Near East – North Africa Regional Agricultural Credit Association (NENARACA)

Islamic Republic of Iran:

Bank Keshavarzi, The Agricultural Bank

by

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Key indicators

Territory:	1,648,000 km²; agricultural land: 10%; range & marginal lands: 30%
Population, growth:	66.7 million (2003-04), 1.2% growth rate
Rural population:	22.8 million (34%)
Population density:	40.5/km²
Active population:	21 million (2003-04)
Number of villages:	64,000
Rural households:	4.5m (engaged in agriculture: 2.2m)
Literacy rates:	
6 years and older:	85%
6-29 years	96% (2003-04)
Life expectancy:	71 years
Agriculture:	27% of GDP, 35% of non-oil exports, 23% of employment (2003) Growth rates: 4.4% (1988-98); 3.8% (2000-02)
Bank rates on deposits:	7-17% (2004); profit-free qard ol-hasaneh [1] 0%
Bank lending rates:	13.5-21 (and above) % (2004); profit-free qard ol-hasaneh 0% Small farmer loans: 13.5%

Central Bank participation papers *(~TB rate)*: 17%

Macroeconomic data, 1990-2003 (period averages)

Year	Inflation rate (CPI)	GDP real growth rate	GDP per capita (constant 1995 US$)	GDP per capita PPP (calendar year) in US$
1990	7,63	11,24	1,291.28	3,878.00
1991	17,13	10,63	1,405.80	4,336.00
1992	25,81	6,11	1,467.89	4,696.00
1993	21,20	2,10	1,474.87	4,808.00
1994	31,45	0,89	1,464.19	4,880.00
1995	49,66	2,87	1,482.24	5,107.00
1996	28,94	5,52	1,539.88	5,352.00
1997	17,35	3,39	1,566.06	5,416.00
1998	17,87	2,00	1,572.15	5,405.00
1999	20,07	2,47	1,587.46	5,570.00
2000	14,5; 00-01: 12.6	5,37	1,649.06	5,884.00
2001	12.6; 01-02: 11.4	4.8	1,690.0	
2002	11.7; 02-03: 15.8*	6.5	1,720.0	
2003	17.5; 03-04: 15.6*	6.7; 7.4%*		

*CBI 2004:1

Exchange rates of US$ to Rials

Year	*Interbank market rate**	*Parallel market rate**	*BK conversion rate***
2000-01	8077.65	8188.13*	
2001-02	7921.52	8088.45*	7924
2002-03	7958.05	8018.94	8140
2003-04	8281.53	8323.05	8482

*Average selling rate. The interbank market rate exists since the unification of the rates; for the preceding years, the rates given in this column are the non-oil export rates

** As officially used by Bank Keshavarzi in converting data given in Rials (Rls) into US$.

Note: Economic figures may vary according to source.

Fiscal year: 21 March – 20 March

[1] This is the common transcription in Iran of what is internationally transcribed as qard hasan, qard al-hasan or qard al-hassanah (see Annex 2 for the spelling in Arabic).

Executive summary

I. Economic, social and financial context

Area and population: The Islamic Republic of Iran, with area of 1.65 million km² and a population density of 40/km², is highly urbanized. Of its 67 million inhabitants, only 23 million, or 34%, live in rural areas, spread over 64,000 villages, with an average of 70 households.

Economic context: The economy of Iran is oil-reliant and import-dependent. With the Islamic Revolution of 1979, government policies shifted to self-sufficiency and smallholder agriculture; but progress was impeded by the war with Iraq, 1980-88, the American embargo and a soaring inflation rate. The inflation rate is now down to around 16%; GDP grows at rates around 7%. Inflation, due to a lack of budgetary restraint, remains a major challenge. Agriculture, which accounts for 27% of GDP and 23% of employment, rests largely on smallholders, which have replaced feudal landlords since the land reform of 1962. Yields are low, due to fragmented holdings and low literacy of an aging farm population. Subsidized credit and price guarantees have distorted markets and undermined development.

Social context: In terms of social and human development, enormous progress has been made since the 1970s. Iran's inhabitants now enjoy a quality of life near the top of the middle-level human development category; but there are wide regional disparencies. Population growth is down from 3.4% p.a. during 1976-91 to 1.2%, creating a bulge in the population pyramid. Creating employment for the increasing numbers of young people entering the labor market remains a major challenge, particularly for women with a labor force participation of only 10% (compared to 62% among men).

Financial sector context: Government dominance and interference have been characteristics of banking in Iran throughout its history. This has created an overall climate of financial repression, impeding financial intermediation. The first Iranian bank was founded in 1930. Since independence, the financial sector has gone through four major phases: an institution-building period under stable macroeconomic conditions during 1950-72; a period of credit expansion, low problem loans and high inflation during 1973-77; a period of nationalization and bureaucratisation under full government control, accompanied by a surge in non-performing loans, during 1979-88; and inconsistent monetary and fiscal policies since 1989, leading to ups and downs of abundance and shortages of financial resources, relaxation and restrictions of international capital flows. Since 1983 all banks in Iran adhere to Islamic banking principles. The financial system is centrally controlled, with sectoral credit allocations and profit rates (*interest rates*) as key instruments of intervention. Most deposit rates as well as profit rates on agricultural credit are negative in real terms: contrary to the principles of Islamic banking: brotherhood and social justice for all participants in financial transactions – depositors, borrowers and banks. Small depositors have suffered most.

The banking sector comprises the central bank, six state-owned commercial banks, four state-owned specialized banks, among them the Bank Keshavarzi, (BK), and four private banks. 97% of banking assets are in government hands. BK is the largest single source of agricultural credit. Commercial banks are required to lend a quota of 25% to agriculture, either directly or through BK. There are signs of incipient liberalization: private non-banks were authorized in 1996, private banks in 2000; exchange rates have been unified at market level since 2002. The government is now making preparations for the restructuring of the banking sector.

Microfinance is poorly developed in Iran; sustainable institutions are absent. Major constraints have been a culture of subsidization, controlled lending rates, objections against lending and interests on loans and deposits, and a dearth of value-adding non-farm microenterprise opportunities in large numbers of very small villages. Since 2000, the Ministry of Agriculture has piloted the establishment of a small number of Microcredit Funds

for Rural Women. With support from IFAD, DRMFS-International has recently initiated a pilot Rural Micro Finance Support Project in cooperation with BK, establishing joint-liability groups for channeling credit to the unbanked. With the involvement of local NGOs, some of the groups may evolve into SHGs. UNDP has helped to establish SHGs in a few villages and is now in the process of up-scaling. BK has been the major provider of microcredit to special categories of beneficiaries.

II. Bank Keshavarzi (BK) – the Agricultural Bank

Mandate: towards customer and shareholder value in rural finance
BK, a government-owned agricultural bank, has a twofold mission: acting as a development bank implementing the government's objectives; and a commercial banks maximizing shareholder value.

History of reform: from directed agricultural credit to sustainable banking
Established in 1933 as a credit fund BK underwent several changes in structure and name. Increasing losses during the 1980s called the bank's future into question: close it, merge it, or reform it? In 1992, the bank was transformed into a deposit, bank, functioning as a financial intermediary between savers and investor-borrowers. Yet, during a transitional period until 1996, losses continued to increase, bringing the bank to the brink of bankruptcy. During *the new era*, 1998-2004, structural reforms focused on self-reliance through deposit mobilization, expansion of outreach, and profitability. Steps were taken to build the infrastructure of a learning organization by systematically developing staff capacity and promoting customer-orientation. To become a full-service bank, BK has made progressive use of new opportunities for modernization of its operations and services through IT. The autonomy of the bank has been strengthened by the conversion of the bank's role in directed credit from that of a *handling bank*, which lends to beneficiaries selected by the government, to an *executing bank*, which follows government directions but selects its own customers.

Since 2000, the bank has embarked upon reform through 26 strategic reform plans. This has included a system of management performance evaluation and job posting which opens positions to competitive appointments every 2-3 years; a participatory approach to strategic reform, involving 6,000 staff members; converting the bank's hierarchical structure into a flat organization, with direct access of branches to the head office; an incentives-based system of suggestions for improvement; and the privatization of subsidiaries and services. Among the achievements of the new phase were the expansion of the branch network from 480 to 1800 as of 2004; the decline of the proportion of government-funded directed credit from ~80% to ~30%; the growth of deposits to 72% of its funds and of the bank's deposit market share from 1% in 1995 to 6.3% in 2003; rationalization of all procedures; staff retraining; and the computerization of the branch network. For the first time in its history, the bank made profits and wiped out its accumulated losses in 2001-02; since then it has been profit-making: a remarkable achievement given the restrictive policy environment. It is now on the way to full-fledged universal banking and progressively deeper market penetration.

Phases of reform of Bank Keshavarzi

Phase	*Period*	*Characteristics*
0	1933-78	*Prehistory:* Predecessor institutions operating as loan funds
1	1979-91	*Start-up phase:* Establishment of BK as a loan fund from government resources
2	1992-97	*Transition period:* Transformation into a deposit-taking bank with directed and commercial banking operations, simplification of procedures
3	1998-2004	*New era:* Increasing autonomy and self-reliance in a restrictive policy environment; customer orientation as a priority; modernization through IT; directed credit converted into *managed credit;* deposit mobilization through urban expansion; strategic restructuring into learning organization since 2001
4	2005-…	*Towards universal banking:* A universal bank in a liberalizing environment, self-reliant and profitable, with a diversified portfolio, retail and wholesale services, expanding outreach to rural and urban areas by *taking the bank to the customer*

Ownership and governance: towards banking autonomy
BK is a government-owned bank specialized on agriculture. To raise fresh capital and strengthen its autonomy, a proposal for privatization and trading at the stock exchange has been submitted to parliament. The Bank is governed by a board of four directors, presided over by the Chairman of the Board & Managing Director, appointed by the General Assembly of Banks. The ultimate policymaker is the Supreme Council of Banks, chaired by the Governor of the Central Bank. Full banking autonomy is still some way off. Internal control is situated in the Division of Supervision & Inspection. External supervision falls under the authority of the General Assembly of Banks as the representative of the government. External audits are carried out by statutory auditors of the State Audit Administration.

The bank's capital and sources of funds: towards self-reliance
Given its loss-making past, the bank has been periodically recapitalized by the government. This brought capital and reserves up to 8.1% of total assets in 2001-02, as the bank entered into its profit-making era. With the growth of assets, the capital ratio is now 6.6%. Deposits have become the bank's main source of funds, reaching 57% of total liabilities and capital in 2003-04, surpassing the amount of loans outstanding. The historical rise of deposits has been paralleled by the fall of borrowings, now down to 27% of liabilities and capital.

Organization and management: towards a learning organization
With 1800 branches divided among 32 provincial directorates, BK has the widest delivery network of any bank in Iran. The total number of staff is 15,225, 19.4% of them at the head office; 13.1% are female. The head office is comprised of 22 departments in seven divisions, plus a R&D Center and a Panel of Advisers. BK has two subsidiaries: the Crop Insurance Fund and the Relief Fund for Damaged Agricultural Units. Branches are profit centers. Through incentive payments, staff can more than double their regular salaries. Performance indicators include savings mobilization, loan collection rate, loan disbursement, quality of documents, and bank service. Lending authority is decentralized. BK is a member of APRACA, CICA and NENARACA. It maintains relations with Crédit Agricole (France), DG Bank (Germany), the IDB and IFAD and works with 160 corresponding banks and bank branches. BK has had a credit line from DG Bank and two credit lines from IDB. It has not received any ODA, but benefits from a grant to DRMFS-International to expand outreach through solidarity groups. BK considers Crédit Agricole as the model case of an agricultural bank that has fully entered commercial banking with a diversified portfolio without ignoring agriculture. Staff training is considered of crucial importance in turning BK into a learning organization. There is a shortage of international training materials translated into Farsi and adapted to the operational realities in Iran.

Financial services: towards universal banking
BK offers a wide range of financial services with over 90 products, among them 21 deposit products, 15 credit products, electronic banking, insurance and foreign exchange services. Total outreach is around 14 million clients. As of March 2004, BK held 13.9 million deposit accounts; during 2003-04 it disbursed 1.51 million loans. BK lends at rates fixed by the central bank: for agriculture at 13.5%, for agro-industrial activities at 15% and for agricultural services and consumption at 23-25%. Loans outstanding to the private sector as reported on the balance sheet for FY 2003-04 amounted to $5.24bn, plus $0.26bn to government agencies, totaling $5.5bn.[2] $3.39bn were freshly disbursed during that year. Mandatory credit (to 10% of borrowers) has been declining and will be phased out within five years. The average loan size was $2,240 (non-mandatory credit: $1,970). 73% were working capital loans, 27% investment loans; 75% of all loans84828482 were for agriculture and livestock. Little credit goes into value-added activities such as processing, packaging and trading: a vast but historically neglected field. 79% of the number and 70% of the amount of loans are short-term up to two years. All loans are Islamic contracts: 80.5% at fixed, 16.8% at flexible

[2] Calculated at BK's official conversion rate of 8482 Rials to the US$.

profit-sharing rates (*mudarabah*), and 2.7% (*qard ol-hasaneh – see footnote 1*) at an administrative fee only.

Deposit rates vary from 0% (on 78% of total deposits) to 7-9% on short-term and 13-17% on long term deposits. They carry negative real returns, with the exception of 4 to 5-year fixed deposits. Deposits have increased at annual real rates above 25% in recent years. At the end of FY 2003-04, deposits amounted to $4.04bn, that is 119% of disbursements and 73% of total loans outstanding as reported on the balance sheet. 77.5% of deposits in 2002-03 and 69% in 2003-04 are unremunerated: either as sight deposits or as profit-free qard ol-hasaneh savings accounts with a lottery component, the latter a very successful fund raiser. At a ratio of 1:15, there is a gross imbalance between qard ol-hasaneh assets and liabilities: a matter of concern in Islamic banking.

Crop insurance is a compulsory for borrowers. In 2002-03, 712,000 farmers received indemnities. The crop insurance fund is not commercially viable; only 38% of indemnities paid in that year were covered by premiums. 474,000 farmers received relief payments for uninsured losses due to natural calamities in 2002-03, and 381,500 farmers in 2003-04, covering around 2% of total damages.

Financial performance: towards profitability
Total assets at the end of FY 2003-04 amounted to Rls 60.1tr ($7.1bn), with real growth rates around 25% during each of the preceding three years. There is no information on the components of off-balance sheet operations, amounting to Rls 50.66tr ($6.0bn). The collection rate hovered around 80% over the past ten years. It improved to an overall rate of 82.5% in 2003-04 (86.8% on credit from BK's own resources). The loss ratio was 2.7% in 2002-03 and 2.0% in 2003-04, ignoring rescheduling. Paying late is largely due to calculated unwillingness, rather than inability, to repay, BK being considered a lenient lender. All loans have to be secured; in 2003-04 95% of the number and 83% of the amount were covered by third-party guarantees. Many potential small borrowers face problems in providing the required guarantees. Authority over non-collateralized loans is highly differentiated, which may lead to two problems: at the lower end, third party guarantees relieve the loan officer of thorough collateral and creditworthiness examinations, inviting moral hazard; at the higher end, discretion over uncollateralized lending appears exceedingly high and open to political pressure. Loan collection is in the hands of 1500 collection units. Loans are classified as distressed after 6 months. Loan rescheduling and interest exemptions due to natural calamities are decided by parliament; six out of the seven preceding years, and between 150,000 and 589,000 persons p.a., were affected.

Until 2000-01, BK has been a loss-making bank. In 2001-02, BK succeeded for the first time in its history to wipe out its accumulated losses and breaking even. During the last two years, its return on average assets (after tax) was 1.1% and 1.7%, its return on average equity 15.1% and 22.3%, respectively. 91% of the banks income is derived from borrowers; but only 14% of its expenditure go to depositors. There is no information on the profitability of each of the large number of financial products.

III. The reform process: strengths and weaknesses

The macroeconomy **–** *Strengths and success factors:* The Islamic Republic of Iran is a middle-income country with an enormous potential for growth and development. Highlights of its strengths include abundant revenues from oil exports to self-finance development, a new emphasis on self-reliance of banks through deposit mobilization, incipient liberalization, and incipient success with inflation control.

Weaknesses, limitations and risks: Government intervention in all spheres of the economy, but particularly in banking, is perhaps the most crucial limiting factor. Inflation and financial repression through profit (or: *interest*) rate control, grossly negative real returns on deposits

and subsidized directed credit have distorted rural financial markets and severely restricted the growth of a diversified rural economy. There is no legal framework for microbanking and microfinance institutions.

Bank Keshavarzi – Strengths and success factors: Over the past twelve years, BK has taken reform and restructuring into its own hands: perhaps its single most important asset. The transformation from a credit fund to a financial intermediary has gradually gained momentum, with self-reliance through resource mobilization, expansion of outreach and profitable operations as top priorities. The bank is now becoming a full-service bank with deepening and widening outreach, making progressive use of new opportunities for modernization of its operations and services through IT. The autonomy of the bank has been strengthened by the conversion of the bank's role in directed credit from that of a *handling bank* to an *executing bank*, selecting its own borrowers. Since 2000, the bank has entered into a process of strategic restructuring and implemented 26 strategic reform plans geared to good governance, efficiency and profitability. First steps towards privatization have been taken. Aided by recapitalization through the government, the bank has wiped out its accumulated losses in 2001-02 and is now profit-making: a remarkable achievement given the restrictive policy environment and the extent of government intervention in banking matters. Inspired by the experience of Crédit Agricole in France and with the assistance of an international consulting firm, the bank plans to turn into a full-fledged universal bank with operations in both rural and urban areas, privatized and traded at the stock market. One of the most daring plans is the reform of its corporate culture. Based on a comprehensive participatory process involving to-date some 6,000 staff members, its hierarchical structure is being converted into a flat organization, with direct connections of the branches to the head office. At the same time, BK plans to revamp its banking culture, *taking the bank to the customer* instead of expecting the customer to come to the bank. This will require new instruments and strategies, including both retail and wholesale services. In this context, the bank will contribute to the diversification of the economy and of income-generating activities, diversifying at the same its portfolio to finance farm, off-farm and non-farm activities.

Weaknesses, limitations and risks: The main limiting factors result from a policy environment of macroeconomic instability, government control over banking, and massive interference in rural financial markets. Historically, this has created a corporate culture of supply-oriented state banking, with little grassroots banking experience. Weaknesses and limiting factors include a lack of private sector involvement; inadequate profit (or interest) rates; lack of autonomy; dual banking standards due to the handling of government programs; inadequate outreach to women and young adults; low level of portfolio diversification; and inadequate resources *to take the bank to the people.*

IV. Conclusions and Recommended Priority Projects

Overall assessment: In the light of all the restraining factors, it is all the more remarkable how far BK has gone in the process of reform: upon its own initiative and without donor assistance. Among its assets are the experience, the strongly positive attitudes and the initiatives already taken by its board and management, with the objective of turning BK into a self-reliant, profitable universal bank with a wide outreach to rural as well as urban areas and an emphasis on agricultural development and rural diversification. To attain this objective, BK still has a long way to go; but there is no doubt that it is on the right track. BK may serve as a model to other agricultural banks in the region, indicating the way forward in a policy environment which is not conducive to financial self-reliance and sustainability.

Priority project 1: Policy dialogue towards sustainable Islamic banking.
BK is an exceptionally dynamic and innovative bank; but its further growth is hampered by a combination of macroeconomic factors and government control over banking. The core problem results from a contradiction between a high inflation rate and controlled profit rates on deposits and loans, resulting in negative real returns on deposits as well as the Bank's

capital, which poses a moral problem in terms of Islamic banking. This has hampered deposit mobilization and the overall volume of financial intermediation between depositors and borrowers; it has eroded the value of the capital of depositors and the bank; it has restrained the growth of the Bank's services; and it has restricted the Bank's microfinance services to women and the poor the cost of which cannot be covered from the financial income. The first suggested strategy is geared to macroeconomic stability: bringing down the inflation rate. The second strategy is fundamental to financial systems development and institutional sustainability: deregulating the profit rate on deposits and credit and making banks autonomous in the determination of profit rates. NENARACA may assist through support to high-level policy seminars on market-based profit rates on deposits and loans with just and equitable real returns to all parties involved in the transaction; and through exposure visits abroad for policymakers, including exposure to market-based Islamic microfinance in Indonesia.

