JOURNAL FOR IRANIAN STUDIES

Specialized Studies

A Peer-Reviewed Quarterly Periodical Journal

Year 2.issue 5, Dec.2017

ISSUED BY

Arabian Gulf Centre for Iranian Studies

Disarray of Credit in Iran
Economic Causes and Consequences

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The Iranian media is regularly inundated with advertisements by banks and thousands of uncertified credit institutions that publicize attractive interest rates on people's savings for up to 30%.[1] These credit institutions do not follow the financial rules of Iran's Central Bank and have been working throughout the country haphazardly for about two decades, leading to credit disarray and instability in the Iranian financial system.

In 2016 and 2017, many credit institutions and banks- certified and noncertified- in Iran declared bankruptcy or were about to. This spectacle is denoted as what Iranians call "non-bank credit institutions". In fact, noncompliance with the regulations of the main financial authority in the country- the Central Bank- resulted in their closure and the loss of client rights.

The high interest rates by these non-bank institutions have attracted many clients. This was in spite of Iran's Central Bank warning about the possibility of imminent bankruptcy.(1) In 2017, the crisis worsened when it came to public attention that some credit institutions like 'Caspian' and 'Arman' were unable to repay clients. This subsequently, raised client fears about a pending bankruptcy, especially given that 'Caspian' suffered a $1.2 billion loss. Then, panic moved to another institution called 'Hijaj', when a number of its branches were shut down. The clients surrounded the headquarters of this institution in Tehran demanding their money back for fear of losing their savings. Although 'Hijaj' publicly refused to acknowledge its bankruptcy, the siege of its headquarters only came to an end when protesters were dispersed by the police. After the crisis had worsened, Iran's parliament stepped in, giving the Central Bank and the Minister of Economic and Financial Affairs a time limit, march 2018, to solve this crisis and to strategize how to overcome the legal status of the non-bank credit institutions.(2)

This disarray in Iran's credit market resulting from the existence of non-bank institutions and their illegal behavior, resulted, not only, in the bankruptcy of some of these institutions and the loss of client savings, but also squeezed economic growth and people's lives in general. While all recognized credit institutions in Iran have conformed to Central Bank expectations , most non-bank credit institutions work independently with their own regulations and standards.

This study aims at specifying the reasons behind the credit disarray in Iran and analyzing its current and future bearing on the Iranian people and the economy. This is to be done by shedding light on Iran's banking sector, starting from the establishment of the non-bank institutions to the severity of the credit crisis over the past two years.

First: Components of the Iranian banking sector

The Iranian banking sector consists of three major components; the public sector (the government) with its banks that specialize in trade, exportation, mining, agriculture, housing, and industry. The second component is a limited private sector that started in the beginning of the new millennium.(3) The third component is the thousands of non-bank credit institutions that are working independently all over the country. The governmental banks control a big part the banking transactions-especially commercial banks like the Bank of Exports, Bank of Commerce, Bank Melli, and others. They are the biggest banks in terms of assets and the oldest in Iran- going back to the pre-1979 revolution.(4)

On the other hand, there is a limited number of private banks in Iran or banks that have been privatized like the Basarjad Bank. While there are about seven thousand non-bank credit institutions; only five thousand of them are active; 3500 specialize in microfinance and the other 1500 are big credit unions. The total assets of these institutions in 2010 amounted to $60 billion(5) distributed in the cooperative sector(6) and amongst the political and economic elite in Iran. The Iranian Revolutionary Guards Corps (IRGC) is one of the largest economic powers in the private banking sector and credit institutions that are widely spread around the country.

In recent years, the non-bank credit institutions are the major cause of credit disarray in Iran. These institutions provide services in distant and rural areas throughout the country, leading to a significant increase in their numbers. Most of them are strongly linked to the cooperative sector and key powers in Iran, such as the IRGC. They work independently away from Iran's Central Bank supervision and standards, heightening their involvement in financial crimes, such as, money laundering, smuggling, and terrorism. Indeed, these activities have given Iran a bad reputation in the international arena. According to the data from the Swiss Basel Institute for Governance in 2017 (See Table 1),(7) Iran was classified as the number one country in the world in money laundering and sponsoring terrorism for the fourth year in a row.

