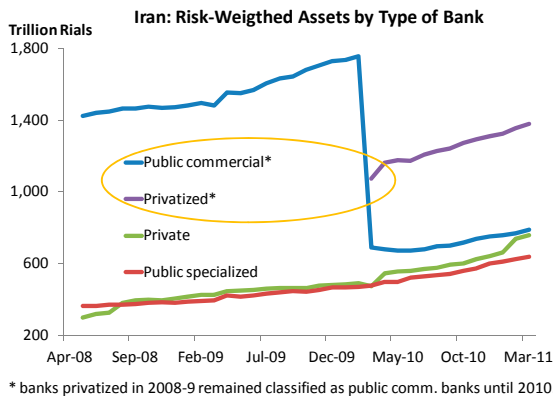
35. **Banks are able to operate with low capital because of limited market discipline and connectedness with each other.** Discipline is imposed by counterparties, and is supported by the supervisor and the accounting and auditing bodies. Iranian banks do not rely on foreign funding and do not need international ratings.¹⁹ Iranian banks also borrow little from each other. To some extent, the sanctions hamstringing the supervisor, justifying more forbearance than would be the case in their absence. Finally, how and what banks report to the market is determined by the state accounting and auditing body, although efforts are made to keep local standards in line with evolving international standards. Restoring capital through fresh equity or consolidation would require strong measures to restore bank profitability.

¹⁸ Assuming a provision cover of 50 percent, the cover observed in India which is the weakest among Iran's comparator countries.

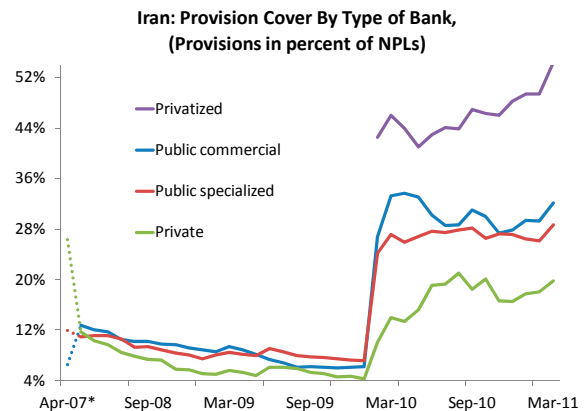
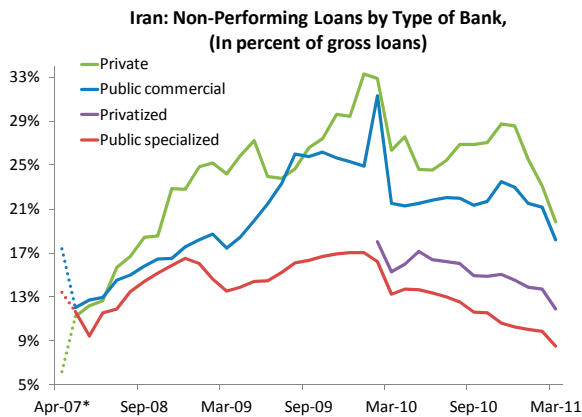
¹⁹ Capital Intelligence, a specialist emerging market bank rating agency, rates three out of 26 Iranian banks: one private, one specialized and one privatized.

Box 4. Iran: Analysis of Financial Soundness Indicators by Type of Bank

Privatized banks have become the largest segment of the four types of banks operating in Iran. Their financial soundness indicators can be tracked separately since February 2010 when they were reclassified from the category “Public commercial banks” to “Privatized banks.” The capital adequacy ratios of Iranian banks have fallen steadily over the past two years, except for private banks. Both public commercial banks and the recently privatized banks operate below Iran’s regulatory minimum ratio of 8 percent (Basel 1 definitions).