Priority project 2: Banking with solidarity groups, focusing on educated young adults
More than 10 million adults in rural areas are without access to credit. It appears safe to estimate the additional effective demand for credit within the coming ten years at an additional 2.5 million borrowers as a minimum; this would bring BK's total borrower outreach to 5 million. Among the unbanked is a target group of increasing size and economic potential: educated young adult women and men. Their demand is expected to gradually shift from investments in conventional activities such as livestock, farming and gardening to diversified actitivies with an increasing value-added component, leading at the same time to the diversification of the bank's portfolio. As the bank is required to request security, mostly in the form of personal guarantees, and has to keep transaction costs down, we recommend to implement a new product nationwide: loan channeling on a national scale through solidarity groups, using chain guarantees as a collateral substitute. BK has been pilot-tested this approach in cooperation with International Enterprise for Development of Rural Micro Finance Services (DRMFS-International), an NGO, funded by IFAD. With a potential outreach of 2.5 million and an average solidarity group size of 14, the total number of groups to be established is 180,000, or 18,000 per year over a ten-year period. The expansion of credit channeling through solidarity groups on a national scale and the doubling of BK's outreach is a gigantic task. It should be noted that in the virtual absence of SHGs as financial intermediaries and NGOs as promoting agencies, linkages between BK and SHGs presents no viable alternative in the short and medium run. Next steps include: Generating the political will in BK to adopt solidarity group lending as a national strategy and to go ahead at full force; establishing a national steering committee of decision-makers and a technical team entrusted with the implementation; exposure visits to India (with one million groups linked to banks) and Indonesia; operational planning and phased implementation.

Subproject 2A: Profitability studies of financial products
BK has over 90 financial products, including 15 credit products, without any information on their costs and benefits. We recommend to study the costs and profitability or benefits of each product, including the newly suggested solidarity group product, with objective of eliminating unprofitable products and reducing the costs of those retained, developing at the same time a system of monitoring product costs and benefits.

Priority project 3: Taking the bank to the people
Each branch of BK serves about 40 villages. With limited resources, BK has shifted transaction costs to its customers, expecting them to come to the bank. Taking the bank to the people, as BK intends to do, would be more efficient. This will require an individualized approach to creditworthiness examination and loan tracking. Initial costs are high, but decline rapidly once a track record for repeat loans has been established and the effects of economies of scale and scope set it, particularly in high-potential areas. Customized financial services would be guided by five principles: business lending only; analysis of the household as an economic unit with all its assets and liabilities; graduation from small short-term loans (including those through solidarity groups) to larger-size and longer-terms loans; loan

protection through formal or non-formal collateral in addition to personal guarantees; and computerized monitoring. The single most important element in a financial technology geared to zero arrears is a system of daily loan tracking. Key elements include instant information, direct control at all bank levels, immediate action, staff incentives, and customer incentives. NENARACA may assist with exposure training may be arranged in banks which have successfully applied major elements of this technology, among them Bank Rakyat Indonesia and Centenary Rural Development Bank in Uganda.

Next steps may include a review of the proposals for priority projects by management, a joint planning seminar with NENARACA, and preparations for exposure visits and training.

Part I
Economic, social and financial context

1. The macro-economy

Area and population: Iran[3] has an area of 1,648,000 km²; 11.5% of it is under cultivation, 19.4% are other cultivable land, 7.5% forests, and 54.5% hills and pastures. The population is 67 million (2004), the population growth rate 1.2%, the population density around 40/km². The urban population has been growing at 3% p.a. while the total rural population has begun to fall.; many rural villages have been deserted altogether. As of 2003, 23 million, or 34% of the population, live in rural areas (down from 39% in 2000). About half of them are estimated to be engaged in agriculture. With an average rural household size somewhat below five[4], the total number of rural households is around five million, spread over 64,000 villages. Villages are relatively small, with an average population size of 360 inhabitants in about 70 households.

The economy of Iran is oil-reliant and import-dependent. 70%-75% of of the government's budget are derived from oil revenues. With the Islamic Revolution of 1979, government policy shifted priorities to self-sufficiency and smallholder agriculture. However, any progress during the 1980s came virtually to a standstill due to the war between Iraq and Iran (1980-88) and the American embargo. In 1989, the government launched a reconstruction program with a focus on diversified industrial and agricultural development. However, due to fluctuations in international oil prices and internal factors, the government found it difficult to control inflation, which hovered around an official rate of 20% and perhaps twice that rate in real terms. Annual GDP growth rates were mostly between 4.% and 5.5% between 1991-92 and 1996-97; they declined to 2.4% toward the end of the millennium. With increasing international oil prices, the GDP growth rate climbed to a sturdy 6.7% since 2001-02. The IMF's forcast for the coming five-year development plan, 2005-2010 is 5.5%, which is probably more realistic than the government's estimate of 8%.

The basic principle of **economic policy** is economic diversification and self-sufficiency, geared to growth and stability. Core elements of that policy as given in the third five-year development plan (2000/01-2004/05) are economic liberalization; administrative reform; domestic and also foreign resource mobilization; restructuring and privatizing or merging public enterprises; the recapitalization of banks; the elaboration of operational guidelines for private banks and private non-banks; the reduction of mandatory credit by 10% p.a. of the 1999-2000 benchmark; macroeconomic stability; and employment generation in both urban and rural areas. Strategies to combat **poverty** include intensification of smallholder agriculture, microenterprise promotion, and access to finance among low-income groups and women.

Incipient liberalization: Iran has had a system of multiple **exchange rates:** the stock exchange rate, the retail banking rate and the priority sector rate for strategic commodies (rice, wheat, medicine). The first two converged around RI 8000 to the US$ in 2000, when the latter still stood at RI 1752.50. The wide discrepancy between official and inofficial exchange rates in the past has virtually disappeared. Since 21 March 2002 the different exchange rates have been **unified at market level**, and legal restrictions on foreign exchange have being reduced. All foreign exchange transactions were shifted to a newly

[3] The Islamic Republic of Iran is located in one of the politically most volatile regions of the world, which has curtailed the economic exchange with its neighbors and, together with the American embargo, impeded its integration into a global economy. It borders the three CIS states of Armenia, Azerbaijan and Turkmenistan as well as the Caspian See to the north; Turkey and Iraw to the west; the Gulf and the Gulf of Oman to the south; and Pakistan andd Afghanistan to the east.

[4] The number of large families has been decreasing. At the same time, there is an increasing number of households of the elderly, with perhaps one remaining young adult child.

established interbank market. It is expected that in future, the Central Bank will not intervene in international transactions of banks (except in emergency situations of exchange rate supervision). Each bank will be obliged to mobilize its resources domestically or internationally and become independent of Central Bank allocations.

Monetary and credit policies

The financial system is centrally controlled. Monetary policy is exercised through interventions in banking operations, not open market operations. As stated by CBI (2004:27), "The banking system constitutes the core of the financial sector in Iran and plays a critical role in transmitting monetary policy impulses to the entire economic system." Once the Islamic Consultative Assembly has approved the government's annual budget, the Central Bank presents a detailed monetary and credit policy to the Money and Credit Council for approval; certain core elements of that need to be approved by the Cabinet. The Usury-Free Banking Act of 1983 stimpulates that short-term credit policies need to be approved by government and long-term credit policies have to be incorporated within the Five Year Development Plan and approved by the parliament. The two main policy instruments are sectoral credit allocations, referred to as banking facilities, and rates of return on banking facilities.

Banks may extend 35% of increase in the outstanding non-public credit from from sectoral allocations; only private banks and non-banks are exempted from sectoral allocations. In 2003-04 mandatory sectoral allocations to the non-public sector were:

Agriculture	25%
Manufacturing & mining	33%
Housing	20%
Construction	8.5%
Export	9.5%
Domestic trade, services, misc.	4.0%.

In 2003-04 outstanding credit of banks was authorized up to a ceiling of Rls 3.6 trillion; 25% of the increase was to be allocated to the public sectgor and 75% to the cooperative and private sectors; at least 65% of the latter have to be extended in the provinces to projects aiming at job creation in less developed regions, on the basis of indices set by the Cabinet.

Rates of return on bank credit (the equivalent to interest rates) were set during 2003-04 at 13.5% for agricultural loans, 16% in manufacturing & mining, 15% or 18% in housing depending on whether or not credit was tied to preceding savings, 15% in exports and a minimum of 21% in commerce, services, construction and miscellaneous.

Provisional returns on bank deposits were set at 7% for short-term deposits, 9% for special short-term deposits and 13-17% for long-term deposits up to five years.

To stop the accelerated growth of liquidity during the preceding two years, CBI was authorised to issue new participation papers (the equivalent to T-bills) up to Rls 10 trillion, plus Rls 5 trillion by the private sector, with a 17% provisional rate of return p.a.

Macroeconomic stability is a major objective of the government; but inflation continues to be a major problem. In the late 1990s it has oscillated around 20% officially, but inofficially more around 40%. Major reasons for the high level of inflation are seen in the low productivity of the economy and the high risks of investments. As one national expert put it, "inflation is the biggest thief," imposing a heavy indirect tax far more on the poor (among them large numbers of underpaid government employees) than on the rich. During 2001, the government followed a strictly contractionary policy in order to fight inflation, taking liquidity off the market and liberalizing trade, particularly imports. The official annual inflation rate fell to around 12% during 2001 and 2002 (through the real inflation rate as assessed by Iranian experts might be twice that much), but climbed up to 17.5% in 2003. The IMF warns that Iran

may be threatened by economic instability and low growth if it ignores budgetary restreint and continues to lavish money on subsidies. The fiscal deficit, which was 0.2% of GDP in 2003-04, might climb as high as 1.4% during the current year. The IMF recommends to curb credit to the rapidly growing private sector, to limit banks' access to the central bank's overdraft facility, and to tighten the supervision of the financial sector.

International assistance: Iran's achievements in the fields of economic and social development, including those of Bank Keshavarzi, have been fully due to its own initiative. Eg, in 1995 and 2000 Iran received a mere 0.2% and 0.1%, respectively, of its national product in development assistance (World Development Indicators, 2002). This is partly due to Iran's international isolation in conjunction with the American embargo, partly to its wealth derived from oil exports. Iran has thus not been able to benefit much from donor-funded transfer of knowledge. NENARACA's support for studies and workshops in which Bank Keshavarzi has participated is exceptional.

2. Agriculture and the rural economy

Agriculture in Iran rests largely on village-based smallholders, which have replaced feudal landlords since the land reform of 1962. It accounts for 27% of GDP and 35% of non-oil exports (2003). Agricultural productivity increased during the 1990s by an average of close to 5%, but, due to a prolonged drought, fell below zero in 1999-2000; during 2000-02 it climbed up to 3.8% p.a. Farming is the largest sub-sector (55% of value added), followed by livestock (42%), including 54 million sheep and 26 million goats (about one-quarter held by semi-nomadic tribes). After the Islamic revolution, agriculture and rural development were given high priority for achieving food security, especially for small farmers. Agriculture provides employment to 23% of the labor force and supplies a large proportion of the country's food requirements. Self-sufficiency ratios in food production in 2001, according to FAO estimates, were 59% in wheat, 68% in rice, 128% in pulses, 26% in oils, 46% in oilseeds, 102% in potatoes and 49% in sugar.[5] Land and labor are abundant; but in many areas water is a limiting factor. Iran produces 80% of the world's saffron, 50% of pistachios, 17% of dates, 13% of cherries, 12% of walnuts and 9% of apricot and raisins.

National average yields are low, with high variability, both under irrigation and rain-fed conditions. The FAO attributes this to fragmented holdings, an aging farm population with low literacy, lack of improved varieties, inadequate fertilizer application, poor management of irrigation, weed and post control, and lack of focused research and extension. Government, in its endeavor to increase productivity, has offered incentives in the form of subsidized credit for input purchases and price guarantees for major crops, now being reduced. This has distorted markets, but had little positive effect.

Rural cooperatives have been promoted by the government as an instrument of input supply and marketing of agricultural products of their farmer-members; wheat is exclusively purchased by cooperatives (which perhaps explains the low level of self-sufficiency in wheat). In 2000-01, there there were 2,948 rural cooperatives with 4.4 million members, and 255 cooperative unions. Total capital of the primary societies amounted to Rls 3.32bn. Loans to members amounted to Rls 347bn. No recent data are available. Cooperatives receive loans from BK at 12.5% and on-lend to their members at 13.5%, the same rate at which BK lends to the agricultural sector. (CBI 2001:22-23)

Market size and market potential for financial institutions: With 34% of the population living in rural areas, the size of the rural financial market is 23 million people. The primary market for rural financial services is about 4.5 million rural households; at least 2.2m of them are farm households. The secondary market are approximately 10 million adults with a

[5] Other foods: citrus 101%, apple 106%, dates 116%, grapes 123%, red meat 100% poultry 101% milk and milk products 99%, vegetables 104%, barley 72% and maize 38%.

potential demand for financial services. With an urban population of about 44 million people, the primary market for urban financial services is about 10 million households; the secondary market is about 22 million adults. There are 64,000 villages, minus those which are deserted, with a potential demand for decentralized financial services. Many of them would be too small for their own local financial institutions, and would have to join together with neighboring villages. There is scope for an estimated 10-15,000 community-based financial institutions.

3. Social and human development

The UN (2003:14) reports that Iran's inhabitants enjoy an average quality of life, which is near the top of the middle-level human development category. With a HDI value of 0.72 in 2002, Iran appears to be within reach of the level of high human development countries. Enormous progress has been made since the 1970s, despite a decade of war, continual economic sanctions and the almost total absence of international assistance.

Between 1991 and 2001, GDP has grown by 4% per year, per capita income by 2.5%; strenghtening the economy remains an important challenge. Life expectancy has risen from 62 years in 1988 to 70 years in 2000 and 71 in 2003, due to a considerable extent to a great expansion of health care and public health. Infant (<1 year old) mortality rates have fallen drastically from 93 per 1000 live births in 1974 to 29 in 2000, child (<5 years old) mortality rates from 153 to 36. Illiteracy has been steadfastly reduced; nearly all children now receive some primary education. The overall literacy level rose from 50% in 1976 to over 80% in 2000; the literacy rate for those 6 years and older now stands at 85%, for those 6-29 years at 96% (2003). Between the provinces, there are wide disparencies. On many indicators, Tehran tops the list, while Sistan and Baluchistan rank at the bottom. (UN 2003:36)

Between 1976 and 1991 Iran's population rose at an annual rate of 3.4% from 34m to 56m, one of the highest growth rates in the world. This was followed by a striking reduction to now 1.2%, resulting from a decisive change in government population policy and the rapid spread of family planning, though not everywhere in rural areas. The bulge in the population pyramid (38% are between 10 and 25 years old) is now resulting in increasing numbers of **young people seeking employment: a major challenge to the country – and to BK!** Mass unemployment, especially of young adults, now presents one of the country's major challenges. Between 1991 and 1999, employed increased by less than 2% per year, while unemployment rose at 9% annually. At least half a million new jobs need to be created a year. With a labor force participation of 62% among men and 10% among women, the problem appears all the more pressing for women. Yet among the young aged 15-24, the problem concerns both sexes: the unemployment rate of young men is 35%, without much difference between urban and rural areas; for young women it is 41%, but substantially higher in urgan (58%) than in rural areas (26%). (UN 2003:31-32)

4. The financial sector

Historical overview

The history of banking in Iran began with the establishment of the Imperial Bank of Persia, a subsidiary of the Bank of England, in 1889. The first Iranian bank, the National Bank of Iran, was founded in 1930 as a commercial and de facto central bank, under the name Bank Melli still the largest, government-owned commercial bank of Iran. Government dominance and interference have been characteristics of banking in Iran throughout its history.

1950-72 was the institution-building period under stable macroeconomic conditions. Between 1950 and 1961, 21 new banks began operations, 17 of them private banks, which dominated in numbers, and four state-owned development banks, which dominated in total assets. The specialized state-owned banks in agricultural, housing and industrial finance provided

subsidized term loans from low- or zero-interest rate resources provided by government, with the objective of directing funds to targeted sectors and projects, while commercial banks provided short-term credit at higher interest rates. The rise in the number of commercial and specialized banks in a low-inflation environment contributed to a substantial increase in financial deepening and declining capital costs during the 1960s until the mid-70s: the ratio of M^2/GDP as a measure of financial deepening climbed from 16% in 1940 to peaks of nearly 70% in 1959 and 1968. The Banking and Monetary Act of 1960, revised in 1972, provided the legal base for the creation of the central bank as the executing agency of the Money and Credit Council, which has continued to function as policy-making agency in the hands of parliament until today. There is thus no tradition of autonomous central banking.

1973-77 is the period of credit expansion and inflation. The macroeconomic environment changed drastically with the oil-price jump of 1973-74. Increases in government expenditures, private deposits and bank lending had expansionary monetary effects. This led, under conditions of limited domestic production capacity abd labor shortages to a surge in inflation from 3% in 1972 to 25% in 1977, uncontrolled by monetary policy. Real interest rates turned negative by a wide margin. As the cost of debt was significantly lower than the cost of equity or internal funds, companies borrowed heavily. In this inflationary environment, banks were able to make profits by lending at low real interest rates and shifting the burden to depositors, who received negative real returns: again a situation which still characterized the situation today. In 1977 the development banks' long-term interest rate was 10% while the short-term rates of commercial banks was about 14%. The credit boom of 1973-77, coupled with a low problem-loan ratio, financed a massive increase in private investment, which came to an end with the Islamic revolution in February 1979.

1979-88 is the period of nationalization and bureaucratization. The overall decline in economic activities and the expropriation of private companies disrupted the operation of the financial sector in 1979. Some borrowers fled the country, leaving huge bank debts behind. In other cases, the new owners refused to recognize pre-expropriation bank debts. The banks were forced to take over technically bankrupt companies; their non-performing loans surged to unprecedented heights. All banks and insurance companies were nationalized and placed under the Higher Council of Banks as administrative authority, while the Money and Credit Council remained the monetary and credit policy authority. Ownership, governance and control of the banking system came under full control of the government. Competition all but disappeared; bureaucratic practices prevailed: with dire consequences on the efficiency of the banking system. The ministries, not the market, decided over credit allocations.

In 1983 the Islamic Banking Law replaced conventional banking practices with Islamic principles of equity participation and expected revenue or profit-sharing arrangements on deposits or loans, respectively. Complete government ownership of banks and many companies, government control over deposit and lending rates, extensive directed credit programs and high reserve requirements resulted in negative real yields on deposits, market uncertainties reflected in high black-market exchange rate premiums, credit shortages and a significant reduction in the depth of financial intermediation. Under government ownership, the difference between specialized and commercial banks narrowed. At the same time, the central bank turned into a micro-manager of the banking sector, favoring the public sector hugely over the private sector as borrower.

The period since 1989, after the end of the Iran-Iraq war, witnessed times of relative abundance and of shortages of financial resources, of relaxation and of restrictions on international capital flows. Bank resources were treated like budgetary funds, disregarding the basic development criterion of the efficient allocation of scarce financial resources to investments with the highest rates of return. Since the mid-1990s the Money and Credit Council has set planned sectoral credit allocations for the private sector, but these were not properly monitored and implemented; construction and housing ended up receiving the highest share. Steps were taken to liberalize the system, increase deposit rates and reduce

financial repression. With quantitative credit allocations as the main policy instrument, the financial authorities were unable to competently apply consistent monetary and fiscal policies, which resulted in a surge of inflation in the 1990s and a fall of real returns on short-term deposits below zero. Yet, liberalization continued. Since 1996, private non-bank financial institutions (NBFIs) started operating, and private banks since 2000; directed credit is being phased out; the Tehran stock exchange has started trading again; and the iron grip on deposit and lending rates has been slightly relaxed. An increasing number of public enterprises is being auctioned off through the stock exchange; and managers of publicly traded corporations are required to disclose financial statements and deliver results. With 97% of banking assets still in the hands of government, demand-led financial intermediation is still in its infancy. (Jalali-Naini & Khalatbari 2002)

The banking sector

After the Islamic Revolution in 1979, the banking sector was nationalized. It consists of the central bank (Bank Markazi), 14 banks – 6 state-owned commercial banks, 4 state-owned specialized banks and 4 newly established private banks[6] – and several private non-bank financial institutions. In 2001 the total number of bank units including branches, counters and representative offices was 15,732; Bank Saderat and Bank Melli held 21.0 and 20.5 %, respectively. The share of the Agricultural Bank (Bank Keshavarzi, BK) was around 10%. BK, now with 1800 branches, has the largest rural network. The central bank (CBI) is in charge of implementing monetary, banking and credit policies and their supervision. Since the early 1990s, banks have become universal banks, without sharp dividing lines between urban and rural spheres of banking. This has created a new spirit of competition among the banks, the branches of which are frequently located next to each other. The government is now (2004) planning to restructure the whole banking sector, which may include mergers and privatizations – after due recapitalization of state banks and perhaps the transformation of mandatory credit allocations into bank capital. BK may be affected.