Table (1)

Top five countries for money laundering and sponsoring terrorism from 2012-2017.

2012	2013	2014	2015	2016	2017
Iran	Afghanistan	Iran	Iran	Iran	Iran
Kenya	Iran	Afghanistan	Afghanistan	Afghanistan	Afghanistan
Cambodia	Cambodia	Cambodia	Tajikistan	Tajikistan	Guinea-Bissau
Haiti	Tajikistan	Tajikistan	Guinea-Bissau	Uganda	Tajikistan
Tajikistan	Iraq	Guinea-Bissau	Mali	Guinea-Bissau	Laos

Source: Basel AML Index 2017

The Iranian economist, Ahmad Alavi has said that Iran's bad reputation in this concern has resulted from the following reasons;

1- A financial and banking system, which is inefficient
2- A lack of honesty and transparency,
3- The governmental and private institutions exhibiting irresponsible behavior,
4-The failure of financial and commercial laws in overcoming money laundering

He added that, as Iran's laws are dependent on Shiite fatwa's passed over a period of centuries, the laws have not evolved, contributing to the failure in guaranteeing the impartiality of the economic and credit system. Also, the Iranian financial monitoring institutions have been impotent, paving the way for financial corruption to prevail in an embarrassing way not only for the political regime,(8) but, as well as, for the religious leadership. This was evident when the Iranian Supreme Leader, Ali Khamenei made recommendations in one of his speeches on March 21, 2016, at the Nowruz festival. He spoke about the serious need to overcome corruption- especially bribery and trafficking- as an important step in implementing the strategy of developing a 'resistant economy' as strategized by the Iranian leadership.(9)

The Iranian financial system has been subject to financial constraints by the international community since 2012. Iran's banks cannot exchange financial transactions with other countries using SWIFT- the international payment network, as result of international sanctions on Tehran resulting from its nuclear and ballistic programs. These constraints have been damaging for Iran's economy and have severely hindered economic growth. After signing the nuclear deal with the P5+1 group at the beginning of 2016, many sanctions were lifted on Iran, while others remained, in particular those on financial transactions with major banks in the world- mainly US and European banks, resulting in banks and companies being hesitant in doing business with Iran. This hesitancy was shown in the level of trade and the flow of foreign investments to Iran even after the nuclear deal.

Second: The non-bank credit institutions and the emergence of the crisis

The mainstay of the economic system in any country is a well-oiled financial system run by a central bank that directs the economy by controlling the interest rates, liquidity ratios, savings, and investments. This is known as the monetary policy of the country. This policy requires complete supervision by the central bank over banks and credit institutions involved in financial activities; otherwise, the monetary policy would fail.

The non-bank credit institutions were established in Iran at the beginning of the new millennium, tasked with providing micro-finance under Central Bank supervision. These institutions increased in number, spread all over the country, and were notably involved in banking activities by giving loans and more sizeable interest rates on savings than those offered by official banks. Consequently, they became independent institutions and worked without the supervision of the Iranian Central Bank.

The small credit institutions have limited power, in comparison with the larger institutions in Iran, which are linked to state institutions such as the IRGC. The IRGC saturates all economic activities in Iran, attracting and investing depositors' funds, winning people's sympathy and political loyalty by providing attractive financial benefits. For example, the IRGC linked credit institution 'Caspian' gave up to a 35% interest rate and attracted many clients, as they hoped to acquire an additional 10% interest rate on their savings more than the Iranian official banks rate of 18 to 22%.

If these non-bank credit institutions were only tens or hundreds, Iran's Central Bank could have taken control of them, but there are thousands of these institutions spread all over the Iranian provinces. Only a small number of them work officially, while the others work independently away from the supervision of the Iranian Central Bank. Also, the licenses of these institutions are issued by ministries that have nothing to do with the authorized financial institution in the country. Most of these licenses were issued during President Mahmoud

Ahmadinejad's government. So far, some major banks in Iran are still noncertified and work using their owners' political power like the Basij and IRGC 'Bank of Mehr' that came into existence in 1993.