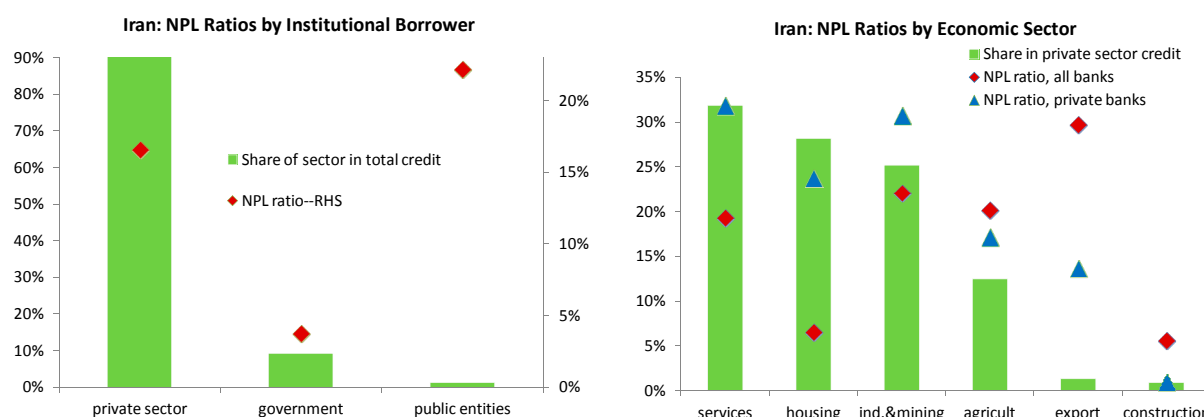


All four types of banks have reduced their NPL ratios and improved provision cover over the past year, as a result of sustained efforts to collect credits in arrears and with indirect government support. Among the types of banks, private banks report the highest NPLs as well as significantly lower provision cover than other banks. This under-provisioning wipes out their advantage from a reported higher capital adequacy ratio.



Box 4. Iran: Analysis of Financial Soundness Indicators by Type of Bank (concluded)

Private banks' NPLs originate from private borrowers in the service, housing, and industry & mining sectors. The breakdown of NPLs by sector and type of banks indicates that private banks have been worse than other banks in assessing risk in these sectors, possibly reflecting their concentrated use of longer maturity and generally riskier participatory facilities. For example, in the housing sector, the average private bank has reported NPLs of 24 percent of outstanding credits, compared to 6 percent for the average bank. NPLs on facilities extended to nongovernment public entities stand at 22 percent, but the share of such credits in total lending is marginal. The payment performance of the public sector therefore has little impact on overall bank soundness.



VI. A FRAMEWORK FOR FINANCIAL STABILITY

36. **Iran has been improving banking practices and standards of information disclosure and corporate governance.** The listing of privatized banks has expanded the number of listed private banks. As a result, half of the banking system is now disclosing financial information to the Securities and Exchange Organization on a quarterly basis, thereby improving transparency of the banking sector. Furthermore, the CBI issued a regulation on the classification and provisioning of banking facilities in 2007 that made core financial soundness more comparable across banks, thus helping to reveal the extent of forbearance needed for banking to work in the context of economic isolation.

37. **The 5th FYDP aims to extend the CBI's regulatory reach and strengthen its supervisory powers, especially over public banks.** In particular, the CBI has been given authority to disqualify directors and senior officers of banks, and extend its fit and proper tests to public bank officers. The FYDP authorizes the government to allow public banks to retain after-tax profits into capital, instead of accruing to the budget. The CBI is also further revamping its regulatory framework to align it with international practices, by increasing fines for noncompliance with regulations, introducing regulation on related party lending, large exposures, and mandatory disclosure of core financial soundness indicators. However, CBI's prompt enforcement powers ("cease-and-desist") remain limited as violations are

referred to a high-level Bank Disciplinary Committee which is comprised of non-CBI members.

38. **The recent decline in NPLs as a result of improved collection and the establishment of credit registry are important steps to improve credit allocation.** Further steps to address the large NPL portfolio should include an accurate mapping of NPLs. The establishment of an asset management company (AMC) would also help banks focus on the normal banking needed for economic activity, rather than collection of credits in arrears, and coordinate financial restructuring (Box 5). Removing controls on credit allocation and rates of return²⁰ will also be important to ensure proper incentives for more considered risk-takings by banks.

39. **Enhancing financial stability would also require shoring up banks' provisions and capital.** The intrinsic volatility of Iran's economy calls for a higher minimum capital adequacy and stronger liquidity buffers, a Basel-3-type capital conservation buffer above the minimum, and a higher provision cover. This would necessitate stronger bank earnings, by allowing banks to set rates of return on their assets and liabilities freely and reducing operating costs.

40. **The launching of a centralized, real-time database with positive credit data in 2011 is a first step towards establishing a comprehensive early warning system.** The early warning system should strive to anticipate vulnerabilities, based on the international experience, and monitor risk-taking in as detailed a manner as necessary, in particular for the riskier types of bank exposures and concentration of risks. High dependence on funding from large depositors requires close monitoring, as does connectedness among financial institutions, e.g., through interbank exposures. The early warning system should be under frequent review to capture new risks and innovations in financial intermediation. For example, inter-enterprise arrears or restructured credits should be tracked closely in the current phase of subsidy reform. The system would need to encompass the monitoring of corporate leverage, foreign borrowing of the private sector, and household indebtedness.