Most banks are **state-owned;** since 1996 and 2000, a few private non-banks and banks, respectively, have been established. The state-owned banks are ruled by a common General Assembly comprised of nine ministers, which appoints the managing directors, board members, and statutory auditors; it decides on capital allocations and the budget; and it approves the balance sheet and profit & loss allocations. Banking guidelines are provided by the Central Bank and the Ministry of Economic Affairs and Finance. Supervisory functions are vested in the Supreme Council of Banks, presided over by the Governor of the Central Bank. Allocations to banks are incorporated into the annual budget of the government and implemented in close cooperation with the Organization of Planning and Budget.

In operational terms, banks are considered independent from particular ministries. On principle, internal decisions are made autonomously and from a banking viewpoint. However,as state banks, they cannot determine their own profit (interest) rates. They also handle government programs.

In 2000 a new **Law for Establishment of Private Banks** was approved. The law stipulates that private banks are wholly owned and operated by Iranian national private persons within the framework of the general banking law (CBI 2001:85); however, foreign participation up to 49% may be approved by the MCC. Minimum capital requirements were set at Rls 200bn (US$246m). Several privately owned banks and non-bank financial Institutions have emerged, which mobilize deposits and provide loans. The profit rates they are authorized to pay to depositors and to charge on loans are about 2-3% higher than those of government banks.

[6] Parsian, Saman, Eghtesad-e-Novin and Kar Afarin.

Total banking assets including CBI in 2002/03 amounted to Rls 1,293.07tr (US$159bn); 15.9% of total assets are comprised of claims outstanding on the public sector and 25.3% claims on the non-public sector. The Central Bank's claims on banks amounted to Rls 24.3tr (compared to Rls 131.6tr claims on the public sector), while banks and credit institutions had deposited Rls 82.4tr in the central bank (76% legal and 24% sight deposits). Public sector deposits amounted to Rls 51.5tr.

Total assets of banks and private credit institutions (excluding CBI) amounted to Rls 940.15tr: 83.5% in commercial banks, 15.3% in specialized banks and 15.3% in non-bank financial institutions. Claims outstanding on the non-public sector amounted to Rls 327.07tr or 34.8% of total assets; claims on the public sector amounted to 29.4% of total assets. 8.8% of the banks' assets are deposited in the central bank. In relative terms, commercial banks and NBFIs, compared to specialized banks, mobilize slightly more of their resources from non-public deposits; in contrast, specialized banks, commercial banks, lend a larger share of their total assets to the non-public sector. The overall loans- or facilities-to-deposit ratio (LDR, FDR) is 85%; the ratio is 70% for commercial banks, 67% for NBFIs and 193% for specialized banks; in other words, commercial banks and NBFIs lend less to the non-public sector than they collect from it, and specialized banks almost double the amount.

Table 1: Total assets, claims outstanding and non-public deposits of the banking sector (without CBI), amounts in trillion Rls, 2002-03*

	Total assets		Claims outstanding on non-public sector		Deposits by non-public sector	
	Amount	Percent	Amount	Percent	Amount	Percent
Commercial banks	785.44	83.5	230.29	70.4	328.54	85.8
Specialized banks	143.58	15.3	92.76	28.4	48.07	12.6
NBFIs	11.13	1.2	4.02	1.2	6.03	1.6
Total	940.15	100.0	327.07	100.0	382.74	100.0

*Compiled from tables in CBI 2004

Agricultural credit in 2001/02 has amounted to Rls 37.5tr, up 26% from Rls 29.7tr in 2000/01 which in turn was 31% above 1999/2000. BK is the largest single source of agricultural credit, providing 61% of all institutional credit to agriculture (2001-02); its share has been increasing. Commercial banks are required to provide a 25% quota of their loanable funds to agriculture, either directly or through BK. Their share has fallen from 58.1% in 1999/2000 to 39.3% in 2001/02; no recent data are available. Since 2000/01, there are also non-bank private institutions listed by CBI as providers of agricultural credit; but their share is still negligible at 0.01% in 2001/02. (CBI 1379, 1380) BK is practically a monopoly provider of rural microcredit; the agricultural lending of commercial banks focuses on bigger enterprises and projects.

Table 2: Credit oustanding by banks and non-banks, 1999/2000-2001/02 (in billion Rls)

	1378		*1379*		*1380*	
	Amount	*Percent*	*Amount*	*Percent*	*Amount*	*Percent*
Commercial banks	9,473.2	41.9	12,367.2	41.7	14,719.8	39.3
Agricultural bank	13,148.7	58.1	17,286.1	58.3	22,734.5	60.7
Credit institutions	0	0	0.2	0.0	3.7	0.01
Total	22,621.9	100.0	29,653.5	100.0	37,458.0	100.0

Bank training is provided by the Iranian Banking Institute, which is affiliated with the Central Bank, and by the banks' own training institutes.

Microfinance

Microfinance is poorly developed in Iran. There are a few small initiatives; sustainable microfinance institution-building has generally not been among their operational objectives.

Major constraints have been a culture of subsidization inimical to cost-covering lending rates, far-reaching state control over the financial system, and a dearth of value-adding non-farm microenterprise opportunities in most of the 64,000 villages of Iran.

Informal finance is reportedly widespread, but there is little recent information. Until the early 1970s, the urban Bazar economy was based on a dual informal credit system: one for established Bazari traders at interest rates significantly above the official rate; the other one consisting of interest-free qard ol-hasaneh loans for new entrants to the market upon the recommendation of someone in the Bazari network, and perhaps for emergencies or social purposes.

In rural areas, informal finance appears to be largely limited to small-scale short-term loans by relatives and friends, frequently just for a few days; for emergency loans there is no other alternative. Local traders may provide advances, with the expected crop serving as nonformal collateral.

Among informal institutions are local funds, under the name of Qard-ol-Hasaneh Funds, as financial self-help groups, frequently established by members from their locality of origin. Loans are given mainly to member, mostly in cities, but occasionally to people from their home village. These loans are supposed to be interest-free, as the term qard ol-hasaneh implies; but this does not always seem to be case. We heard of annual interest rates up to 22% or approximately 5% in real terms, which is negligible compared to informal lending rates in other developing countries.

Among the informal institutions on an SHG basis with a potential of developing financial services on an institutional basis are water user associations, which are indigenous to Iran and have a long history.

Semiformal finance: As a result of the many restrictions imposed on the banking sector, the market for informal financial intermediaries in urban areas including provincial centers has grown since the 1980s. A number of them started as charities or qard ol-hasaneh funds providing at first interest-free loans but eventually changed to financial intermediaries charging relatively high rates. Their growth has induced the Ministry of Interior to register them; this has turned them into semiformal financial institutions which do not fall under central bank regulation. (Jalali-Naini & Khalatbari 2002)

The development potential of these funds should not be underestimated. They appear similar to the savings funds in many European countries in the 18th and 19th century which first turned into savings banks and eventually into universal banks. One of the largest such institution in Iran is Bonyad Credit Institution, with an extensive branch network and a very active deposit and lending business. Another one is the Imam Khomeini Emdad Foundation which helps the poor with loans and grants for income-generating activites and the poorest with charity; for that purpose it sets up local Emdad (*social assistance*) committees. The fact that such an institution has remained non-formal cearly shows (a) a strong demand for financial services not fully met by the banks; and (b) the lack of an adequate legal framework[7] for small financial institutions including rural banks with low minimum capital requirements.

In a non-representative survey in villages in four provinces in northern Iran, 22% of repondents reported that they received credit from informal sources (compared to 36% from formal sources, mainly Bank Keshavarzi), mostly friends and relatives. Other sources were Emdad Committees, Qard-ol-Hasaneh Funds and local traders. There may be considerable

[7] Such legal frameworks exist in Indonesia, the Philippines, Nigeria, Ghana and a number of other countries.

regional variation; eg, Qard-ol-Hassaneh Funds were found to be quite popular in East Azerbaijan. (Rashidi & Azadi 2004: 10)

There is a small number of NGOs in Iran, which are increasingly given national and international attention as civil society organizations; but they are not active in microfinance. (Namazi 2000). An exception is DRMFS, recently established by B. Mansuri on behalf of IJO, which has initiated a Rural Micro Finance Support Project (RMFSP) funded by IFAD. In cooperation with Bank Keshavarzi, joint-liability groups predominantly of the unbanked are being established on a pilot base for channeling credit. There appears to be a great potential for their expansion on a national scale, which might eventually double BK's outreach to small rural borrowers and depositors. In a later phase, they may either continue as channeling groups, or evolve into SHGs and community-based financial institutions (*Deh banks*). Further details are given in Annex 8).

Recently UNDP has targeted some 400 women-headed poor households with microcredit in southeast Iran and subsequently, through its Lazoor Project in Damovand, helped to establish self-help groups (SHGs) referred to as community-based funds in some six villages. In cooperation with provincial governments, the project is now entering into a phase of upscaling in six subdistricts in six different provinces, targeting about 1-2000 families in each. It is hoped that provincial governments will eventually expand the initiative at their own. SHGs of about 20 members mobilize their own resources savings through regular compulsory savings. They receive capacity-building and skill training as well as capital injections of about $2-3000 as a revolving fund. The groups help their members to identify investments. Members receive loans of $2-300 for 4-8 months, which they repay in regular instalments. A fee of 5-7% is deducted up-front without any additional profit-sharing or interest. This is equivalent to an effective annual interest rate around 24%, which is considered inadequate for institutional growth and sustainability.

In the framework of its telefood program, the FAO has provided a dozen grants of $10,000 each to groups of 10-25 people for starting individual or joint microprojects, reportedly with good results. Institution-building is not the objective. Projects are identified and monitored in cooperation with the provincial extension services. Examples of investments are mushroom growing, jam and pickle production, dual-purpose ponds for irrigation and trout raising, honeybee-keeping and cereal packaging.

During a recent mission Unido identified a good potential for bamboo cultivation and associated microenterprise processing in northern Iran.

Since 2000, the Ministry of Agriculture, through its Rural Women Affairs Office, has piloted the establishment of Microcredit Funds for Rural Women in the form of savings and credit SHGs. Until 2003, 33 funds were established in 10 provinces. Among the objectives are women's empowerment, skill development, self-reliance through savings promotion and microcredit for small projects – all geared to income and employment generation. (Mafie 2003) Institutional sustainability has remained a major challenge.

Bank Keshavarzi is the major provider of formal agricultural microcredit, comprising loans predominantly to small farmers below $ 1000. BK handles three microcredit projects for women on behalf of government agencies, all of them profit-free qard ol-hasaneh loans: (i) Hazrat Zeinab-e-Kobra Scheme with loans to 62,632 borrowers since 1994, which provides loans of Rls 3-5m to women; in 2003-04 Rls 27bn were disbursed to 10,151 women. (ii) In 2000, Rls 130bn were disbursed through the Iran Scheme to some 66,724 women, approx. 67% for microenterprise activities and the rest for consumer credit. (iii) Credit was also disbursed to carpet-weaving microenterprises of women. None of these has an institution-building component. In addition, credit to rural women is being disbursed through cooperatives. Since 2002 the bank has also provided Rls 1429bn for the employment or self-employment of unemployed male and female youth in villages and small towns.

BK has recently established a Women's Saving Fund of Rls 1bn ($120,000), funded by BK (75%) and several foundations (25%), which is expected to promote women's SHGs in cooperation with the IFAD-supported Rural Micro Finance Support Project of DRMFS-International. (Tehrani 2003)

Islamic banking in Iran

The legal basis of the financial system is the Banking and Monetary Law of 1972, amended by the Banking Nationalization Law of 1972. The operational principles of Islamic banking, which are mandatory for the banking sector, are laid down in the Law for Usury-Free Banking of 1983. After the Islamic revolution of 1979, foreign and private banks were outlawed. The financial system is state-controlled, but is now in the process of liberalization. Since 2000, private banking has been permitted, and several private banks and non-bank financial institutions (NBFIs) have been established, introducing a new element of competition. They are under the central bank's interest rate regulation, but are permitted 2% above the deposit and lending rates of the state banks.

All banks, including private ones, operate in the framework of Islamic banking, based on Islamic law, the Sharia.[8] The basic principle is one of fairness and equity in banking relations: no party in the relationship should incur undue profit or loss relative to the other partner. Fixed interest rates are avoided. While Islamic scholars debate the meaning of usury, this concept is interpreted narrowly in Iran, frequently equating interest-taking (in the sense of a fixed interest rate) with usury. The concept of **profit rate** is used to indicate a sharing in the profit, which is determined ex post, ie at the end of a contract or accounting period; while interest rates are considered fixed and determined ex ante, ie, at the beginning of a contract or accounting period. In Islamic banking, there are basically **two types of transactions** with deposit and credit clients:

- interest-free transactions, referred to as *Quard Al-Hasanah*; and
- profit-sharing transactions.

Accordingly, there are interest-free as well as profit sharing deposits; and interest-free as well as profit-sharing loans.

As the concept of loans is considered tied to the concept of interest-taking, the term **profit-sharing facilities** is substituted for loans. Banks are considered as agencies working with their clients' funds, directing them in three ways:

(a) fixed profit facilities::
- Instalment sale at a fixed rate of profit
- Hire purchase
- Forward purchase

(b) variable profit facilities, based on partnership, in actual fact frequently fixed
- Legal partnership: joint ownership by the bank and the other shareholders of an enterprise
- Civil partnership: capital is jointly raised; the investment is managed by the other person (a corporate entity or individual) and supervised by the bank
- Musharaka: a partnership or joint venture between a financier and an entrepreneur, each party contributing capital and sharing profits and losses on a proportionate basis
- Mudaraba is a contract of investment in a commercial enterprise; trustee finance or a partnership between capial and work; the funds are provided by the bank and the management by the other party

[8] Islamic banking in Iran is based on laws passed by parliament and approved by the Guardian Council. One member of the Council is in charge of the banking sector. In the central bank as well as in each bank including BK, there is a representative of the Islamic Republic of Iran supervising banking banking operations.

- Muzarah: Funds for agricultural investments are provided by the bank, labor is provided by the farmer
- Musaqat is a variant of Muzarah, referring to investments in orchards

c) profit-or interest free facilities:

- Qard hassan, or qard ol-hasaneh, is a form of social banking, either entirely free of charge or with an administrative fee.

Similarly, there are three types of deposits: (a) deposits with a fixed share of the bank's profit; (b) deposits with a variable share of the bank's profit or revenue; (c) Quard ol-Hassaneh deposits without a rate of return (ie, interest-free). Deposits with revenue-sharing, calculated on a monthly basis as in Islamic banking in Indonesia, do not seem to exist in Iran. Partnerships with the sharing of variable profits require, as in venture capital, adequate book-keeping, effective internal control and adequate external supervision. In the absence of these requirements, fixed profit facilities are more appropriate.

Directed interest/profit rates: Profit rates on bank deposits are set by the central bank and approved by the Money and Credit Council. They range from 7% for short-term savings deposits to 13-17% for term deposits of two to four years. In addition, there are Qard al-Hassaneh deposits at a profit rate of 0%. At an inflation rate of 15.6% as given by the central bank for that period, the rates on short-term deposits are negative in real terms at –8.6% to -6.6%; for Qard ol-hasaneh deposits they are –15.6%. For long-term deposits, they are slightly negative or positive depending upon the term.

Table 3: Profit rates on bank deposits in percent p.a., 2003-04

Bank deposit category	*Nominal*	*Real*
Short-term savings deposits	7	-8.6
Special short-term deposits	9	-6.6
Long-term deposits	13-17	-2.6 – +1.4

Lending rates on Islamic contract facilities are differentiated by sector and profitability, ranging from a low of 13.5% for agriculture to 21% and higher for commerce, services and construction. In real terms, they ranged from –2.1% to above +5%.

Table 4: Rates of return on Islamic banking facilities in percent p.a., 2003-04

Sector	*Nominal*	*Real*
Agriculture	13.5	-2.1
Manufacturing & mining	16	+0.4
Housing (with depositing)	15	-0.4
Housing (without depositing)	18	+1.4
Exports	15	-0.6
Commerce, services, construction, misc.	21 (minimum)	+5.4 (minimum)

Keeping interest or profit rates on credit artificially low creates a huge demand which cannot be satisfied at the given rate structure. As a result, formal sector credit is rationed and demand is shifted to the informal market. On that market, risks are higher, resulting in higher interest rates; rates of 30-36% are reported on commercial informal markets.

Contradictions of Islamic banking in an inflationary economy. In an inflationary economy, Islamic banking runs into a serious problem. On the passive side of banking business, **depositors** are encouraged to put their savings either into interest-free current and savings accounts; or into profit-sharing savings or term deposit accounts. In either case, real rates of return have been negative. At real inflation rates around 40% in the late 1990s, despositors lose 40% of the value of interest-free savings every year. At rates of 10-20%, they still lose annually 10-20%, respectively. In recent years, inflation has gone down, while

rates of return on deposits as fixed by CBI have remained stable. In September 2004, the official interest is given as 16%; rates of return on remunerated deposit accounts vary from 7% to 17%; the average is given as 12%. These rates are still negative in real terms, except on 4- and 5-year deposits.

Market distortion. On the active side of banking business, **borrowers** received loans at profit rates within a narrow band which were all below the real inflation rate. This has vastly increased their actual share in the profit, while the value of the banks' and the depositors' resources has been eroded. In September 2004, lending rates in the agricultural, industrial and export sectors are 13.5-16%; the inflation rate is given as 16% and the lending rate in the equilibrium market as 40%: a highly distorted market. Yet, despite profit rates which are negative in real returns, there is a continual debate on "excessively high interest rate"; the public does not seem prepared to listen to explanations to the contrary by the Central Bank.[9]

This has had two consequences which are *contrary to the principles of Islamic banking.* The first violation derives from the shift of wealth from large numbers of depositors to a much smaller number of investors. As many of the depositors belong to the poorer sections of the population and many of the borrowers to the richer ones, the practice of interest-free deposit accounts and of profit rates substantially below the inflation rate has, in theory, made the poor poorer and the rich richer and thus increased inequality. It has also eroded the value of the bank's capital. The Islamic principle of equity has thus been violated in three respects:

- between the two main partners in financial intermediation: depositors and borrower-investors;.
- between borrowers and the bank, whose capital is unduly eroding; and
- between depositors and the bank as the custodian of the value of their depositors' funds.

The second violation lies in the shift of wealth to the state, which is the biggest winner in an inflationary economy. Through inflation, value is shifted from the consumers to the state. If the value of domestic currency decreases by 40% p.a. as was the case in Iran during part of the 1970s, the state gains 40% each year (printing additional bank notes accordingly): the so-called hidden inflation tax. As a result,

- the equity principle is being violated between the state and all consumers.

The inflation tax is therefore a *highly usurious interest rate* on all financial transactions. It not only erodes the value of the funds, it also distorts financial markets and undermines the health of banks as financial intermediaries. It puts government-owned banks into the awkward position of inadvertedly implementing the usurious inflation tax, particularly to the disadvantages of its depositors, of which many belong to the poorer sections of the population. This is an issue which the Central Bank reportedly is much concerned about.

There are two **remedies:**

- Bringing down the inflation rate; and
- adjusting profits rates, calculating deposit and lending rates on the basis of the inflation rate as a floor.

The government has been making serious, and to some extent successful, efforts to bring about macroeconomic stability. But even with the lower current inflation rates, the continued practices of accepting interest-free deposits and fixing profits rates at levels of highly negative real returns appears inequitable.

[9] "Islamic Banking has Come to Stay." Iran Daily, 11 Sept. 2004, p. 6.

Part II

Bank Keshavarzi (BK) – The Agricultural Bank

1. Mandate: *towards customer and shareholder value in rural finance*

The overall **mandate** of BK has been the provision of a full range of financial services to the agricultural and wider rural population. This is geared to the development goal of agricultural development and the improvement of the standard of living of the rural population, particularly through an increase in agricultural production and productivity and the development of rural small industries and microenterprises. With more than 50% of domestic savings concentrated in Tehran alone, the Bank attempts to create more of an equilibrium between value-adding production in rural and urban areas. Its mandate is now being expanded to also reach the lower segments of the urban population. However, the Bank's domain and comparative advantage continue to be rural finance.

On principle, BK functions as a financial intermediary and universal bank, founded on the ideal of self-reliance. BK's **mission** is twofold: acting as a development bank implementing the government's objectives; and a commercial bank maximizing shareholder value. While these two objectives are not fully compatible, there is an emerging awareness that commercial banking with its higher profit margin is a prerequisite for the expansion of the bank's business into agriculture, poverty alleviation, microenterprise development and the promotion of women's income-generating activities.