In recent years, bankruptcy has prevailed amongst credit institutions in Iran. Given their extensive reach throughout the country, these institutions have received a significant amount of people's funds, threatening the financial and economic stability of Iran, as well as risking savings. The total amount of funds deposited in these institutions are unknown, however some Central Bank officers have stated the amount is approximately 15-20% of the total liquidity in the country (i.e. 1122 thousand trillion Tomans equivalent to $295 billion). This amounts to less than $10 billion deposits for more than 450 thousand clients. Mostly, they are laborers and small depositors, with a dark cloud of poverty hanging over them if these institutions were to shut down. In 2016, 12 financial institutions acknowledged bankruptcy but the government kept quiet, while the closure of 'Caspian' and 'Arman' because of bankruptcy, led to protests by clients who were asking for their funds to be repaid.

The government tried to cover up the bankruptcy of credit institutions. to avoid transmitting panic to other banks. However, this failed, as client protests shut down the branches of credit institutions and the media covered the bankruptcy of 'Caspian', 'Arman', 'Thamin Hijaj', 'Josar', and 'Thamin Ala'imah' in 2017.(10) Table 2, below explains the credit disarray in Iran, stemming from the various bankruptcies that have occurred.

Table (2)

credit disarray in Iran

Caspian, Arman, Thamin Hijaj, Josar, and Thamin Ala'imah	Credit institutions that went bankrupt recently
%35	Interest rates offered by some non-bank credit institutions in Iran
thousand 450	The number of clients in noncertified institutions from Iran's Central Bank
financial institutions 12	Went bankrupt but were covered up by the government
Eghtesad Mehr Bank	and 1993 Belongs to the Basij forces since still noncertified by the government
Iran	The number one country for money laundering and sponsoring terrorism in the world

Source: Prepared by the researcher

Third: Causes of frequent bankruptcy cases in Iran

The main reason for the bankruptcy of non-bank credit institutions can be linked to the provision of high interest rates that amounted to 20-35% and the consideration of loans without sufficient collateral. However, there are other undeclared reasons such as weak central management, the failure to follow regulation, the lack of competent professionals in managing such institutions, and successive Iranian governments undertaking irrational behavior.

The failure of the Iranian Central Bank to regulate credit institutions, led to the violation of its own monetary policy. Until 2007, Iran's Central Bank did not have a defined interest rate for private banks and non-bank credit institutions,(11) which entrenched competition between these institutions until most of them went bankrupt. Finally, the Central Bank did intervene to save key credit institutions from bankruptcy, preventing a similar fate for others and averting alarming clients in the country. The Central Bank involvement, in certain situations, came too late. Some institutions went bankrupt like 'Mizan' in 2013, even though it had obtained a working license, as debt accumulation forced the Central Bank to dissolve it officially in May 2015.(12) Also, credit supply was set up by the Central Bank to 'Caspian', with the aim to prevent the recurrence of its bankruptcy and to avert clients' panic, as it had gone bankrupt in 2016.

According to the Iranian banking expert, Ahmad Hatimi, the affiliation of most of these institutions with the centers of power, wealth, and confidante relationships was one of the main grounds for their financial dilemmas. Hatimi believes that most of the mangers in these institutions come from non-banking backgrounds and are not specialists in credit operations. Not only did, the government and the Central Bank fail to register such institutions, but they were also unsuccessful in spreading awareness amongst people of the necessity to avoid investing in such unofficial credit institutions.(13) As a result of professional and administrative inexperience's, these institutions intensively bought assets that were hard to realize in the short run like purchasing real estate and entering contracts for commercial and industrial enterprises. As a result, they were paralyzed, as they were unable to convert these assets into funds to pay back clients' savings during crises and panic.

Also, President Mahmoud Ahmadinejad's government was, no doubt, responsible for part of this credit disarray in Iran, as it gave the permission to financial institutions to emerge away from Central Bank supervision from 2005-2013, resulting in these institutions collapsing or facing serious financial crises.(14) Ahmadinejad's former IRGC affiliation cemented the economic power of this organization extending it to all official and unofficial economic sectors in Iran including the financial and banking sector. During President Hassan Rouhani's first term, many financial crimes and corruption lawsuits were in the courts that exposed Ahmadinejad's government and the extent of its contribution towards the current credit disarray in Iran.