41. **The planned deposit guarantee is an important element of a contingency preparedness framework.** A comprehensive framework would include a special insolvency regime that ensures swift CBI intervention in troubled banks. The planned deposit guarantee fund should be designed as an integral part of such a crisis management framework. The crisis management framework also needs a clear lender of last resort policy, supported by minimum liquidity buffers that allow banks to withstand protracted periods of stress in funding markets without central bank support.

²⁰ The notion of interest rates is not used in Islamic banking. The appropriate term is rates of return. Similarly, banking facilities, rather than loans, is the appropriate term for bank credit.

Box 5. International Experiences with Corporate Restructuring

International experiences with asset management companies (AMCs) indicate that AMCs have been more suited to financial than operational restructuring. The skill mix for operational restructuring rests less with AMC staff than with new, arm's length investors that are free from political pressures.

- *Financial restructuring* means allocating losses on existing assets (burden-sharing). The aim of financial restructuring is to create incentives for new shareholders/management, as well as remaining creditors, to enforce operational restructuring on entities that benefit from financial restructuring.
- *Operational restructuring* involves measures to downscale by selling off unprofitable activities, and increasing cash flow from continuing activities through savings on fixed costs (real estate, equipment, inventory, etc.), variable costs (wages, input costs through more efficient equipment and processes, etc.), as well as increases in revenue (e.g., new products, better marketing of existing products).

International experiences of large-scale corporate restructuring fall into two categories: decentralized and centralized approaches. Under decentralized approaches, creditors negotiate tailor-made debt restructuring with each borrower, with indirect state support (tax relief, bank recapitalization, subsidies on inputs or wages, accounting treatment of distressed claims). This is the approach currently taken by Iranian banks.

Centralized solutions have been used when the size of NPLs and the complexity (large numbers of borrowers simultaneously in distress) overwhelms the restructuring capacity of the banking system. Centralized AMCs present design challenges, in terms of governance structure and pricing of claims taken over from banks.

Prominent examples of centralized approaches are Sweden (1993), various countries during the East Asia crisis (1998), and during the recent global financial crisis (e.g., Ireland, US). Specific lessons have emerged from the international experience with centralized approaches.²¹ The overarching challenge involves balancing what needs to be done (the point of view of economic realities) with what can be done (political realities) given that liquidation of nonviable borrowers is unavoidable.

- The insolvency regime must be effective: bankruptcy needs to be a credible threat to firm owners and managers. This can simply be a matter of court efficiency if nonspecialized courts lack expertise in overseeing company restructuring. However, in most instances, it is political interference in the insolvency process that undermines effectiveness and equal treatment;
- Banks need fresh equity to absorb losses on loans that are being written down. Banks' continuing earnings are insufficient to absorb losses related to systemic insolvencies;
- Connectedness between banks and large borrowers, through ownership links or connected lending, need to be cut back. In many countries, links that went beyond generally accepted large exposure limits or related party transaction limits induced delays or blocked restructuring;
- Banks need incentives to mark down the value of claims upfront, instead of playing for time in the hope of a recovery in value. Incentives work mainly through supervisory discipline (loan classification and provisioning, exposure limits, capital adequacy) rather than market discipline.
- Overcoming supervisory forbearance has been a challenge everywhere.

²¹ See S. Claessens (2005), Policy Approaches to Corporate Restructuring Around the World: What Worked? What Failed, in *Corporate Restructuring: International Best Practices*, World Bank; T. Laryea (2010), Approaches to Corporate Debt Restructuring in the Wake of Financial Crises, IMF.