BK has listed the following **guiding principles** in its annual reports of the last few years: (1) customer satisfaction; (2) profitability and shareholder value; (3) financial order and discipline; (4) human resource enhancement; (5) financial self-reliance; (6) innovation and continuous improvement of services; (7) adherence to Islamic banking rules.

2. History of reform: *from directed agricultural credit to sustainable banking*

The first window for agricultural credit in Iran was opened in 1930 by Bank Melli Iran (The National Bank of Iran). In 1933, the Agricultural and Industrial Bank was established. At its origin, the bank was a credit fund, not a financial intermediary. It neither mobilized savings; nor did it cover its costs. It underwent several changes in structure and name. In 1969 it became the Agricultural Cooperative Bank of Iran (ACBI) with the mandate to enhance the state of rural cooperatives and provide short-term credit to small farmers. This was paralleled by the establishment of the Agricultural Development Fund of Iran in 1968 as a financial institution for the emerging commercial farming sector after land reform. In 1972, the Fund was converted into the Agricultural Development Bank of Iran (ADBI)

After the Islamic Revolution, the banking sector was nationalized, and numerous mergers took place, among them the merger of ACBI and ADBI. Thus originated the Agricultural Bank, or Bank Keshavarzi (BK), in 1979. Due to the Iraq-Iran war, 1980-88, the newly established bank stagnated during the 1980s. It continued operating as a loan fund; deposits were only accepted from public institutions. By 1991, 22% of credit disbursed was financed through deposits; 71% of the bank's resources were borrowings from other banks. Increasing losses led to an official debate over the future of the bank (BK 2004:29):

- Close it, merge it, or reform it?

A new phase was prepared in 1991 and started to be implemented in 1992 when the Bank was transformed into a deposit bank, with the objective of providing savings services to the rural population and mobilizing its own resources. It started to expand its branch network, are simplified operational procedures, and initiated studies on how to overcome the restrictions

imposed on the banking sector. Between 1992 and 1997, a period which BK(2004:29) refers to as a transitional period, deposits rose from 21% to 43% of disbursements. BK's share in the national deposit market grew from 1% to 2.8%. But the new approach proved to be costly: losses increased from Rls 16.7bn in 1992 to 213.4bn in 1997.

1998-2004, referred to as *the new era (BK 2004a; Rasoulof 2004)*, marks the second stage of the new approach which had been started in 1992. Steps were taken to build the infrastructure of a learning organization by systematically building staff capacity and promoting customer-orientation. Key concepts introduced into the bank's mission statement were efficiency, profitability and productivity. **Structural reform are focused on five key areas:**

- Resource mobilization and marketing strategies, including: expanding the branch network into urban areas where two-thirds of national liquidity are kept; mobilizing savings from agricultural enterprises; diversifying sources of income; establishing a customer information system; marketing services to specific market segments from high-income to low-income groups, with special programs for women, youth and other unbanked target groups; improving arrears management and externalizing debt collection to private agencies. BK's market share in savings is 6.3% (2003) and constantly increasing.
- E-banking development strategies, including: on-line banking; intranet links between head-office and branches; electronic services such ATM and debit cards
- Credit and investment services, including: removal of restrictions; portfolio diversification; rationalizing disbursement procedures; establishing a borrower data bank; strengthening loan monitoring; improving the investment guarantee fund
- Financial strategies, including: emphasis on shareholder value through productivity and profitability; diversification of sources of income; assets and liability management; strengthening the self-reliance of provincial directorates and branches; restructuring loss-making branches; reducing operating costs by collecting interest-free current and savings deposits; increasing capital adequacy; reducing dependency on borrowed resources
- Human resource and productivity strategies, including: staff empowerment through participation in decision-making, decentralization and devolution of authority; job posting; system of suggestion for improvements; comprehensive staff training to transform the bank into a learning organization; revision of the staff grading, promotion, wage and salary system using productivity indices; job enrichment and job enlargement.

During this era, the transformation into a proper financial intermediary[10] has gradually gained momentum, with self-reliance through resource mobilization, profitability and expansion of outreach as top priorities. To become a full-service bank, BK has made progressive use of new opportunities for modernization of its operations and services through IT. The autonomy of the bank has been strengthened by the conversion of the bank's role in directed credit from that of a *handling bank*, which lends to beneficiaries selected by the government, to an *executing bank*, which follows government directions but selects its own customers ("managed credit").

Since 2000, the bank has entered into a process of strategic restructuring through **26 strategic reform plans** geared to good governance, efficiency and profitability. Here are some of the more innovative strategies introduced by the bank:

- A system of management performance evaluation, combined with job posting which opens every management position to competitive appointments every 2-3 years

[10] A financial intermediary is a financial institution which mobilizes deposits and transforms them into loans, thus *intermediating* between depositors and borrower-investors.

- A participatory approach to restructuring and strategic reform, involving to-date some 6,000 staff members and over 100 managers
- Converting the bank's hierarchical structure into a flat organization, with direct access of branches to the head office
- An incentives-based system of suggestions for improvement
- Privatization of to-date 19 of the bank's subsidiaries and services (eg, credit examination, insurance processing, training, research, office work, staff transportation, recruitment, staff services, E-banking, telephone banking); privatization of management performance evaluation and debt collection are under preparation
- The first website of any bank in Iran, with services in Farsi and English

Among the **achievements of the new phase** were the expansion of the branch network from 480 to 1800 as of 2004; the decline of the proportion of government-funded directed credit from ~80% to ~30%; the growth of deposits to 72% of its funds and of the bank's deposit market share from 1% in 1995 to 6.3% in 2003; rationalization of all procedures; staff retraining; and the computerization of the branch network.

Banking as an art: For the first time in its history, the bank made profits in 2001-02 and wiped out its accumulated losses; since then it has been profit-making: a remarkable achievement given the restrictive policy environment and the extent of government intervention in banking matters. The most remarkable achievement of the bank in recent years has been the growth of assets, deposits in profits despite the constraints imposed by a repressive[11] policy environment. BK is now ***mastering the art of banking and rural finance in a difficult policy environment.***

The next phase. Parallel to the next five-year development plan and in the context of the government's intention to restructure the banking sector, BK is now in the process of making preparations for a new phase, starting in 2005. Inspired by the experience of Crédit Agricole in France which turned from an agricultural into a universal commercial bank without neglecting agriculture, and with the assistance of an international consulting firm, the bank plans to turn into a full-fledged universal bank, self-reliant and profitable. It will be privatized and traded at the stock market; 19 subsidiaries and some 40-50 services have already be privatized or externalized. One of the models under consideration for the new era is the restructuring of its operations into a holding company, holding some 7-10 separate companies. Preparations are being made to turn its hierarchical structure into a flat organization, with 640 main branches which account for 85% of all transactions directly connected to the head office. While directed credit will be largely phased out the coming five years, the bank will revamp its banking culture, *taking the bank to the customer* instead of expecting the customer to come to the bank: in rural as well as urban areas. The ***objective*** is deeper market penetration:

- Universal banking, including E-banking, and tapping the liquidity reserves in Tehran and other large cities
- Diversification of BK's portfolio and of the local economy in rural towns
- Providing financial services to the unbanked in the villages.

This will require new instruments and strategies, including both retail and wholesale services. In this context, the bank will contribute to the diversification of the economy and of income-generating activities, diversifying at the same its portfolio to finance farm, off-farm and non-farm activities. A new management development system (with on-the-job training, job posting

[11] The term *financial represssion* has been coined by McKinnon (1973).

and performance **incentives) and intensified staff training will be at the core of efforts to turn BK into a *learning* *organization*:**[12] providing value to the customer (Rasoulof 2004).

Table 5: Phases of reform of the Agricultural Bank

Phase	*Period*	*Characteristics*
0	1933-78	*Prehistory:* Predecessor institutions operating as loan funds
1	1979-91	*Start-up phase:* Establishment of BK operating as a loan fund depending on government budget
2	1992-97	*Transition period:* Transformation into a deposit-taking bank with directed and commercial banking operations, simplification of procedures
3	1998-2004	*New era:* Increasing autonomy and self-reliance in a still restrictive policy environment; customer orientation as a priority; modernization through IT; directed credit converted into *managed credit;* deposit mobilization through urban expansion; strategic restructuring into learning organization towards good governance, efficiency, profitability; incipient privatization; profits since 2001
4	2005-…	*Towards universal banking:* A universal bank in a liberalizing environment, self-reliant and profitable, with a diversified portfolio, retail and wholesale services, expanding outreach to rural and urban areas by *taking the bank to the customer*

3. Ownership and governance: *towards banking autonomy*

Ownership : BK is a corporate body fully owned by the government as shareholder. A proposal for partial privatization and trading at the stock exchange has been submitted to parliament and has been pending for several years. This would raise fresh capital and strengthen the Bank's autonomy and commercial orientation.

Governance: The Bank is governed by a board of directors of four, presided over by the Chairman of the Board & Managing Director. Ultimate authority lies with the General Assembly of Banks, which appoints the Bank's board members, managing director and statutory auditors; and with the Supreme Council of Banks as the ultimate policymaker under the chairmanship of the Governor of the Central Bank. BK is a legal entity with financial and administrative autonomy; yet, full banking autonomy is still some way off.

Internal control is well-structured in BK. It has been recently re-organized and is now situated in a single Division of Supervision & Inspection, comprising a Legal Department, a Branch Affairs & Assessment Department, and an Inspection & Auditing Department.

External supervision falls under the authority of the General Assembly of Banks as the representative of the interests of the government as shareholder..External audits are carried out by statutory auditors of the State Audit Administration in the Ministry of Economic Affairs and Finance.

[12] The concept of a *learning organization* was first introduced by Argyris (1978) and has subsequently found wide acclaim among organizational theorists and practitioners (eg, see Senge 1990). A *learning organization* has systematized the acquisition, processing, evaluation and storage of information with the objective of organizational adaptation, restructuring and change, which of course requires a certain autonomy to do so. Organizational learning is transported by learning individuals, but in the framework of structures and incentives provided by the organization which are conducive to learning. Eg, in many banks around the world, staff have learned from experience that directed credit and large-scale term loans may lead to investment and recovery failures, while repeat loans starting small and short-term are more likely to lead to sustained growth, both of the enterprises financed and the financing bank. Yet, as an organization, their bank has frequently not learned, bound perhaps by governmental directives and policies of financial repression.

4. The bank's capital and sources of funds: *towards self-reliance*

Capitalization and recapitalization: BK is owned and capitalized by the government. Given the loss-making nature of the bank in the past, this has required periodical recapitalizations by the government. In 1998-99, paid-up capital stood at RI 419.5bn, while losses amounted to RI 307.4bn, reducing shareholder equity to a mere RI 112.9bn. In 1999-2000, losses amounted to RI 258.9bn. In 2000-01, losses were brought down to RI 2bn. At the same time, government recapitalized the bank, injecting RI 334bn; total equity at the end of that year amounted to RI 697.5bn (US$ 85.1m), or 2.8% of total assets. Before the recapitalization, total equity had not only decreased in real but also in nominal terms. To maintain its real value, capital would have to increase at least by the rate of inflation every year. To wipe out the bank's accumulated losses and strengthen the bank's equity base, the government injected another Rls 2.0tr in 2001-02, which brought the bank's paid-up capital to Rls 2,752.8bn and total equity to Rls 2,756.1bn, or 8.1% of total assets. With the profit for 2002-03, total equity rose to Rls 3,100.3bn in that year – an increase of 12.5% roughly corresponding to the inflation rate. Total equity in 2002-03 amounted to 6.6% of total assets, 9.0% of net loans outstanding & dues from non-government entities, and 13.7% of Islamic facilities. In2003-04 the percentage of equity remained the same. There is no information on risk-weighted assets**.**

Table 6: Total equity of BK in billion Rls and percent of total assets

Year	Amount of total equity	% of total assets
1998-99	113	0.9
1999-2000	163	0.9
2000-01	697.5	2.8
2001-02	2,756.1	8.1
2002-03	3,100.3	6.6
2003-04	3,990.9	6.6

Capital and reserves, after recapitalization, amounted to 8.1% of total assets in 2001-02 and 6.6% in both 2002-03 and 2003-04 – a decline which is due not to losses but to portfolio growth; this percentage was 0.9% in 1998-2000.

Table 7: Sources of funds in percent of total assets, 1998-99 – 2003-04

Sources of funds	*2000-01*	*1999-2000*	*1998-99*
Capital and reserves	2.8	0.9	0.9
Deposits	48.4	38.2	36.9
Domestic borrowings	38.1	45.9	48.1
Other liabilities	10.7	14.9	14.2
Total :	*100.0*	*99.9*	*100.1*
Amount in billion Rls	*24,597*	*17,500*	*13,067*

Sources of funds	*2003-04*	*2002-03*	*2001-02*
Capital and reserves	6.6	6.6	8.1
Deposits	57.0	52.7	50.0
Domestic borrowings	26.6	28.8	31.7
Other liabilities	9.7	11.9	10.2
Total :	*99.9*	*100.0*	*100.0*
Amount in billion Rls	*60,096.9*	*47,124.8*	*33,933.4*

Deposits have become the Bank's main source of funds. They reached 37% of total assets in 1998-99, 53% in 2002-03 and 57% in 2003-04: a remarkable achievement considering that real returns on deposits are negative due to inflation. In 2002-03 deposits amounted to 109% of Islamic contracts, up from 103% in 2001-02.

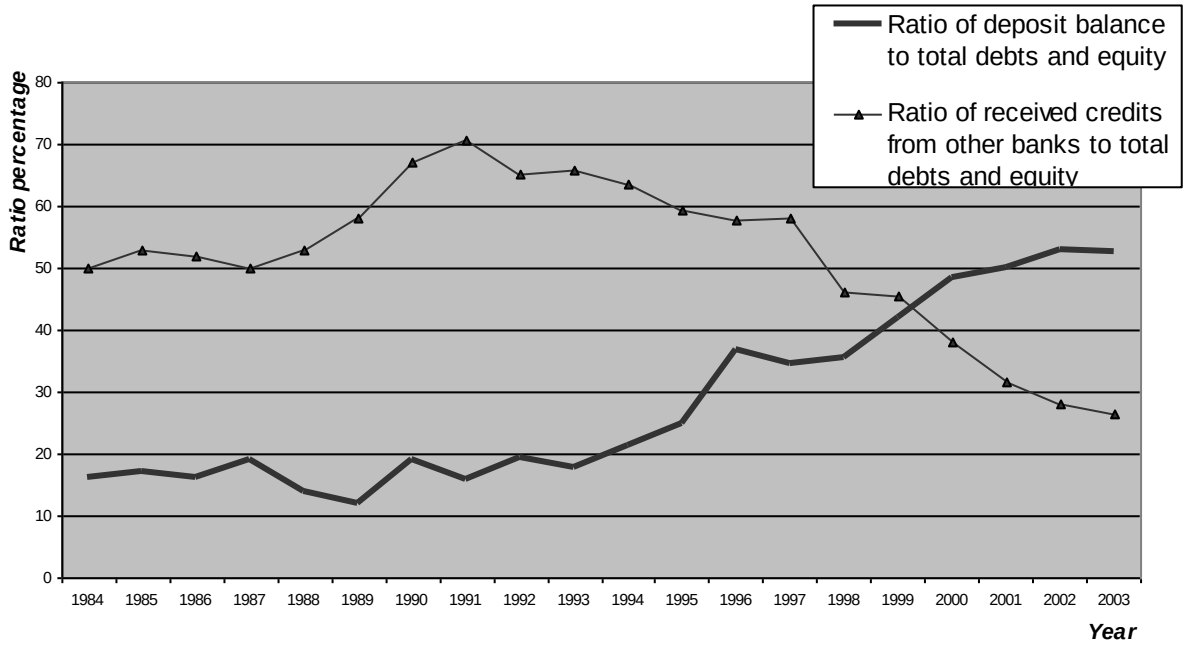
The rise of deposits as a source of funds is paralleled by the decline of borrowings. **Borrowings** from the state banking sector including the central bank amounted to 29% of total assets in 2002-03, and 27% in 2003-04, down from 48% in 1998-99. This includes resources from the mandatory agricultural lending quota of commercial banks. No foreign exchange borrowings appear in the balance sheet. The historical rise of deposits (from 16% to 52.5%) and fall of borrowings (from 50% to 27%) during 1984-2003, expressed as a ratio of total debt and equity, is given in the table and graph below.

Table 8: Ratio of bank borrowings to total debts and equity, 1984-2003 (in %).

Year	*Deposit balance*	*Bank borrowings*
1984	16	50
1985	17	53
1986	16	52
1987	19	50
1988	14	53
1989	12	58
1990	19	67
1991	15.8	70.6
1992	19.4	65.2
1993	17.7	65.7
1994	21.2	63.5
1995	25.0	59.2
1996	36.7	57.6
1997	34.6	58
1998	35.4	46
1999	41.9	45.5
2000	48.4	38.0
2001	50.0	31.6
2002	53.0	28.0
2003	52.5	26.6

Source: BK 2004:24

Graph 1: Ratios of deposits and borrowings, Bank Keshavarzi, 1984-2003



5. Organization and management: *towards a learning organization*

Delivery structure and decentralization: The BK head office is comprised of 22 departments, reorganized in 2002 into seven divisions, each under a Director General: IT & E-banking, Relations & Resource Mobilization, Investment & Credit; Regional Directores, Financial and Logistics Affairs, Human Resources & Productivity, and Supervision & Inspection. There are a Research & Development Center and a Panel of Advisers which report directly to the Chairman & Managing Director.

The bank has the widest delivery network of any bank in Iran. Over the last 13 years, the network has expanded from 480 to over 1820 branches, now (mid-2004) reduced to 1799, comprising 586 in rural and 1213 in urban locations, 95 of them in Greater Tehran (up from 7 in 2000). The branches are divided among 32 provincial directorates. In the past, the urban branches catered for rural people only. Over the past 13 years, their market orientation has gradually shifted, offering deposit services to both the urban and rural population; credit is still largely restricted to agriculture and the rural economy. BK is in the process of establishing a country-wide online system for some 300 branches.

Lending authority is to a considerable extent decentralized and highly differentiated. There are 13 levels of loan approval authority, 5 of them by branch size. Depending on business volume and area coverage, branches are divided into five grades. Branches at the lowest level of the echelon may decide over loans between Rls 10m and 20m; at the remaining four levels, lending authority is up to Rls 25m, 50m, 200m and 300m. Above that, there is an extra category of upgraded branches with authority up to 500m and the central branch in Teheran with authority for working capital or investment loans up Rls 2bn and combined working capital and investment loans of any single client up to Rls 3bn. The lending authority of provincial directorates depends on the potential of the area as assessed by BK. It ranges from a low of Rls 750m for working capital or investment loans or Rls 1bn for a combined loan to a high of Rls 5bn for each type of loan or Rls 7.5bn for a combined loan. Above that level, loans are decided at the head office: up to Rls 10bn by the Credit & Investment Dept; up to IR 20bn by the Credit Committee; and above that by the Board.

Branches as profit centers: Two approaches to performance measurement and remuneration are combined in BK: (a) Branches are systematically rated as centers of performance. The rating has substantially changed from mere disbursement to profit-oriented performance including resource mobilization: the bank's challenge number one. The major performance indicators are: savings mobilization, loan collection rate, loan disbursement, quality of documents, and bank service. (b) The totality of branches are treated as a profit center domain.

Through these two systems of incentive payments, which include bonuses and extra salaries, staff can practically more than double their regular salary. In fact, only 26% of personnel expenses are on basic salaries and wages, while 66% go into varies types of bonuses, allowances, benefits and aids, including 5% as employee performance bonus (2002-03). To those agricultural banks in the NENA region which have not introduced performance rating and incentive payments, BK may serve as an example.

Human resources: The total number of staff is 15,225 (2004), comprising 14,770 officials and 455 contractual employees. 19.4% of staff are at the head office. 13.1% are female (up from 7.4% in 2000).

Staff training, which is instrumental in turning BK into a learning organization**,** is a high priority in BK. BK (2004b), with a total staff around 15,000 reports that 14,174 staff members and 36,536 trainees were trained in 2003-04, which includes multiple participation and distance learning. Between 1998/99 and 2003/04 the number of person-training hours

increased from 483,376 to 784,118 p.a. The number of days of training per capita is given as 6.8, the number of hours p.c. 54. There are 25 course offerings. In quantitative terms, the most attractive courses are in computer and information technology with 13,522 participants, followed by management training (7,460 participants), marketing and resource mobilization (3,511 participants), insurance (1,752 participants), loan collection (1,712 participants), credit (1,098 participants) and accounting (1,098 participants).