Fourth: The impact of the credit disarray on the Iranian people and the economy

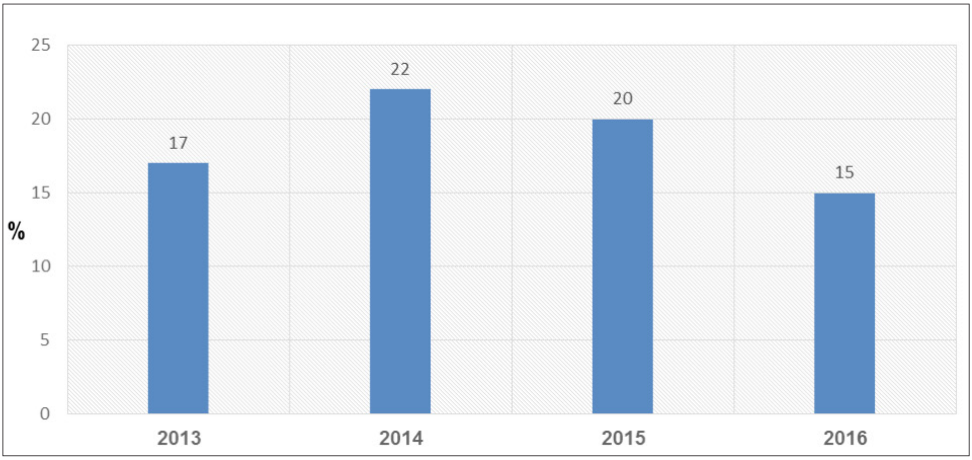
There is no doubt, that any credit or financial institution that works away from the supervision of the central bank will result in the financial system to wither away, leading to the loss of rights, public mistrust, financial corruption, and, most importantly, a negative consequence on people's lives.

Following are the economic consequences of credit disarray on the Iranian people and economy:

1. The interest rate discrepancies between official banks and non-bank credit institutions that work independently away from the Central Bank undermines the financial policy of the country and threatens investment. The most important objective underpinning financial policy is to manage inflation rates by adjusting interest rates and money supply into the market. Today, Iran's Central Bank is heading towards changing its financial policy in relation to the high interest rates (18-22%) and decreasing it to encourage investment, reactivate the industrial sectors, and control the increasing prices.

Table (3)

Interest rates on savings in Iran during the years 2013-2016



Source: Prepared by the researcher according to the Central Bank of Iran

2. The nonexistence of a regulatory body facilitates money laundering and terrorism financing, maintaining Iran's top rank on the blacklist of the Financial Action Task Force (FATA), that is tasked with fighting money laundering and terrorism financing. This year, FATA warned from any financial transactions with Iran because of its involvement in money laundering and terrorism financing. The US Department of State's Annual Report 2016 on world exertions to fight terrorism revealed that Iran was the number one country in sponsoring terrorism around the world.

The Swiss Basel Institute for Governance in August 2017 provided resounding evidence on banking and financial corruption in Iran when it announced that Iran was still the number one country in money laundering and sponsoring terrorism for the fourth year out of 146 countries.(15)

Table (4)

A random list for countries involved in money laundering and terrorism financing

Country	Ranking	Overall Score	Risk
Iran	1	8.6	
Algeria	54	6.48	
Ecuador	58	6.37	
Russia	64	6.22	
Malaysia*	70	6.1	
South Africa	99	5.32	
Dominica	104	5.12	
Qatar	107	5.1	
Germany	121	4.78	
Denmark	140	4.05	

Source: Basel AML Index 2017

3. The non-banking institutions control savings, however possess low experience's, in the fields of administration and banking. This has resulted in the redirection of savings into high-risk speculations in the exchange, gold, and real estate markets. This happened during President Ahmadinejad's government,(16) leading to economic instability in the country.(17)