Appendix I. Main Islamic Financial Contracts Used in Iran

| Credit Instruments | | | |
|---|--|---|---|
| Definitions | Modalities | Use | Accounting |
| <p>Non profit sharing facilities or transaction contracts Transactional contracts based on sale/ purchase agreements with a predetermined rate of return, fixed maturities and fixed payments.</p> | Rate of return (interest rate) on non profit sharing facilities are subject to a ceiling (12 percent). | | |
| <p>Installment sale</p> | The bank buys a good whose ownership is immediately transferred to the user that will repay the price with a margin in a number of instalments on a predefined period of time. | For all kind of customers (private persons, companies) and all kind of financing, especially housing and machinery. | The bank enters in its accounts (assets) the value of future instalments and not the purchase price. On the liabilities side it enters the difference between the total future instalments and the purchase price as unearned profit. This part will be discounted at each payment of instalment. |
| <p>Havaleh: <i>The undertaking by one party (the Jael, Bank or employer) to pay a specified amount of money (the Joal) to another party in return for rendering a specified service in accordance with the terms of the contract. The party rendering the service shall be called "Amel" (the Agent or Contractor).</i></p> | Kind of credit short-term facilities in order to develop productive, commercial and servicing affairs. | For small amounts, especially for real estate repair. | |
| <p>Forward transactions (Salaf) <i>cash advance purchasing of manufactured products on the basis of the given price.</i></p> | The repayment is supposed to be made in goods at a fixed maturity. | For working capital financing | |
| <p>Hire purchase (Ijarah)</p> | Comparable to instalment sale with the difference that the ownership of the good is transferred to the user (borrower) at the end of the contract. | Frequently used for housing | Accounting method is comparable to that of instalment sale and ownership of good is accounted off-balance. |
| <p>Gharz-al-Hassaneh Loan: <i>An interest-free loan extend a definite period of time.</i></p> | Charity loans without interest but the bank may charge a 3 percent fee maximum. | For small loans to poor people. | |

Appendix I. Main Islamic Financial Contracts Used in Iran

| Credit Instruments | | | |
|--|--|--|------------|
| Definitions | Modalities | Use | Accounting |
| Participatory lending Are based on profit sharing between bank and customer on the proceeds of the loan. | Remuneration on a floating basis supposed to reflect the real rate of return. No ceiling on rate of return. | | |
| Mozarebeh : <i>A contract wherein the bank undertakes to provide the cash capital and other party (the Amel or Agent) undertakes to use the capital for commercial purposes and divide the profit at a specified ratio between the two parties at the end of the term of the contract.</i> | Very common for all commercial transactions. Risky transactions. | For commercial transactions : domestic and international (export and import but the law prohibits extending mozarebeh facilities to the private sector for imports). | |
| Civil partnership (Mosharekat madani) Joint venture | | | |
| Investments Are shares in companies | | | |
| Legal partnership <i>Refers to providing some part of the capital of new incorporated companies or buying some part of the capitals of the existing companies in order to help development in various economic sections in terms of productive plans.</i> | Minority shareholding in a company where the bank is not an active partner. | | |
| Direct investment <i>Refers to providing the required capital to implement productive and developing projects.</i> | Investment in a company initiated by the bank and where it plays a dominant role as shareholder and/or manager. | | |

Appendix I. Main Islamic Financial Contracts Used in Iran

| Deposit and Debt Instruments | | | |
|---|---|--|-------------------|
| Definitions | Modalities | Use | Accounting |
| Non profit sharing deposits | | | |
| Gharz-al-Hassaneh (GAL): | | | |
| current account | no remuneration | In the sharing of profits, GAL funds are considered as own funds of the bank: profits are not shared but the bank may give the following rewards to the depositors: - nonfixed bonuses in cash or in kind to Gharz-al-Hassaneh deposits. - exempting the depositors from, or granting discounts thereto, in payment of commissions and/or fees. - according priority to depositors in the use of banking facilities | |
| Savings | withdrawal on sight no remuneration | | |
| Profit sharing deposits | | | |
| Term investment deposits | Bank shall make use of funds in a profitable way and share the profit with the customers: a minimum remuneration is guaranteed (provisional rate) that will be supplemented in case the profit is higher than it. | Term investment deposits shall be used in joint venture, Mozarebeh, hire-purchase, instalment transaction, Mozara-ah, Mosaqat, direct investment, forward dealings Havaleh transactions. | |
| Debt instruments | | | |
| Participation paper (Sukuk) | | | |
| Issued by CBI, Government and governmental organisations. | | | |

Appendix I. Main Islamic Financial Contracts Used in Iran (concluded)

| Example of profit sharing: | | | | |
|----------------------------------|------------|-----------|---------------------------|------------|
| Resources | Amount | Percent | Use of funds | Amount |
| Own funds | 20 | | Loan | 70 |
| GAL current accounts | 10 | | Investment | 10 |
| GAL savings | 10 | | Statutory deposits (CBI) | 10 |
| Total own funds | 40 | 40 | Other | 10 |
| Term deposits (shared resources) | 60 | | | |
| Total shared resources | 60 | 60 | | |
| Total resources | 100 | | Total use of funds | 100 |
| Profit | 30 | | | |

Note: If the profit made by the bank is 30, 60 percent of this profit (18) will be shared with the providers of term deposits. If the profit is below a certain guaranteed threshold, the bank will be obliged to pay this minimum rate of return. It can't pay less but it has to pay more in case the profit is higher.