Training is being coordinated by the Management Training and Improvement Department at the head office and implemented through five regional training institutes: in Mashad, Bobulsar (the largest of the five), Shiraz, Sherafkhone near Tabriz and Kermanshah. A central training institute will be opened in Tehran by the end of 2004. The number of permanent staff of the training department at the head office is 25. In eight provinces there is one training expert. In the remaining 20 provinces training is handled by non-specialized bank staff on a part-time basis. University professors may be recruited to offer special courses and workshops. Outsourcing of management training is under preparation: to the Organization of Industrial Management, a management training institute inTehran with branches in provinces, and the Iranian Banking Institute of CBI.

At the international level, management has participated in training by APRACA, NENARACA, the Islamic Development Bank (IDB) and numerous corresponding banks, the latter, with cost-sharing, at an average of 6-7 occasions per year. At the time when the bank was newly established, staff were sent to the World Bank for training courses in project preparation and appraisal. There is no permanent link to any bank training institute abroad.

A training needs analysis, an operational plan and an organisational chart of the training department were not available. It might be that with the opening of the central training institute in Tehran BK will enter into a new stage of training institution building. There seems to be a shortage of training materials. International training is not coordinated and not integrated into the bank's overall training system; this does not mean that it is not useful. However, two major related training needs have been identified:

- The translation of international training materials into Farsi
- The adaptation of such training materials to the operational realities in Iran and BK.

A fast-modernizing bank like BK requires a training system which not only keeps pace with its development but, at least at the management training level, is ahead of its time. This would require:

- An overall review of the training system,
- a thorough training needs analysis
- close cooperation between international and national trainers to rationalize the course offerings and incorporate internal training materials.

Wholesale and retail operations: The Bank divides its lending operations into two major areas, although they are not differentiated in the balance sheet: retail loans (direct facilities) and wholesale loans (indirect facilities) through cooperatives. Because of excessive defaulting, cooperative lending has declined from 20% of loans disbursed in 1996-97 to 5.6% in 2003/04. In addition, BK acts as a handling bank for off-balance sheet government loans to small farmers; and to the private sector within the framework of government projects, in which BK also plays a senior supervisory role. Through these off-balance sheet operations, BK almost doubles the volume of its lending operations. In, 2002-03, off-balance sheet operations amounted to Rls 33.4tr, adding 71% to total assets and virtually doubling its loan portfolio.

Self-help groups, on which there is no national-wide information, might serve either as grassroots financial intermediaries, which mobilize their own resources and have access to

BK refinance, or as solidarity groups with joint liability, functioning as credit channels. The latter approach is now being tested on a pilot scale by DRMFS, with support from IFAD. This could provide a solution to the collateral and personal guarantee problem of women and other small borrowers. The experience of NABARD in India in recent years, which has promoted over one million SHGs (90% of the members are women) as autonomous local financial intermediaries and linked them to banks (March 2004), may serve as an example and exposure training site.

Auxiliary organizations: BK has two subsidiaries, incorporated into the Bank's charter: the Crop Insurance Fund and the Relief Fund for Damaged Agricultural Units. The **Crop Insurance Fund,** which insures crops, orchards, livestock and natural resources, was established in 1983 to cover losses in strategic crops such as wheat, rice, cotton, sugar beet and soybean, to which dairy cattle insurance has been added, covering 16% of cultivated land. The fund is not commercially viable. The **Relief Fund for Damaged Agricultural Units** was established in 1979 to support farmers in cases of natural disaster, covering crops, livestock, agricultural machineries etc. damaged through natural calamities. It is pure relief operation depending on annual budgetary allocations from the government. It has not received any support from international organizations. Whatever is covered by the insurance fund is excluded from the relief operations. With a limited annual budget, only a small percentage of all losses from natural calamities is covered. Eg, in 1999-2000 when agriculture was severely affected by drought, total compensation amounted to Rls 419bn (US$52m), covering less than 5% of total damages due to drought. (see chapter 6.4)

Memberships and international relations: BK is a member of three international bodies:

- NENARACA – Near East and North Africa Regional Agricultural Credit Association
- APRACA – Asia Pacific Rural and Agricultural Credit Association
- CICA – Confédération Internationale de Crédit Agricole

BK maintains relations with Crédit Agricole (France), DG Bank (Germany), the Islamic Development Bank (IDB)[13] and the International Fund for Agricultural Development Fund (IFAD). BK has had a credit line from DG Bank and two credit lines from IDB[14]. BK has 16 refinancing agreements with maturities up to one year and 10 long-term financing agreements. BK considers Crédit Agricole as the model case of an agricultural bank that has fully entered commercial banking with a diversified portfolio without ignoring agriculture.

BK has relations with 160 corresponding banks and bank branches and holds accounts in 32 of them. In a descending order, the countries in which BK maintains corresponding bank relations are Germany, UAE, Italy, Switzerland and Austria. Since 2003, BK is authorized to directly sign financing agreements with a maturity of less than one year with its foreign bank partners.

For several years IFAD has been in the process of preparing a loan project in rural finance with BK, which has not yet materialized.[15] Meanwhile, IFAD has provided a grant for a pilot

[13] Iran is a shareholder in IDB. BK has relations with several of IDB's subsidiaries: it is a shareholder of the Islamic Corporation for the Development of Private Sector (ICD), a member of ADFIMI, a training association; and connected with ICBA, a research center, through a MoU.

[14] The first amounting to $10m, the second, amounting to $13.5m, just signed.

[15] Areas tentatively identified for support include:

- ✓ Setting up a Microfinance Services Unit at the head office
- ✓ Enhancing deposit mobilization
- ✓ Promoting savings-linked microcredit services
- ✓ Revising profit rates on loans and deposits, taking inflation into account
- ✓ Training in microfinance, savings mobilization and tied financial and social intermediation
- ✓ Setting up a Microcredit Risk Fund
- ✓ Pomoting self-help groups of women and the rural disadvantaged and their IGA

rural microfinance project through DRMFS-International, with the objective expanding the bank's outreach to women, young adults and other underprivileged people who organize themselves in channeling groups, mostly in remote areas. There are no other donor-supported projects.

6. Financial services: *towards universal banking*

6.1 Overview: financial products and outreach

Products: BK has the image of a provider of agricultural credit, while in actual fact it offers a wide range of financial services to all segments of the rural and, gradually, the urban population. It now offers over 90 financial products (2004), twenty more than in 2000. Among them are 21 types of savings and deposit products and 15 types of credit products. BK is also the first Iranian bank to offer web-based services. Its products and services include:

- Six types of savings accounts which are profit-free (interest-free) but participate in lottery draws every six months)[16]
- Five types of profit-free (interest-free) checking accounts
- Ten types of profit-bearing deposit accounts
- 15 types of credit accounts (*lending facilities*)
- Six types of consultation, appraisal, supervision and guarantee services
- 12 bank draft, checking and clearing services
- Three types of telephone banking services
- Two types of insurance and relief services
- 14 types of foreign exchange services
- 15 types of other services, including linked products

To market its image as a universal bank with a full package of financial services is a challenge to the Bank's Relations & Resource Mobilization Division and its extensive branch network.

Outreach: Total outreach of the Bank is reportedly around 14 million clients; this is the estimated number of clients, who may hold several accounts. There is no breakdown by occupation, sex or other criteria. Small producers and the poor are the Bank's primary **target group:** "Microfinance is our task; the poor are our target group."

Saver outreach has been increasing rapidly in recent years:

From 7.75m accounts as of March 2001, to:
11.33m accounts in March 2003,
13.92m accounts in March 2004, and
16.56m accounts in July 2004.

Special efforts are made to increase saver outreach and deposit mobilization, namely through faster services through branch computerization; product differentiation; and branch expansion. While the bank aims to revamp its customer orientation by "taking the bank to the people", there are as yet no door-step collection services.

Borrower outreach: In 2003-04, BK disbursed loans to 1.51m borrowers, an increase of 11.3% over the previous year (1.36 million borrowers). During the decade since 1995 the

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- ✓ Linking informal rural community groups and women's groups with banks
- ✓ Increasing BK's profitability, its financial self-reliance and capital base.

The delay is due to arrears of Iran as a member of IFAD.

[16] Depositors are entitled to prizes up to an aggregate value of 2% of the total average balance of deposits during the preceding six months.

number of borrowers has almost tripled. There are no data on the total number of active borrowers. As the majority (79%) of borrowers are in the short-term category up to two years and most of these have loans not exceeding one year, we may estimate the total number of borrowers with loans outstanding at around 2.5 million.

Table 9: Borrowers, 1995-96 – 2003-04

Year	*Number of borrowers*	*% in government-directed programs*
1995-96	576,006	20
1996-97	598,231	20
1997-98	774,239	23
1998-99	807,604	19
1999-2000	958,420	42*
2000-01	1,040,000	
2001-02	1,290,000	
2002-03	1,360,000	
2003-04	1,513,729	9.7

*Increase over the previous year due to government support to farmers affected by the drought.

Client satisfaction is a key concern of the bank. In the framework of an orientation towards "putting the bank into the hearts and minds of the people," the bank has studied client satisfaction in 2000. Through a sophisticated study, it was found that of first importance were respect for the client and staff responsiveness, not the profit/interest rate. In 2003 the bank conducted a study in 11 provinces on factors of customer satisfaction; the results are to guide the branches in their services. In its 2003 Performance Report, the bank presents a total of 56 measures taken to improve customer satisfaction.

6.2 Credit

Profit (*interest*) rates of BK: BK's profit or interest rates are fixed within the framework provided by CBI. With regard to agriculture, these are determined by social rather than commercial criteria. BK has generally simplified its scale, ranging from 13.5% to 25% as given in the following table

Table 10: Lending rates of BK, effective p.a., 2004 (in percent)

Subsector	*Profit rate*
Agriculture, livestock and fisheries	13.5%
Agro-industrial activities	15.0%
Agricultural services and consumer lending	23-25%

Volume of credit: BK and its branches, like state banks in many countries, mainly report loan data on *annual disbursements* rather than *loans outstanding*, a concept which needs to be explained time and again.[17] Loans outstanding as reported on the balance sheet include only loans from bank's own resources, which may be either mandatory (ie, directed by government) or freely decided by the bank. Information on the total portfolio, with or without mandatory loans from government resources, is not easily available.

Total portfolio outstanding including mandatory credit from government resources was Rls 52,337bn in 2003-04 (a figure which does not appear in the balance sheet). Loans outstanding to the private sector as reported on the balance sheet during 2003-04 were Rls 44,459bn ($5.24bn), plus Rls 2,219.8 ($0.26bn) loans outstanding to government agencies.

[17] Loans outstanding are the total amount of credit disbursed up to a given point in time which has not yet been repaid, regardless of amounts due or overdue, minus write-offs. It is **not** the amount due or overdue at a given point in time. Net loans outstanding are gross loans outstanding minus provisions (calculated according to criteria determined by the central bank). BK reports net loans outstanding in its balance sheet.

Rls 28,754bn ($3.39bn), were freshly disbursed to 1.51 million borrowers during that year.[18] About the same percentage of loans outstanding was freshly disbursed in the two preceding year. This reflects that fact that most of the loans are seasonal loans which are practically rolled over every year. It is unknown to what extent these loans are repaid every year from own earnings of the borrowers or borrowed from relatives or friends. Disbursements in 2003-04 exceeded those of 2002-04 by 37.1%, a real net growth of 20%, substantially above the inflation rate.

Table 11: Annual disbursements and loans outstanding, 1999-2000 – 2003-04 (amounts in billion Rls)[19]

Year	*Number of loans disbursed*	*Loans disbursed*		*Loans outstanding as reported on the balance sheet*
		Amount	*Growth*	
1999-2000		8,055	19%	14,171
2000-01		10,634	32%	18,716
2001-02	1,290,000	16,488	55%	25,709
2002-03	1.360,000	*22,608*	37%	34,472
2003-04	1,513,729	*28,754*	27%	44,459

Mandatory credit: Of the total (unreported) portfolio of Rls 52.4tr, 31% were mandatory and 69% non-mandatory. The mandatory portion of credit is declining; of the disbursements during 2003-04, 20.5% were mandatory and 79% non-mandatory: this is almost a reversal of percentages compared to ten years ago when mandatory credit accounted for 70% of total disbursements. It is expected that mandatory credit will be phased out within the next five years. From a handling bank of government resources, BK has first changed to an executing bank which selects its own customers and is now turning into an autonmous banks which serves its customers from its own resources.

Table 12: Mandatory and non-mandatory credit: amounts in Rls billion and in percent of total portfolio and loans disbursed during the year, 2003-04

	Total portfolio		*Amount disbursed during the year*	
	Amount	*Percent*	*Amount*	*Percent*
Mandatory	*16,356.8*	31.3	5,882	20.5
Non-mandatory	*35,979.8*	68.7	22.872	79.5
Total	52,336.6	100.0	28,754	100.0

Average loan size: The overall average loan size as disbursed in 2003-04 was Rls 19.0m. Only 10% of borrowers in 2003-04 received mandatory credit; their average loan sizes were substantially larger: Rls 40.0m compared to Rls 16.7m for non-mandatory credit.

Table 13: Mandatory and non-mandatory loans disbursed in 2003-04: number, amount and average loan size

Loan type	*Number of loans*		*Amount in billion Rls*		*Av. size*
	No.	*%*	*Amount*	*%*	
Mandatory	146,981	9.7	5,882	20.5	40.0
Non-mandatory	1,366,748	10.3	22.872	79.5	16.7
Total	1,513,729	100.0	28,754	100.0	19.0

Loan purpose: In 2002-03, 26.9% of loans disbursed were investment loans, 73.1% working capital loans. Most of the loans disbursed in 2002-03 were for agriculture and livestock,

[18] During the first four-month period,March 21 to July 20, 2004, of the current fiscal year, 385,047 loans were disbursed, amounting to Rls 7.56tr.

[19] Annual disbursements during 1991 and 1998 in billion Rls (growth rate in parentheses): 1991 957; 1992 1076 (12%); 1993 1752 (62%); 1994 2364 (34%); 1995 3362 (42%); 1996 3695 (9%); 1997 5288 (43%); 1998 6791 (28%). (BK 2004:25)

totalling 75% of all loans (in terms of volume): 42% for crop farming and orchards, a percentage which was lower during the drought years, and 33% for animal husbandry, higher than in previous years. 2% were lent to fisheries. 11.5% went into agro-industries and agro-services, a substantial decrese from 1995-96; rural handicrafts attracted a mere 1.4% of the bank's credit. The category "other", with 10%, includes beekeeping, sericulture, trading in agricultural inputs and other trading. Forestry & pastures are of negligible volume. There are no statistics on seasonal loans with maturities up to one year.

Table 14: Loans disbursed in 1995-96, 1999-2000 and 2002-03 by purpose (in %)

Loan purpose	*1995-96*	*1999-2000*	*2002-03*	*2003-04*
Crop farming & orchards	42	36	41.7	40.1
Animal husbandry	30	28	33.2	31.0
Fisheries	1	2	1.9	2.6
Forests and pastures	0	0	0.6	0
Agro-industries & agric. services	23	12	11.5	16.8
Carpet weaving & rural handicrafts	2	2	1.4	1.6
Other	2	20	9.7	7.85
Total percent	*100*	*100*	*100*	*100*
Total amount in Rls billion	*2,281*	*5,317*	*22,608*	*28,754*

Lack of value addition: The Bank has started to shift some of its portfolio in the direction of higher-yielding loans to cross-subsidize its agricultural lending. However, it appears that little credit has gone into value-adding activities including processing, packaging and trading[20]. In fact, this field seems to have been historically neglected, with the result that the rural population[21] has little imagination, or entrepreneurial spirit, beyond agriculture and production in purely quantitative terms:

- Value-adding activities in villages and rural towns are a vast field of potential growth in income and employment compared to many other countries.

Islamic financing facilities: All loans are Islamic contracts. There are three major types:

- Profit-sharing loans (mudarabah), with flexible negotiable rates, amounting to 16.8% of the total amount disbursed in 2003-04;
- Loans at a predetermined fixed rate amounting to 80.5% of disbursements (down from (up from 74.7% in 2002-03), including much-preferred installment sales (41.1 %), civil partnerships (musharaka, 23.6%), advance purchase of crops before they are harvested (salaf, 15.2%), Jo'aleh tripartite partnerships between bank, contractor and borrower (0.5%), and hire purchase (0.1%)
- Profit-free loans (qard-al-hassanah) provided at a fee of 4% equivalent to the bank's administrative costs, amounting to 2.7% of disbursements: a substantial drop from 7.3% in the previous year, and practically back to its relative level in 2001-02.

Two products, Jo'aleh tripartite partnerships and hire purchase, have negligible amounts and numbers. It is questionable whether the bank should burden itself with such products.

[20] This is a field of expertise of the Common Fund for Commodities (CFC), a UN agency in Amsterdam. The subject was discussed in the forthcoming *Proceedings of an International Expert Meeting on Finance for Small-Scale Commodity Processing: From Micro to Meso Finance*, held on 9-11 November 2003 in Khartoum. Eligibility of funding by the CFC requires country membership; but the findings and recommendations of the CFC are available to anyone.

[21] At least in the villages recently visited in the context of the RMFSP project of BK with DRMFS-International.

Table 15: Number and amount of loans disbursed in 2001-02 and 2002-03 by type of Islamic contract (in percent)

Type of contract	*Number*		*Amount*	
	2001-02	2002-03	2001-02	2002-03
Mudarabah profit-sharing	12.5	12.4	18.3	18.0
Installment sales	34.6	31.7	36.4	34.2
Civil partnership	18.3	17.45	28.6	26.4
Salaf advance crop purchase	27.6	25.8	13.6	13.5
Jo'aleh tripartite partnership	0.1	1.2	0.05	0.5
Hire purchase	0.0	0.0	0.2	0.1
Qard ol-hasaneh interest-free	6.9	11.45	2.9	7.3
Total percent	*100*	*100*	*100*	*100*
Total number or amount	*1,292,062*	*1,360,682*	*16,488.1bn*	*22,607.6bn*

Type of contract	*Number 2003-04*		*Amount 2003-04*	
	Number	% of number	Av. Size	% of amount
Mudarabah profit-sharing	186,540	12.3	25.9m	16.8
Installment sales	566,581	37.4	20.9m	41.1
Civil partnership	218,419	14.4	31.0m	23.6
Salaf advance crop purchase	395,688	26.2	11.1m	15.2
Jo'aleh tripartite partnership	19,451	1.3	7.7m	0.5
Hire purchase	389	0.0	72.0m	0.1
Qard ol-hasaneh interest-free	126,661	8.4	6.2m	2.7
Total percent		*100*		*100*
Total number or amount	*1,513,729*		*19.0m*	*28,754*

Loan periods: Loan periods are reported by BK in three categories: short-term loans with a maturity up to 2 years, medium- and long-term. In the framework of BK's move to a more commercial approach, the latter were redefined in 2002: medium-term loans were reduced from 2-10 to 2-7 years, long-term loans from 10-15 to 7-10. Due to the risks associated with longer-term loans during the years of drought and inflation around 1999-2000, short-term loans rose to 88% in terms of volume during that year.

Table 2: Disbursements by loan period, 2003-04

Loan term	*Number*	*%*	*Amount*	*%*
Short-term up to 2 years	1,194,791	78.9	20,211.030	70.2
Medium-term (2-7yrs)	278,085	18.4	7,066.970	24.6
Long-term (>7-10 yrs)	40,863	2.7	1,491.261	5.2
Total number	*1,513,739*	*100.0%*		
Total amount in Rls bn			*28,769.261*	*100.0%*

Loan sizes are not reported by the Investment & Credit Division for recent periods.[22]

[22] In 1999-2000, the last period for which data on loan sizes were available, the vast majority of loans were small-size loans: 38% of the new loans were in the lowest category, below IR 3m ($374); 81% of the loans, accounting for 35% of the volume, were in the two lowest categories, up to IR 10m ($1,250). 0.5% of the loans, accounting for 20% of the amount, were IR 100m and above ($12,250, including loans of IR 1bn ($122,500) accounting for 9% of the total volume disbursed.

Foreign currency loans: Adding loans in foreign currencies, total disbursements in 2002-03 amounted to Rls 25.0tr. In 2002-03, the bank appraised 33 projects worth US$ 146.6m to be financed in foreign currency from the Oil Stabilization Fund. Another 34 projects amounting to US$131.1m were approved and 66 projects amounting to US$ 341,7m reached the agreement signing stage. Many of these projects are in food processing.