Also, working independently from central bank supervision means that depositing funds in these institutions is of high risk in comparison with the official ones. The noncertified institutions do not deposit the required capital ratios in the Central Bank (usually 10% of the total deposits in any bank), which increases the level of risk in times of crisis's, leading to bankruptcy,(18)

4. Recurring bankruptcy in Iran threatens trust and stability of the financial system. When bankruptcy recurs after debt accumulation by the non-banking institutions one after another, they are paralyzed from being able to pay back customer deposits, and clients lose confidence in the whole financial system; bank and non-bank. As a result, panic prevails amongst clients who might rush to withdraw their money at any given time, leading to bankruptcy and, ultimately, exposes the economy to a serious financial crisis and a downward turn in investments.

Conclusion

The recurring bankruptcy of credit institutions in Iran is more than a financial disability that can be fixed. The major problem is the current banking system, as it permits the emergence and continuity of institutions, serving narrow economic, and political interests, not banking stability.

As discussed, there are many reasons that might lead these institutions towards bankruptcy, such as, high interest rates, loans without sufficient collateral and lack of Central Bank regulation. Another important reason is the high-risk investment in an exaggerated way that threatens stability of these institutions and clients' funds. Iran's Central Bank acknowledges the shortage of qualified human resources in such institutions and the lack of diversification in investments. Most of these institutions invest in real estate or industries that are hard to divert their assets into liquidity to fulfill clients' requirements in an emergency. This is like the situation of 'Thamin Hijaj', 'Caspian', and 'Arman' institutions that went bankrupt in 2017. Stemming from these factors, there is no guarantee for the non-recurrence of the same scenario in similar credit institutions in Iran.

Endnotes

(1) Mehdi Dehghan. KAYHAN LONDON. Iran's Broken Banking System. 29 April 2017.
(2) 7 .2 July 2017.
3) Iranian Banker. Op. Cit.
4) Egyptian Institute for Political and Strategic Studies, The Internal Powers in the Iranian Society, second aspect: Economic Powers, Istanbul, October 2015 ,20, p 6.
5) Nida Zaidi. Smart earning method. Top 10 Biggest Banks of Iran in 9 .2016 November 2015.
6) Egyptian Institute for Political and Strategic Studies, p 7.
7) Article 44 of the Iranian constitution defines the cooperative sector as the one that includes production and distribution cooperative companies and institutions established in villages and cities in compliance with the Islamic rules. According to this definition, properties of the religious authority-economic organizations- go under the so-called Biniad: a name given to economic organizations in the form of charities under direct supervision of the Iranian Supreme leader with no parliamentary or governmental supervision. These organizations provide financial aids to poor people in Iran and those injured in Iran's wars. It also hires millions of Iranians in the fields of industry, food, drinking, constructions, trade, tourism, transportations, oil, and other fields.
8) Basel Institute Governance. Basel AML Index 2017 Report. 16 August 2017, Switzerland, p 3.
9) Ahmad Alavi, Arabian Gulf Center for Iranian Studies, Why Iran Occupies the First Rank in the World in Money Laundering? August 2017 ,23.
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11) Yousuf Moteiri, Almanatiq Newspaper website, Bankruptcy of five Iranian banks…and the Iranian security forces attack protesters who ask for their funds back, June 2017 ,19.
12) Central Bank of Iran. Banking Profit Rates. Term deposit rates. CBI Website.
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14) Bijan Khajehpour, Al-Monitor. "Iran's central bank must regulate unlicensed actors", June 2017 ,15.
15) The Baghdad Post Web site. «Financial institutions bankruptcy threatens Iran's banking sector", 20 June 2017.
16) Basel Institute on Governance. Op. Cit. p 3.
17) Ali Reza Ramzani, Why is Iran's Central Bank unable to Control Financial Markets? October ,10 2016.
18) In August 2016, Iran closed about fifty million unknown bank accounts- with no names or addresses- referring to the possibility of using them in illegal operations.
19) The Iranian Trade Law does not permit official banks to declare bankruptcy. Some banks go bankrupt but continue working without declaring bankruptcy officially. Usually, the Iranian central bank interferes to save credit establishments when they go bankrupt.