Special schemes: The bank finances a number of projects from special funds largely provided from government budgetary allocations in the following fields:

(1) Water management, including dam construction, water-shed and water table management, land leveling and drainage, canal covering and procurement of pumps
(2) Mechanization, including agricultural equipment (particularly for minimum tillage) and machinery, 34,253 items in all
(3) Tuba project for 138,000 ha (2002-03) of orchards and groves, particularly nut and olive trees
(4) Hazrat Zeinab El-Kobra Scheme for self-employment of female household heads,with an outreach of 10,336 women in 2002-03
(5) Iran Scheme for interest-free Qard ol-hasaneh loans to women, with an outreach of 27,339 women in 2002-03
(6) Agricultural graduates Employment Scheme to create jobs for agricultural graduates, with an outreach of 2,308 in 2002-03
(7) In addition, the bank has disbursed funds from various government agencies on their behalf.

Table 16: Special schemes, 2002-03 (amounts in billion Rls)

Scheme	*2002-03*
Water management	1,221.1
Mechanization	989.2
Tuba project	752.3
Hazrat Zeiabe Kobra Scheme for women	31.9
Iran Scheme for women	96.4
Agricultural graduates Employment Scheme	351.5

6.3 Deposits

Deposit rates: Profit-sharing rates on deposits are directed by the central bank. In 2004, they varied from 0% to 17%, the same overall range as in 2000. Average cost of deposit funds are relatively low, which is due to the sizeable volume of unremunerated qard ol-hasaneh accounts and current accounts, accounting together for 78% of total deposits.

Table 17: Interest/profit rates on deposits in BK, 2000-01 and 2004 (in percent)

Type of deposit account	*2000-01*	*2004*
Interest-free current account	0	0
Interest-free lottery savings account	0 (+2 for lottery)	0 (24 for lottery)
Short-term deposits	7	7
Special short-term deposits	9	9
Long-term deposits (1-5 years):	15-17	13-17

Deposit-taking is among the highest priorities of BK. Minimum deposits to open an account are Rls 50,000 (US$6). The Bank has 21 deposit products: five types of profit free current accounts, six types of profit-free savings accounts which participate in semi-annual lottery draws; and ten types of profit-bearing deposit accounts. The total number of deposit accounts was 11.3m in 2002-03, an increase of 46% over 2000-01. The number of accounts is growing at an increasing pace. They reached 13.9m in 2003-04, an increase of 23% during one year, and 16.5m in July 2004, an increase of 19% during a four-months period. Clients

may hold several accounts; there is no information on the number of depositors. In recent years annual increases in the deposit balance have been above 40%, reaching $4.04 billion as of March 2004. BK's market share in savings is 6.3% (2003) and continually increasing.

Table 18: Deposit accounts and deposit balances in billion Rials

Date	*Number of accounts*		*Amount in Rls bn*	
	Absolute	*% increase*	*Absolute*	*% increase*
20/3/2001	*n.a.*		*11,896.5*	
20/3/2002	*n.a.*		*16,976.4*	*42.7%*
20/3/2003	11,331,484	46%	24,027.5	41.5%
20/3/2004	13,924,453	23%	34,244.9	42.5%

Qard ol-hasaneh accounts , which include sight deposits and profit-free savings accounts with a lottery component, attracted a total of 10.3m or 91% of all accounts, with a total deposit balance of Rls 11.5tr, or 46% of deposit balances. A very attractive account is an interest-free *qard ol-hasaneh* lottery savings account with semi-annual draws the consolidated value of which is equivalent to an effective annual interest rate of 2%. In 2002-03, this deposit product attracted 9.2 million accounts, this is 81% of all accounts and 21% of total deposits balances. Only 9% of deposits accounts are *term deposits* with a maturity of 1-5 years accounting for 20% of deposit balances, two-thirds with a maturity of 5 years.[23] The largest part of deposits are sight deposits, amounting to 57% of all deposits..

Table 19: Deposit accounts, 2002-03

Type of account	*Number of accounts*		*Amount (in bn RI)***	
	Millions	*Percent*	*Billion RI*	*Percent*
Sight deposits:		9.7	14,030.7	56.5
Qard ol-hasaneh	*1.1*	*9.7*	*6,245.7*	*25.1*
Other	*n.a.*	*n.a.*	*7,785.0*	*31.3*
Qard ol-hasaneh savings deposits	9.2	81.4	5,214.4	21.0
Profit-bearing investment deposits:	1.0	8.9	5,021.0	20.2
Short-term:	*0.7*	*6.2*	*3,105.2*	*12.5*
Long-term	*0.3*	*2.7*	*1,915.7*	*7.7*
Other deposits	n.a.		579.5	2.3
Total	*11.3*	*100*	*24,845.6*	*100.0*

In 2003-04 deposit balances increased by 42.5% and reached a total of $4.04bn. Sight deposits declined from 56.5% to 46% of total deposits; qard ol-hasaneh savings deposits increased from 21% to 23%; term deposits went up from 20% to 29%. Deposits in that year amounted to 119% of disbursements and 73% of total loans outstanding as reported on the balance sheet.

Table 20: Deposit accounts, 2003-04

	Amount (in bn Rls)	Percent
Sight deposits	15,757.2	46.0
Qard ol-hasaneh savings deposits	7,947.6	23.2
Profit-bearing investment deposits	10,021.1	29.3
Other deposits	519.0	1.5
Total deposits	34,244.9	100.0

Asset and liability management: There are two types of deposit as well as loan contracts: interest-free quard al-Hasaneh and profit-sharing. Balancing the two types of contracts is one

[23] Five-year deposits amounted to Rls 1,329.1bn in 2002-03. This included Rls 83bn in the Atieh Investment Deposit Scheme (a 73% increase over the preceding year), where clients make regular deposits over a five-year period and then receive a lifelong monthly annuity.

of the objectives of Islamic asset and liability management. Quard al-Hasaneh deposits amounted to Rls 11.5tr, loans to Rls 1.65tr (2002-03): a vast amount of excess liquidity, which is invested in other loan products. However, the Quard al-Hasaneh deposits are all short-term, more than half of their volume is in sight deposits.

In an inflationary economy, term finance and the challenge of matching long-term liabilities with long-term assets poses particular problems. This is a field where, in an oil-rich country, the government tends to intervene, rather than donors as in poorer countries. This theme requires further analysis.

6.4 Agricultural insurance and relief[24]

The **Crop Insurance Fund** insures crops, orchards, livestock and natural resources. Indemnities paid amounted to to Rls 457.1bn ($58m) in 2002-03, covering 712,000 persons in that year; premiums amounted to Rls 173.3bn. Annual crops and orchards are a highly loss-making segment, livestock insurance is profitable to the bank; the natural resources segment is breaking even. On the whole:

- The fund is not commercially viable; only 38% of indemnities paid in 2002-03 were covered by premiums.

Table 21: Crop Insurance Fund performance, 2002-03 (amounts in billion Rls)

Coverage	*No of insured*	*No of contracts*	*Premium*	*Indemnity paid*
Annual crops & orchards	663,000	533,000	118.2	382.0
Livestock, fish farms	46,709	164,341	52.6	72.6
Natural resources	2,192	887	2.5	2.5
Total	*711,901*	*698,228*	*173.3*	*457.1*

The **Relief Fund for Damaged Agricultural Units** supports farmers in cases of natural disaster, but only for uninsured risks. The bank reports that in 2002-03 farmers lost Rls 20.19tr due to natural calamities, 88% of that drought-related. The bank paid Rls 392.5bn in indemnities to 474,000 farmers, covering less than 2% of total damages. In 2003-04, farmers lost Rls 16.4tr due to natural calamities, mainly drought, frost, floods and earthquakes; the bank paid Rls 388.3bn to 381,481 farmers, covering 2.4% of total damages.

Table 22: Relief operations, 1999-2000 – 2003-04

Year	*Amount in bn RI*	*No. of beneficiaries*
2003-04	388.3	381,481
2002-03	392.5	474,691
2001-02	540.0	691,453
2000-01	395.6	694.491
1999-2000	419.0	802,241

6.5 Other financial services

Electronic banking: Over 99% of BK's branches offer electronic banking services (2002-03). Services include:

- Telephone banking: information on accounts via phone or fax in 430 branches
- ISTA-Bank: information on accounts on computers installed in the branches
- Mehr Card: withdrawing or depositing money at any of 300 branches with ATM or PIN PAD

[24] See also chapter 5, auxiliary organizations.

International and foreign banking services: BK offers credit in foreign currencies from its own resources or the Oil Stabilization Fund, provides foreign exchange services, issues letters of credit (L/C), handles customer drafts and handles financing and refinancing agreements. In 2002-03, total income from such services amounted to Ris 203bn.

7. Financial performance: *towards profitability*

7.1 Portfolio quality

Total assets of BK at the end of FY 2003-04 on 20 March 2004 amounted to Rls 60.10tr (US$ 7.085bn). Annual nominal growth rates since 2000-01 were 39.3%, 38.0%, 38.9% and 27.5%; real growth rates, using CBI official inflation rates, were 26.7%, 26.6%, 23.1% and 11.9%. **Net loans outstanding** to the private sector in 2003-04 amounted to Rls 44.46tr or 74.0% of total assets; net loans outstanding to government to Rls 2.22tr or 3.7%. 10.4% of total assets were deposited in the central bank (4.2%) and in other banks (6.2%). Off-balance sheet operations amounted to Rls 50.66tr. *(Appendix 1)*

The collection rate over the past ten years, oscillated around 80%; the arrears ratio, conversely, around 20%. In 2002-03 it was down to 74.6%, in 2003-04 it recovered to 82.5%. The collection rate is negatively influenced by mandatory credit. Collection rates of credit from BK's own resources were 79.8% in 2002-03 and 86.8% in 2003-04; the collection rates of mandatory credit were 64.4% and 71.1%, respectively. Compared to the benchmark standard set by BRI/Indonesia of collection rates consistently above 95% since reform in 1984, this is not satisfactory.

Table 23: Collection rates* in percent, 1991-2004

Year	*Collection rate*
1991-92	77.9
1992-93	76.1
1993-94	80.5
1994-95	82.6
1995-96	84.9
1996-97	80.0
1997-98	77.7
1998-99	78.1
1999-2000	79.8
2000-01	78.8
2001-02	77.1
2002-03	74.6
2003-04	82.5

* Collection rate = payments collected/payments due

Aging of arrears is reported in four categories: from <1 year to >5 years. There are no data on the percentage of loans overdue 1, 3 and 6 months as is good international practice. During 1999-2000 and 2000-01, 10% of the outstanding portfolio was in arrears (half of that for more than one year); in the following two years they went up to 15% (more than half of that for more than one year) and fell back to 11% in 2003-04. In 2003-04, BK has succeeded for first time to reduce the absolute amount of overdues. Over the past five years the percentage of loans overdue one year and more in terms of total overdues has steadily increased. The percentage of loans in arrears one year and more has increased from 4.9% in 1999-2000 to 8.8% in 2002-03 and hast declined to 7.0% during the last fiscal year. BK is apparently carrying along a certain amount of overdues which by international practice should have been written off, while at the same time managing better its new portfolio.

Table 24: Aging of arrears in percent, 1999-2000 –2003-04

Time overdue	*1999-2000*	*2000-01*	*2001-02*	*2002-03*	*2003-04*
Below 1 year	64	54	49	46	37
1-3 years	2	12	23	28	31
3-5 years	15	13	11	10	14
Over 5 years	19	21	17	16	18
Total percent	*100*	*100*	*100*	*100*	*100*
Amount in bn IR	*1,422*	*1,845*	*3,943*	*5,329*	*4,882*
Total portfolio in bn *Overdues in %*	14,171 10.0%	*18,716.4* *9.9%*	*25,708.5* *15.3%*	34,472.3 15.5%	44,458.8 11.0
Overdue >1 year *% of total overdue* *% of portfolio*	*697* *49%* *4.9%*	*997* *54%* *5.3%*	*2,248* *57%* *8.7%*	*3,037* *57%* *8.8%*	*3,105* *64%* *7.0%*

Provisioning amounting to 2% is considered adequate by BK, with annual loan losses reportedly 2.7% in 2002/03 and 2.0% in 2003-04 (orally reported). However, this does not take rescheduling into account; nor does it take into account the percentages of loans overdue >1 year amounting to 8.7%, 8.8% and 7.0%, respectively, during the past three years, which would be considered as bad debts by international standards,

7.2 Risk management

Loan security: All loans, even the smallest, have to be guaranteed or collateralized. While government organizations may offer bulk reinsurance for their programs, BK is still obliged to demand security. 96% of loans, and 83% of the loan volume, are guaranteed by a third party: most relatives, friends or neighbors (2003-04). Just 2.4% % of borrowers offer fixed collateral or bonds: mainly for larger loans, accounting for 15% of the loans disbursed in 2003-04.

Table 25: Type of security, 2003-04 and 2002-03 (in percent)

Security	*2003-04*		*2002-03*	
	% of number	*% of amount*	*% of number*	*% of amount*
Third party guarantee	96.3	82.9	95.3	83.2
Physical collateral	1.6	14.3	1.9	12.5
Bonds or shares	0.8	1.9	1.1	2.7
Other	1.3	0.9	1.7	1.6
Total percent	*100.0*	*100.0*	*100.0*	*100.0*
Total number	*1,513,729*		*1,360,682*	
Portfolio in billion Rls		*28,754.0*		*22,607.4*

Many potential small borrowers reportedly face problems in providing the required personal guarantees, particularly among women. Informal self-help groups might provide a solution: either as solidarity groups channeling bank, loans as in the case of the pilot RMFS Project, or as grassroots financial intermediaries.

Authority of non-collateralized lending: Despite the fact that collateralized loans concern only a small part of the portfolio and a very small number of borrowers, the authority to decide over non-collateralized loans is highly differentiated, varying by the level of an organizational unit in the corporate hierarchy, type of loan (investment vs. working capital), and the collection rate of some of these unit:

- At branch level, physical collateral is not required for loans up to Rls 100m**,** which constitute the vast majority of loan contracts.
- Provincial directorates may sanction uncollateralized loans up to Ris 200m. For investment credit, their authority is extended to Rls 500m if their collection rate is

>95%. For working capital credit, it is extended to Rls 1bn if their collection rate is >90%, Rls 600,000 if it is 80-90% and Rls 400m if it is <80%.

- At the head office, the Investment & Credit Division may authorize collateral-free working capital or investment loans up to Rls 2bn, the Credit Committee up to Rls 3bn and the Board without any limit.

Effectiveness of loan security: While the overall emphasis on loan security is an essential part of risk management, the effectiveness of the system appears to be diminished by the following factors:

- The system appears unnecessarily complicated.
- Discretion for uncollateralized lending is exceedingly high, ranging from Rls 200m at branch level to unlimited loan sizes at the board level.
- This opens the system to moral hazard and political pressure.
- Substituting personal guarantees for collateral of a very large part of the portfolio creates undue risks.
- The shift to third party guarantees relieves the loan officer of the necessity of a thorough collateral and creditworthiness examination and may create moral hazard.

As BK plans to bring the bank closer to the people, loan officers may focus in the future more on an assessment of existing formal and non-formal collateral and of a household's repayment capacity. This may be a much more effective risk management strategy than simply passing the risk to a farmer's neighbor, who may not be willing to take that risk. At the same time, it would strengthen the bank's role as a responsible partner of rural and agricultural entrepreneurs. Only small start-up loans to low-income people, the landless and other unprivileged but enterprising people should be exempt from collateral requirements. On the whole, determining loan security requirements should be left more to the discretion of loan officers trained in the art of creditworthiness examination and repayment capacity assessment.

7.3 Repayment management

Loan collection is in the hands of 1500 collection units, one per branch. At the head office, the Supervision & Branches Affairs Department with a staff of 22 is in charge of the management and supervision of loan collection.

Loan rescheduling and penalties in case of arrears*:* Loans in arrears are moved to the overdue account and are automatically rescheduled for three months, with a penalty of 6% on the amount overdue. After an additional three months, the loans are classified as *distressed* as required by the central bank; and legal action is taken. No statistics were available.

Loan rescheduling and interest exemptions due to natural calamities: Rescheduling, normally for a period of one year, is decided by parliament in response to natural calamities not covered by the Relief Fund. During six out of seven years since 1996-97, loans were rescheduled, affecting sizeable proportions of the portfolio. Rescheduling as ordered by parliament is combined with interest exemptions at government's expense, except in 2002-03 when exemptions were paid out of the bank's internal resources. During these years, between 150,000 (in 1996-97) and 589,000 (in 2000-01) clients, approximately 40% of all clients with loans outstanding, benefited from loan rescheduling and interest exemptions. In 2002-03 Rls 1.67tr were rescheduled; interest exemptions amounted to Rls 4.20tr; about 260,000 clients benefited: around 16% of all clients with loans outstanding.

Table 26: Rescheduling of loans, 1996-97 – 2002-03

Year	*Amount in bn RI*	*No. of clients*	*Interest exemptions in bn RI*
2002-03	1,670	259,664	4,199

2001-02	2,103	516,651	3,314
2000-01	2,750	589,000	3,006
1999-2000	2,355	412,000	458
1998-99	1,900	370,000	121
1997-98	0	0	0
1996-97	900	150,000	60

Arrears analysis – inability or unwillingness to repay on time? In terms of repayment performance, there is little difference, if any, between agricultural loans and commercial loans (about 20% of the portfolio); the specific risks of agriculture are apparently of no particular impact. Given an arrears ratio of 20% and annual loan losses of 2%, it is evident that the vast majority of defaulters eventually do repay. There is evidence that paying late is largely due to calculated unwillingness, rather than inability, to repay. BK as a government bank is considered as a lenient lender. Late repayment is a calculated act: At an interest rate of 16% and a penalty of 6%, total costs of funds to the defaulter are 22%, while the value of the funds on the money market is 40%-50%, depending on the risk of the investment.

Incentives for timely repayment have proven to be very effective in many countries. For example, the Microbanking Division of BRI/Indonesia, perhaps the most profitable microfinance operation with a wide outreach charges 44% p.a. on rural loans, but refunds 11% in case of timely repayment. As a result, more than 95% of its 2.6m borrowers at village level repay on time. At positive real returns, all its loanable funds are generated through 27 million deposit accounts, producing in addition a sizeable quantity of excess liquidity.

7.4 Cost coverage and profitability

Sources of income and cost coverage: In 2001 BK changed the format of its income and expenditure statement. During FY 2000-01, *total income* amounted to Rls 2,342bn: 94.4% derived from Islamic contracts, 0.2% from banks and 5.4% other income. *Expenditure* amounted to Rls 1,949bn: 61.9% financing costs (10.4% to depositors, 51.5% to banks and CBI), 22.0% personnel costs, 5.0% general administrative costs, 11.2% provisions for bad debts and depreciation. Compared to 1998-99, income from Islamic contracts had increased from 91.5% to 94.4% of total income; while payments to depositors had increased from 7.5% to 10.4% of total expenditure, paralleled by a decline of payments for bank and CBI borrowings from 59.5% to 51.5%. (Appendix 1)

During FY 2003-04, the bank reports *joint income* from mandatory credit of Rls 5,124.5bn and payments to depositors of Rls 762.7bn, resulting in Rls 4,261.8bn as the bank's share of profit. *From its own resources*, the bank reported a total income of Rls 620.7bn, resulting in a total income of Rls 4,982.6. Total costs (without payments to depositors under the joint income calculation) amounted to Rls 3,834.9bn: 42.4% financing costs of borrowings, 31.2% personnel costs. 14.5% general administrative costs, 7.4% provisions and 4.5% other costs.

Adding up both sources of income, joint and from own resources, total income was Rls 5,745.2bn; 91.3% is derived from profits and deferred penalties, 5.1% from commissions and 3.6% from other income. Total expenditure was Rls. 5,359.6bn: 14.2% to depositors, 30.3% borrowing costs, 22.3% personnel expenses, 10.4% general administrative costs, 5.3% provisions and 3.2% other costs. Compared to 2000-01, payments to depositors had increased from 10.4% of total expenditure to 14.2%, while costs of borrowings had declined from 51.5% to 30.3%: a substantial gain for the bank at the expense of depositors, as the bank has increased its amount of interest- or profit-free deposits and decreased its borrowings.

Profitability: Until 2000-01, BK has been a loss-making bank. In 2001-02, BK succeeded for the first time in its history to wipe out its accumulated losses, making a profit or loss of zero.

In 2002-03, its net profit after tax amounted to Rls 443.4bn; and in 2003-04 to Rls 890.6bn. For the first time its history, BK was now in a position to calculate its return on average assets (ROAA) and its return on total average equity (ROAE). Its ROAA (after tax) in the last two years was 1.1% and 1.7%, respectively; its ROAE a remarkable 15.1% in 2002-03 and a stunning 22.3% in 2003-04.[25] No wonder the bank was recently voted the best bank of Iran by The Banker and no. 9 in the MENA region.

Table 27: Return on average assets and average equity, 2002-03 and 2003-04 (in %)

	2002-03	*2003-04*
ROAA	1.1	1.7
ROAE	15.1	22.3

The bank's return on net income during 2003-04 was 77.5%; its net profit earned from own resources 53%; its net profit earned from own resources as a ratio of average assets 5.4% and its efficiency ratio 10.7%.

Profitability of financial products: BK has an extraordinarily large number of financial products. An analysis of the transaction costs and profitability of each product would enable the bank to rationalize this wide array of products, cut costs and increase its profitability: a challenge for the newly created R&D Center.

[25] ROAA calculated on paid-in capital only during the two years was 16.!% and 32.3%, respectively.

Part III
The reform process: strenghts and weaknesses

1. The Macroeconomy

1.1 Strengths and success factors

The Islamic Republic of Iran is a middle-income country with an enormous potential for growth and development. Highlights of its strengths include:

- Abundant revenues from oil exports to self-finance development
- Value emphasis on self-reliance of banks in terms of resource mobilization
- Balanced emphasis on smallholder and commercial agriculture
- Incipient liberalization to create a conducive environment for private business and private banking
- Establishment of private banks and non-banks since 2000
- Incipient (but still inadequate) success with inflation control

1.2 Weaknesses, limitations and risks

Government intervention in all spheres of the economy, but particularly in banking, is perhaps the most crucial limiting factor. Inflation and financial repression, combined with massive programs of subsidized directed credit, have distorted rural financial markets and severely restricted the growth of a diversified rural economy. Limiting factors include:

- Delay of progress due to war during the 1980s and the American embargo
- Centralization and state control, risk of government interference
- Government control over banking and interest rates
- Widespread programs of directed subsidized credit
- Continual (though declining) high inflation
- Negative real returns on deposits: distorting financial markets, eroding the value of deposits, shifting wealth from depositors to investors and the state
- Lack of legal framework for local financial institutions
- Inadequate attention to microfinance institutions, existing self-help groups and bank linkages

2. Bank Keshavarzi

2.1 Strengths and success factors

A crucial and decisive strength of the bank lies in its reform experience. Over the past twelve years, it has taken reform and restructuring into its own hands. Emerged from the re-organization of predecessor institutions in 1979, it stagnated during the war years, 1980-88, and continued to operate as a fund. A new era of restructuring and reform started in 1992 when BK was transformed into a deposit bank, with the objective of mobilizing its own resources and carrying out profitable banking operations. This transformation has gradually gained momentum, with self-reliance through resource mobilization and profitable operations and expansion of outreach as top priorities. Since then, the branch network has expanded to 1800, including urban branches for deposit mobilization; the proportion of government-funded directed credit has declined from ~80% to ~30% of the total portfolio (20% of disbursements from bank's own resources in 2003-04); deposits have grown to 72% of loanable funds; the number and profitability of commercial banking services has increased; procedures have been rationalized; staff has been systematically trained; the branch network has been computerized.

The bank is now becoming a full-service bank with deepening and widening outreach, making progressive use of new opportunities for modernization of its operations and services through IT. The autonomy of the bank has been strengthened by the conversion of the bank's role in directed credit from that of a *handling bank* to an *executing bank*, which selects its own borrowers. Since 2000, the bank has entered into a process of strategic restructuring and implemented 26 strategic reform plans geared to good governance, efficiency and profitability. Privatization plans have been before parliament for several years; first steps towards privatization have been taken by privatizing 19 of the bank's subsidiaries and services. Aided by recapitalization through the government, the bank has wiped out its accumulated losses in 2001-02 and is now profit-making: a remarkable achievement given the restrictive policy environment and the extent of government intervention in banking matters.

The bank is now in the process of making preparations for a third phase, starting in 2005 parallel to the next development plan of the country. Inspired by the experience of Crédit Agricole in France and with the assistance of an international consulting firm, the bank plans to turn into a full-fledged universal bank with operations in both rural and urban areas, privatized and traded at the stock market. As directed credit is being gradually phased out, the bank is becoming increasingly autonomous, though for the time being still in the framework of a repressive policy environment.

One of the most daring plans is the reform of its corporate culture. Based on a comprehensive participatory process involving to-date some 6,000 staff members, its hierarchical structure is being converted into a flat organization, with direct connections of the branches to the head office. At the same time, BK plans to revamp its banking culture, *taking the bank to the customer* instead of expecting the customer to come to the bank. This will require new instruments and strategies, including both retail and wholesale services. In this context, the bank will contribute to the diversification of the economy and of income-generating activities, diversifying at the same its portfolio to finance farm, off-farm and non-farm activities. Highlights of strenghts and success factors include:

- Strong orientation to rural finance, financial intermediation, and universal banking
- Positive experience with restructuring and reform over the past 12 years
- Ability and willingness of the government to recapitalize the bank
- Strong and unbiased emphasis on both savings and credit, vigorous deposit mobilization (though hampered by inadequate returns to depositors)
- Wide range of of financial products and services, including electronic and foreign exchange services
- Wide delivery network and strong customer orientation
- Large scale of operation and vast saver and borrower outreach
- Differentiated decentralized lending authority
- Conversion of branches into profit centers
- Emphasis on staff performance measurement and performance incentives
- Attention to arrears management and provisioning
- Openness to innovation
- Actively preparing for transformation into a profitable, self-reliant universal bank with outreach to all segments to the population including the poor in rural areas.

2.2 Weaknesses, limitations and risks

The main limiting factors result from a policy environment of macroeconomic instability and government control over banking and massive interference in rural financial markets. Historically, this has created a corporate culture of state banking, resulting in a lack of grassroots banking experience and demand-following financial products. Weaknesses and limiting factors include the following:

- Government ownership, lack of private sector involvement
- Lack of profit-margin or interest rate autonomy
- Dual banking standards due to the handling of sizeable government programs
- Inadequate outreach to women and young adults
- Low level of portfolio diversification, lack of financial products for non-agricultural activities and value-addition in rural areas
- Lack of doorstep services; inadequate resources *to take the bank to the people*
- Lack of incentives for timely repayment, resulting in inadequate loan collection rates
- Inadequate lending rates and spread
- Inadequate volume of deposits (despite major progress) due to negative real returns
- Low profitability (particuarly due to interest rate controls)
- Inadequate capital base
- Lack of cooperation with community-based financial institutions and self-help groups

Part IV
Conclusions and Recommended Priority Projects

1. Overall assessment

In the light of all the restraining factors of financial repression discussed in Part I, it is all the more remarkable how far BK has gone in the process of reform and restructuring. BK has done so upon its own initiative and without donor assistance. Among its biggest assets are the experience, the strongly positive attitudes and the initiatives already taken by its board and management to reform and restructuring, with the objective of turning BK into a self-reliant, profitable universal bank with a wide outreach to rural as well as urban areas and an emphasis on agricultural development and rural diversification. To attain this objective, BK still has a long way to go; but there is no doubt that it is on the right track. BK may serve as a model to other agricultural banks in the region, indicating the way forward in a policy environment which is not conducive to financial self-reliance and sustainability.

Within the framework of BK's ongoing plans and concerns, our recommendations pertain to three areas:

- policy dialogue towards a more conducive, less interventionist policy environment;
- a drastic increase in outreach through solidarity group lending to include the unbanked, particularly the increasing numbers of educated young adults in villages including those in remote and marginal areas, and in rural towns;
- the operational transformation of banking services from a bank-centered and supply-leading approach to a customer-centered and demand-leading approach, *taking the bank to the people*, particularly in high-potential areas.

2. Priority project 1: Policy dialogue towards sustainable Islamic banking

Bank Keshavarzy is a dynamic and innovative bank in government ownership. Within the framework of its rural-agricultural mandate, it offers an exceptionally broad array of financial products and services to all segments of the population: mainly to small-holders, but also to women, the poorer sections of the population and commercial farmers. Its potential is enormous, but far from being fully realized. It has a strong orientation to deposit mobilization and self-reliance, portfolio diversification, and profit-making. With 1,800 branches and an estimated 14 million clients[26], with almost 17 million savings accounts and some 2.5 million loan accounts, its saver and borrower outreach is vast. In a macroeconomic situation of incipient liberalization, it is ready for the transition to sustainable universal banking, predominantly in agriculture and rural areas but also in urban areas.

However, the Bank's further growth in outreach and profitability is hampered mainly by a combination of macroeconomic factors and government control over banking, not by internal factors. This poses a particular challenge to supportive interventions in the process of restructuring and reform at the policy level. The core problem results from a contradiction between a high inflation rate and controlled profit rates (the Islamic equivalent to interest rates) on deposits and loans, resulting in negative real returns on deposits as well as the Bank's capital. This poses a moral problem to the guardians of social justice and Islamic banking.

When inflation rates during the mid-1990s reached 50%, depositors and consumers lost half the value of their funds in a single year. Similarly, BK's capital was devalued by 50%; this brought the bank down to the level of technical bankruptcy. Since then the government has made strong efforts to bring the inflation rate down to 12% in 2001 and 2002; but in 2003, the

[26] Once client may hold several accounts.

inflation rate increased to 17.5% and is unlikely to fall below 15% in 2004. Inflation imposes a so-called inflation tax, to the benefit of the state. The biggest losers are the depositors. 78% of total deposits – the bulk are qard ol-hasaneh sight and savings deposits – are unremunerated. At an inflation rate of 15%, these depositors loose 15% of the value of their deposits every year, and more if the inflation rate is higher. 12.5% of deposits are short-term at profit-sharing rates of 7-9%; at the same inflation rate, these depositors loose 6-9% of the value of their deposits. Only long-term depositors break even. To a corresponding extent, the state unintentionally cashes in on what is called *the usurious inflation tax*.

Agricultural borrowers are charged profit rates of 13.5% by BK; at an inflation rate of 15%, this corresponds to a negative profit (or interest) rate of –1.5%; at an inflation rate of 17.5% the negative profit rate is –4%. Borrowers thus gain unduly at the expense of the depositors and the bank. Policy makers participating in policy dialogue will ask: But aren't low profit-sharing rates beneficial to farmers, microentrepreneurs and the poor? Unfortunately, experience has shown that they are not, for two main reasons: The first is that such a profit-sharing regime curtails the overall amount of loanable funds. To make matters worse, the scarce resources tend to flow disproportionately into the pockets or farms of big farmers. The second reason is that cheap money tends to flow into investments with low returns or into consumer credit, resulting in repayment problems and underdevelopment. One of the main functions of financial intermediation is the allocation of scarce financial resources to investments with the highest rates of return, barring at the same time their flow into activities with no or low returns. Only high profit-sharing rates guarantee that investments flow into high-yielding activities. But what about subsistence agriculture? These should not be financed through credit. Farmers should be induced to invest in activities with a strong value-added component, such as agricultural processing, trading and other microenterprise activities, maximize their profit, and invest part of their profit in agriculture. High profit-sharing rates thus lead to a higher self-financing rate in agriculture, while credit flows into more profitable activities, leading to higher income of the farm household and to overall development.

Summing up, the results of a situation of high inflation and controlled profit or interest rates are contrary to the principles of Islamic banking; they may be interpreted as unintended usury. Gains and losses are unduly and inequitably distributed between depositors, borrower-investors and the state. The gains of the state from the inflation tax and of diligent borrower-investors from loans prized below the real costs of funds are at the expense of vast numbers of depositors and consumers, and of bank capital. This has hampered deposit mobilization and the overall volume of financial intermediation between depositors and borrowers; it has eroded the value of the capital of depositors and the bank; it has restrained the growth of the Bank's services; and it has restricted the Bank's microfinance services to women and the poor the cost of which cannot be covered from the income of financial operations. In the ultimate analysis, this has distorted rural financial markets and undermined development. Low income-groups have been particularly affected: either by the negative real returns on their savings; or by the lack of access to credit due to insufficient sources of funds.

The first suggested strategy is of course geared to macroeconomic stability: bringing down the inflation rate. The second strategy is fundamental to financial systems development and institutional sustainability: deregulating the profit rate on deposits and credit and making banks autonomous in the determination of profit rates. In the short run, banks will benefit from the existing wide margin between abnormally low costs of funds and the given profit rates on credit, without an immediate profit rate revolution. In the longer however, competitive bidding for funds is likely to result in adjustments in the profit rate structure, with profit rates on deposits above the inflation rate and equating these profit rates of deposits with cost of funds in the determination of lending rates.

This implies that a new mechanism has to be found for compensating Qarz al-Hasanah depositors for the erosion of their funds. Qarz al-Hassanah depositors are opposed to

interest-rate taking on religious grounds. They have to learn that, as Islamic banking is founded on principles of brotherhood and fairness, depositors must be compensated for the loss of the value of their deposits at the rate of inflation. Accepting a usurious inflation tax without compensation would be against the very principles of Islamic banking.

It is expected that within such a conducive deregulated environment, BK will vigorously pursue the realization of its full potential: as bank which mobilizes its own resources, remunerates its depositors fairly and adequately provides credit and other financial services to all segments of the population, has its loans repaid on time, and finances its expansion from its profits, preserving at the same time the value of its capital.

To initiate this process, NENARACA may assist through: (a) support to participatory high-level policy seminars on market-based profit rates on deposits and loans with just and equitable real returns to all parties involved in the transaction according to Islamic banking principles; (b) exposure visits abroad for policymakers, including exposure to market-based Islamic microfinance in Indonesia[27]; (c) linkages with donor technical assistance for policy dialogue and the implementation of reform.

3. Priority project 2: Banking with solidarity groups, focusing on educated young adults

The rural population in Iran is 23 million people in approximately five million households, comprising some 12-15 million adults. BK's borrower outreach is around 2.5 million, leaving some 10 million or more adults without access to credit. Not all of these need credit; and there are areas were people object against credit on religious grounds. But we have visited villages in which no one has received a fresh loan within the last five years; while many expressed the need for credit. In a situation of credit rationing, and in the absence of a functioning credit market, it is difficult, if not impossible, to estimate the actual effective demand for credit. This is all the more difficult as the demand for credit is a dynamic entity, contingent upon the emergence of investment opportunities, the overall development climate, and the perceived availability of credit unrestricted by administrative impositions. It appears safe to estimate the additional effective demand for credit within the coming ten years at an additional 2.5 million borrowers as a minimum; this would bring BK's total borrower outreach up to 5 million.

Among the unbanked is a target group of increasing size and economic potential: educated young adults. Young women typically remain in the village, used to work on the farm, with livestock and in the house. Of the young men a certain number migrates to the cities; but there opportunities are rare and conditions harsh. Many therefore remain in, or return to, the village. Together, young adult women and men could easily constitute the bulk of the potential target group of an additional 2.5 million borrowers. Initially, the demand would be primarily for investments in conventional activities such as livestock, farming and gardening. Over a ten-year period, an increasing diversification of the rural economy and, correspondingly, of the bank's portfolio may be expected, particularly in rural towns and larger villages. The government is aware of the need to promote employment for the large numbers of young people who enter the labor market each year and appears willing to provide additional resources. The utilization of such resources, eg, for business development services to promote off-farm and non-farm activities, needs to be further explored.

Banks are required to request security, as is the general practice in BK. Young women and men lack collateral. However, the bank accepts personal guarantees; in fact, 96% of all loans (83% of the amount) were disbursed in 2003-04 against third-party guarantees. The bank accepts chain guarantees provided by groups of borrowers, ie, solidarity groups functioning as credit guarantee groups.

[27] Cf. H. D. Seibel & Wahyu Dwi Agung, Islamic Microfinance in Indonesia. GTZ, Eschborn 2004

With limited human resources and under pressure to keep costs down, BK could not simply double its outreach without a new technology. To keep transaction costs down and yet increase outreach to the unbanked drastically, we recommend to implement a new product nationwide:

- loan channeling on a national scale through solidarity groups, using chain guarantees as a collateral substitute.

With a potential outreach of 2.5 million and an average solidarity group size of 14, the total number of groups to be established is 180,000, or 18,000 per year over a ten-year period.

Since 2002 BK has been pilot-testing this approach through its Rural Micro Finance Support Project (RMFSP) in cooperation with International Enterprise for Development of Rural Micro Finance Services (DRMFS-International), an NGO, funded by IFAD from Italian supplementary fund resources (*Annex 3-A*). During the first phase, 2003-04, BK has approved credit amounting to Rls 4.96 billion ($620,000) to 50 groups; actually disbursed were Rls 4.44 billion ($555,312) to 48 groups, averaging Rls 103.33 per group with an average of 13.9 members, or Rls 7.42 million ($939) per member. BK also provides crop and livestock insurance. As the first annual installment has not yet been due, the amount disbursed is equivalent to the amount of loans outstanding. Repayment performance can only be assessed at the end of 2004, after the due date of the first installment. The pilot project has been implemented in four provinces: Ardabil, East Azerbaijan, Kordestan and West Azerbaijan, mainly in remote areas.

The objective of the second phase, 2004-2006, is “to expand the microfinance services in poor and deprived regions of Iran by leveraging the resources and institutional capacity of BK in partnership with civil society organizations.” An additional 300 solidarity groups will be established in the same four provinces, but with a stronger emphasis on high potential areas with a more diversified economy, ie, larger villages and rural towns. 25 of these groups are expected to evolve into self-help groups (SHGs) as financial intermediaries, with about 20 members each. These will continue to channel funds from BK to their members, but at the same time build up their own financial resources. In addition, some two or three community banks (*Deh banks*) are expected to be established, comprising one or several villages each.

This consultant (*Seibel*) considers the expansion of credit channeling through solidarity groups on a national scale and the doubling of BK’s outreach a gigantic task, as spelled out in his recommendations (*Annex 3-B*). Promoting SHGs as financial intermediaries and microfinance NGOs in a country like Iran with almost no SHG and NGO traditions are two equally important, daunting tasks. While DRMFS-International has initiated solidarity group lending from BK resources and will continue facilitating the establishment of 300 groups during 2004-06, it realizes that the expansion of solidarity group lending on a national scale is the business of BK itself, exceeding the capacity of DRMFS-International by a wide margin. It will therefore put its main emphasis on institution-building of a selected number of local financial intermediaries, mainly of the SHG type, and on capacity-building of NGOs as facilitators.

This leaves the task of expanding solidarity group lending on a national scale to BK.[28] BK does not have the capacity, nor the mandate, to establish and monitor large numbers of SHGs as local financial intermediaries, with their own internal loan fund and accounting system. It also cannot rely to any significant degree on NGOs for that task. We therefore

[28] It is conceivable that such a project would be supported by IFAD, which has been examining the feasibility of a loan to BK since 1999. As there is no immediate evidence that negotiations may come to a positive conclusion within the near future, BK may be well advised to rely on its own resources, as done in the past, and proceed with its own planning.

recommend to BK to focus on loan channeling through solidarity groups as a new outreach strategy. To the extent that SHGs exist or come into existence, BK may act as a wholesaler and refinance them, or treat them like solidarity groups and channel loans through them; but this will remain a small number for the time to come.

Loan channeling by BK to solidarity groups is an innovation in Iran; but it is fully within the mandate of BK. At the same, accepting mutual guarantees is fully within the operational experience of BK, which has been granting most of its loans on the basis of third party guarantees. On the whole, it must be considered a major accomplishment that BK has piloted loan channeling through solidarity groups in a policy environment which is not conducive to innovations.

Expanding solidarity group lending to all branches of BK is a gigantic program which can only be achieved over a longer time period, during which some *learning from experience* will be required. BK must ensure adequate monitoring and loan enforcement. Recent experience elsewhere has shown that this requires a full commitment from the executing institution. BK will benefit greatly from exposure visits to the two countries which have gone farthest in group lending: Indonesia and India, in the framework of programs publicized in Indonesia under the title “Linking banks and self-help groups” and in India as “SHG banking”.

In Indonesia, where large numbers of SHGs of various origins exist as financial intermediaries, the program was initiated by the central bank, Bank Indonesia, 1988-2001, in cooperation with GTZ, linking existing SHGs to banks through NGOs as facilitators; Bank Rakyat Indonesia, a government-owned agricultural banks, was one of the major participants. With the onset of implementation on a national scale, the focus shifted to rural banks and loan channeling through solidarity groups organized predominantly by the rural banks themselves. The Asian financial crisis of 1997/98 distracted the central bank’s attention and slowed down further expansion. In a country with 220 million inhabitants, there are now about 800 rural banks involved in linkages with about 16,000 solidarity groups. It is only now, 2003-04, that Bank Indonesia is refocusing on the further expansion of the program. In contrast, progress in India has been straight forward. Inspired by the experience in Indonesia and through exposure visits organized by AFRACA, the National Bank for Agriculture and Rural Development (NABARD) carried out a pilot project during 1992-96 and then decided on national implementation. Since 1996, NABARD has mobilized more than one million self-help groups with around 15 million members and facilitated their access to bank credit and deposit facilities. A decisive factor has been the personal commitment of the general manager and subsequent chairman of the bank, Mr. Nanda. Directing his staff “to either doing it well and full-force, or not at all,” he established a Microcredit Innovations Department (MCID) and made the program the largest and perhaps most successful rural microfinance program in the developing world. Governmental and non-governmental agencies played a crucial role in establishing and guiding self-help groups as local financial intermediaries, which mobilized their own resources and received refinancing from a total of 31,000 bank branches and financial cooperatives, which they on-lent to their members on their own terms. Neither the Indonesian nor the Indian experience can be mechanically replicated in Iran; each country has to go its own way. But BK may greatly benefit from the variegated experience in these two countries; and from the exposure to the experience of adapting the approach to varying historical and local circumstances.

In the absence of SHG traditions and of NGOs as facilitators of SHGs, BK is likely to decide on loan channeling through solidarity groups, an instrument of great simplicity requiring far less preparation, social change and oversight than a full-fledged self-help group approach, and virtually no book-keeping by the group:

- Channeling groups may be considered a *minimum tillage instrument* in microfinance, well suited to the operational capacity of BK within the framework of a restrictive policy environment.

Solidarity group lending as a new outreach strategy on a national scale will require the following **next steps:**

- Generating the political will in BK to adopt solidarity group lending as a national strategy and to go ahead at full force
- Establishing a national steering committee of decision-makers and a technical team entrusted with the implementation
- Exposure visits to countries where group lending has been successfully implemented on a national scale, notably India and Indonesia
- Determining the time frame in which national coverage is to be attained, eg, 10 years
- Determining the procedure in terms of coverage of provinces and of districts within each province:
  - Expanding outreach in the four pilot provinces to all villages, on the basis of operational plans of the branches and provincial directorates
  - Testing solidarity group lending in pilot villages in other provinces
  - Expanding outreach to all branches in all provinces.
- Establishing a task force for the planning and monitoring of solidarity group lending
- Establishing a staff training program for solidarity group lending
- Working out an operational plan through a participatory planning workshop.

Great care has to be taken that the mistakes made by many agricultural banks during the 1970s are being avoided, among them:

- inadequate loan terms (too big, too long, lump sum repayment instead of regular instalments),
- insufficient interest or profit rates which failed to cover costs,
- lack of monitoring and supervision
- lack of insistence on full and timely repayment;
- lack of staff and borrower incentives;
- lack of savings deposit services and lack of resource accumulation through savings, thus forcing the farmers to newly borrow every year instead of relying on his own savings.

Subproject 2A: Profitability studies of financial products

BK has over 90 financial products, including 15 credit products, without any information on their costs and benefits. We recommend to study the costs and profitability or benefits of each product, including the newly suggested solidarity group product, with three objectives: (a) eliminating unprofitable products; (b) reducing the costs of those retained.; (c) developing a system of monitoring product costs and benefits.

A methodology of examining the profitability of financial products has been developed for the SHG banking product (ie, credit to SHGs) of rural banks in India. In cooperation with NABARD, it was also applied to two other major products of rural banks, cash credit and agricultural term loans, and is applicable to any other credit product. The methodology may be supplied to BK upon request. [29]

4. Priority project 3: Taking the bank to the people

BK has 1800 branches, around 1600 of them in rural areas for a total of 64,000 villages, approximately 40 per rural branch. Staff capacity to provide services at village level has been

[29] H. D. Seibel & Harishkumar R. Dave, Commercial Aspects of Self-Help Group Banking in India: a Study of Bank Transaction Costs. Mumbai, NABARD 2002. H. D. Seibel, Linking banks and self-help groups: social banking or a commercial proposition? The experience of India. Cologne 2004.

limited. The bank has developed two coping strategies. The first is bringing the customer to the bank. For loan applications, disbursements and deposits, the bank expects its customers to come to the bank, thereby shifting transaction costs to the customers. This is inefficient. The depth of banking services thus declines with the distance from a branch; remote villages may be entirely out of reach of the bank.

Taking the bank to the people would be far more efficient, as one staff member, through a single visit to a village, group of customers or group of villages, may serve a large number of customers. This however implies that transaction costs are shifted to the bank, for which it would have to be compensated through adequate fees and profit margins; adjustments in the rate structure are the objective of the policy dialogue suggested in Project #1. The second coping strategy is standardizing its loan product, with only limited scope of adjusting its services to the particular needs and capacities of a household.

Taking the bank to the people ultimately includes an individualized approach to creditworthiness examination and loan tracking, **with customized financial services**. Initial costs are high, but decline rapidly once a track record for repeat loans (of increasing size and loan period) is established. The cost effectiveness of this approach is further increased by increasing loan sizes over time (*economies of scale*) and low arrears, combined with additional financial services such as deposit collection and insurance (*economies of scope*). The bank must realize that *taking the bank to the people with customized financial services* will revolutionize its approach to rural finance and truly transform the bank from a relatively passive disbursement agency to an active financial intermediary, maximizing the potential of local economic development.

The following proposal to management would of course have to be reviewed by management, tested, and revised as seen fit. Starting in larger villages and rural towns, customized services would be guided by **five principles:**

- *Business lending only:* In line with the tenets of Islamic banking, BK will not provide consumer loans. For a business to qualify for a loan, it must have been operating for at least six months, have opened a deposit account for six months, and the account must have shown some activities as proof of the business's existence.
- *Analysis of the household:* BK will lend to individuals, either directly or through solidarity groups. It examines first the household as an economic unit – its assets and liabilities, and its income and expenditure together with its cashflow – and then the feasibility of the business, with more emphasis on repayment capacity than collateral and guarantees.
- *Graduation principle:* Loans will start small and short-term, 3-6 or 6-9 months. If repayment performance is satisfactory, the customer may qualify for repeat loans of increasing size and loan periods. The customers learn that BK insists on timely repayment and loan security. As a result, they are cautious in their loan applications and conscientious in their obligations. After three successful loan cycles, they may graduate to so-called automatic loans of a larger size (eg, 30% larger without additional loan examination), possibly at lower profit rates.
- *Loan security requirements:* BK will be flexible concerning formal and nonformal collateral, combining fixed assets and guarantees according to the situation of their customers. Low-income customers may provide personal guarantees; land without a title; movable items like livestock, household items including nondurables, and business equipment. The guarantors, who are concerned about repayment, provide additional information on collateral or indebtedness.
- *Computerized monitoring & control,* with an adequate software package, is crucial for loan follow-up, staff performance analysis, incentives and provisioning.

A major emphasis will be placed on **incentives** at branch, staff and customer levels:

- Converting branches into profit centers

- Introducing individual staff performance rating for lending staff and branch managers on position-specific scales, tied to disbursement and repayment rates, with substantial incentive payments
- Rewarding customers who meet all their obligations, graded on a scale, with repeat loans of increasing size and duration and, after the third loan, a reduction in the effective profit (or interest rate) from; and sanctioning defaulters at the same time.

Arrears management and loan loss prevention are crucial factors in lending. They have an impact on cost-covering margins, outreach, and profit. High arrears rates reflect carelessness in loan examination or leniency in enforcement on the part of the lender; and negligence on the part of the borrower. Invariably, they lead to high loan losses and are detrimental to the bank and the customer. They make the bank reluctant to lend, lower its profit rate and slow down financial intermediation. As a result, customers have less access to loans, are more thoroughly scrutinized, have their loan sizes and loan periods cut down, and pay higher interest rates. At the same time, the costs of arrears management and the incentives for loan recovery must be kept within limits, lest disbursement and outreach are constrained.

The single most important element in a financial technology geared to zero arrears is **a system of daily loan tracking backed by staff and customer incentives**. This system of zero-tolerance of arrears may be applied at four levels: the customer, the loan officer, the branch, and the bank. It may have the following operational elements:

(a) *Daily tracking:* There should be a minimum of five loan officers in every branch, one acting as a head loan officer. At the end of each day, every loan officer knows which customers have missed a payment.
(b) *MIS on-line:* At the end of the day that a payment fell due, the information is entered on-line into a data base.
(c) *Zero-tolerance action:* The very next day, action is taken: reminding the delinquent first orally, then in writing within a week, documenting the results of the investigation; after one month, the total amount falls due; and legal action is initiated. If there are reasons to suspect irregularities, the head loan officer may bypass the loan officer and approach the customer directly. Rescheduling has proven to be a loop-hole for customers and loan officers and should be eliminated, except in special cases.
(d) *Branch control:* The head loan officer receives the MIS data and submits them to the branch manager, who checks the performance of each loan officer.
(e) *Head office control:* The next morning, the general manager of the credit department at head office receives the information. A report from the branch manager may be requested; and a special analysis of branch problems, including fraud detection, and subsequent action may be initiated as seen fit.
(f) *Instant communication:* There should be a direct telephone line of the credit department to the branches to discuss any problems at the loan officer or branch level and initiate action.
(g) *Staff incentives:* Staff members receive substantial individual performance incentives, provided loans in arrears for one day or more do not exceed a percentage to be determined. The repayment performance of their customers has the biggest weight, accounting for 75% of the total score. The incentives of the head loan officer are tied to both his individual collection performance and that of the loan officers under his responsibility. The incentives of the branch manager are tied to branch performance including arrears. Each of these three loses up to 45% of his compensation package if arrears exceed 5%.
(h) *Customer incentives and penalties:* Customers who pay on time have access to bigger repeat loans and receive, after three successful loan cycles, a substantial lowering of the interest rate. Defaulters are dropped from the list of eligible borrowers; those who are late in repaying fall back on the rating scale.

The key elements of the system thus are: instant information, direct control at all bank levels, immediate action, staff incentives, and customer incentives. The MIS brings out problems at loan officer and branch levels and serves as an early warning mechanism for unsatisfactory performance and fraud. Exposure training may be arranged in banks which have successfully applied major elements of this technology, among them Bank Rakyat Indonesia[30] in Indonesia and Centenary Rural Development Bank in Uganda[31].

5. Next steps

Next steps may include a review of the proposals for priority projects by management, a joint planning seminar with NENARACA, and preparations for exposure visits and training.

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Appendix 1: Balance sheet and income statement, Bank Keshavarzi

Balance sheet of Bank Keshavarzi, 2000/01- 2002/03 (in billion Rls)
(Fiscal year: 21 March – 20 March)

	2003-04	***2002-03***	***2001-02***	***2000-01***
ASSETS:				
Cash and bank balances	513.3	258.1	210.4	304.3
Dues from the central bank	2,534.6	2,352.3	1,802.1	1,237.1
Dues from banks	3,737.7	2,169.5	1,294.1	1,025.4
Dues from the government	2,219.8	2,217.5	1,589.5	888.5
Net loans outstanding and dues from non-government entities	44,458.8	34,472.3	25,708.5	18,716.4
Investment & equity participation	1,532.3	658.4	74.5	66.9
Fixed assets	1,242.6	1,126.2	983.2	775.7
Other assets	2,649.3	1,307.1	578.9	1,405.3
Head office–branch account*	1,082.5	2,563.3	1,692.1	177.6
TOTAL ASSETS	**60,096.0**	**47,124.8**	**33,933.4**	**24,597.2**
Total assets in US$	***$7.08bn***	***$5.79bn***	***$4.28bn***	
Off-balance sheet operations**	**50,664.2**	**33,424.6**	**21,470.8**	**17,716.6**
LIABILITIES AND CAPITAL:				
Dues to the central bank	5,068.4	3,862.9	8,476.8	7,045.9
Borrowings from banks	10,944.8	9,303.7	2,265.2	2,315.0
Deposits:	34,244.9	24,845.6	16,976.4	11,896.5
Current and other sight deposits	*15,757.2*	*14,030.7*	*10,121.6*	*6,688.9*
Savings deposits	*7,947.6*	*5,214.4*	*3,481.7*	*3,059.0*
Term investment deposits	*10,021.1*	*5,021.0*	*3,277.1*	*2,063.7*
Other deposits	*519.0*	*579.5*	*96.0*	*84.9*
Reserves and other liabilities	5,847.9	6,012.2	3,459.0	2,642.4
TOTAL LIABILITIES	**56,106.0**	**44024.4**	**31,177.3**	**23,899.7**
CAPITAL AND RESERVES:				
Paid-up capital	2,756.2	2,752.8	2,752.8	752.8
Reserves	251.4	82.5	3.3	2.9
Accumulated profit/(loss) at year's end	983.3	265.0	0	(58.2)
TOTAL SHAREHOLDERS EQUITY	**3,990.9**	**3,100.3**	**2,756.1**	**697.5**
TOTAL LIABILITIES AND CAPITAL	**60,096.9**	**47,124.8**	**33,933.4**	**24,597.2**
Growth over previous year in %	*27.5%*	*38.9%*	*38.0%*	*39.3%*
Off-balance sheet operations**	**50,664.2**	**33,424.6**	**21,470.8**	**17,716.6**
Total (not reported before 2002-03)	*110,761.1*	*80,549.4*	*55,404.2*	*42,313.8*

* Listed as *expected assets*

** Mainly future commitments, unexplained in the comments to the balance sheet

Exchange rates of US$ to Rials	2001-02:	7,924
	2002-03:	8,140
	2003-04:	8,482

Income & expenditure statement of Bank Keshavarzi, 1998-99–2003-04 (in billion RIs)

	2003-04	*2002-03*	*2001-02*
Joint income (from mandatory credit):			
Profits and deferred penalties received	5,099.3	3,551.9	2,247.8
Other incomes	25.2	18.3	12.7
Total joint income:	**5,124.5**	**3,570.2**	**2,260.5**
Less: net payable profit to depositors	762.7	416.3	252.8
Bank's share of profit	**4,361.8**	**3,153.9**	**2,007.7**
Bank's income from its own resources:			
Profits and deferred penalties received	144.8	55.5	3,156.1
Commission received	295.0	258.1	99.7
Other incomes	180.9	154.4	124.2
Total income from bank's own resources	**620.7**	**468.0**	**227.1**
Total income	**4,982.6**	**3,621.9**	**2,234.8**
Expenditures			
Profit paid on borrowed financial resources	1,591.2	1,371.3	817.3
Commissions paid	34.6	2.9	4.9
Aggregate costs (*without provisions!*)	1,751.2	1,249.0	952.4
Percentage of personnel costs:	*68.3%*	*73.9%*	*70.7%*
Provisions and decrease in value of investments	283.6	378.0	191.4
Other costs	173.6	93.4	68.2
Total costs	**3,834.2**	**3,094.6**	**2,034.3**
Profit before tax	**1,148.4**	**527.3**	**200.6**
Less: tax	257.8	83.9	0
Net profit after tax	**890.6**	**443.4**	**200.6**
Net profit after tax in million US$	***$105.0m***	***$54.5m***	***$25.3m***
Accumulated profit & loss statement:			
Net profit	890.6	443.4	200.6
Accumulated profit (loss) at year's beginning	265.0	0	(58.2)
Disposable profit	1,155.6	443.4	142.4
Less:			
Legal reserve	172.3	79.1	0
Profit payment to government	0	16.0	11.1
Repayment of bonds	0	83.3	131.3
Accumulated (loss)/profit at year's end	983.3	265.0	0

	2000-01	*1999-2000*	*1998-99*
INCOME	***2,342***	***1,475***	***1,022***
Operating income:	**2,215**	**1,424**	**945**
Income from Islamic contracts	2,210	1,335	935
Income from banks and statutory deposit	5	89	10
Other income:	**127**	**51**	**77**
EXPENDITURES	***1,949***	***1,388***	***1,021***
Financing costs:	**1,206**	**912**	**686**
Bonuses paid to depositors	156	109	58
Guaranteed profits on term deposits	47	28	19
Costs of borrowings from banks and CB	1,003	774	608
Operating costs:	**526**	**354**	**254**
Cost of personnel	429	273	198
General administrative costs	97	81	56
Provisions and depreciation:	**217**	**122**	**81**
Provision for bad debts	140	64	40
Provision for depreciation	77	58	41
EXCESS OF INCOME OVER EXPENDITURE (before tax)	**393**	**88**	**0**
Tax provision for the year	**137**	**39**	**11**
NET PROFIT (after tax)	**256**	**49**	**(12)**

*Errors in sums due to rounding

Annex 1: Contacts

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BK advisorymeeting, 28 August:

Bahman Yazdhkasti, Member of the Board
Dr. Salami, Member of the Board & Professor, University of Tehran
Dr. Arab Mazar, Executive Director, R&D Center, & Professor, University of Tehran
Dr. Rehani, Special Adviser to the Chairman
Mr. Dabiri Asgari, Director, International Communications Dept.
R. Khodarahmi, Executive Director, Relations & Resource Mobilization

Annex 2: Principles and typology of Islamic finance

Principles of Islamic finance

The principles of Islamic finance are laid down in the sharia, Islamic law. Islamic finance, comprising financial transactions by banks and non-bank financial institutions or private entities is based on the concept of a social order of brotherhood and solidarity. The participants in banking transactions are considered business partners who jointly bear the risks and profits. Islamic financial instruments and products are equity-oriented and based on various forms of profit and loss sharing. As Islamic banks and their clients are partners, both sides of financial intermediation are based on sharing risks and gains: the transfer of funds from clients to the bank (*depositing*) is based on revenue-sharing and should be calculated ex post on a monthly basis[32]; the transfer of funds from the bank to the clients is based on profit-sharing (*lending, financing*), either at a mutually agreed-upon ratio as in the case of mudarabah or at a mutually agreed-upon fixed rate. Such ratios and rates vary between institutions and may also vary between contracts within the same institution, contingent upon perceived business prospects and risks. In Iran, the rates on deposits are usually fixed; in Islamic financial institutions in Indonesia (only 0.74% of total banking assets), they are usually based on monthly revenue-sharing and calculated at year's end.

Islamic banking finances only real transactions with underlying assets; speculative investments such as margin trading and derivatives transactions are excluded. Lending, or financing, is backed by collateral; strictly speaking unsecured lending (ie, without physical collateral or personal guarantees) would normally be considered as containing a speculative element, or moral hazard. Similarly, to avoid speculation and moral hazard, only investors with several years of successfully business experience should be financed on a profit sharing basis. The paying or taking of *riba,* interest, is prohibited.

The same principle of partnership is applied to Islamic insurance. It is based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a mudarabah arrangement for the benefit of the group.

The fundamental principle of solidarity at the societal level finds its expression in a special category of financial products without remuneration, qard ol-hasaneh. Investors without adequate business experience who are considered high-risk may receive a moderate amount of financing on qard ol-hasaneh[33] terms, free of any profit-sharing margin, but usually repaid by instalments and backed by collateral. Similarly, depositors may save in qar al-hassan instruments without receiving a remuneration, usually with the expectation that the funds are used for social or religious purposes or for qard ol-hasaneh loans. In inflationary economies, qard deposits and financings pose unresolved problems.

[32] In one sense, depositors are treated like shareholders; in another sense, they are treated better than shareholders, as they share in the revenue and not the profit.
[33] This is the common transcription in Iran of what is internationally transcribed as qard hasan, qard al-hasan or qard al-hassanah.

Typology of Islamic financial products

(1) Financing products

Profit sharing financing products:	
Musharaka(h) Musyarakah **مشاركة**	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudaraba(h) **مضاربة**	A profit-sharing partnership to which one contributes the capital and the other the entrepreneurship; or the bank provides the capital, the customer manages the project. Profit is shared according to a pre-agreed ratio
Qard Hasan Qard ol-hasaneh **حسن**	Charitable loans free of interest and profit-sharing margins, repayment by instalments.A modest service charge is permissible
Wakala(h) **وكالة**	Agency contract; an authorization to the bank to conduct some business on the customer's behalf
Hawalah **حوالة**	An agreement by the bank to undertake some of the liabilities of the customer for which the bank receives a fee. When the liabilities mature, the customer pays back the bank
Advance purchase financing products:	
Murabaha(h) مرابحة	A sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment by installments within a specified period
Istithna' **إستثناء**	A sales contract between bank and customer where the customer specifies goods to be made or shipped, which the bank then sells to the customer according to a pre-agreed arrangement. Prices and instalment schedules are mutually agreed upon in advance.
(Bai al) Salam Mu'ajjal بيع مؤجل	Purchase with deferred delivery: A sales contract where the price is paid in advance by the bank and the goods are delivered later by the customer to a designee
Ijarah Ajaar آجا	Lease and Hire Purchase: A contract under which the bank leases equipment to a customer for a rental fee; at the end of the lease period the customer will buy the equipment at an agreed price minus the rental fees already paid.

(2) Deposit products

Wadi'ah وديعة	Deposits, including current accounts
Mudaraba(h) **مضاربة**	Deposit products based on revenue-sharing between depositor and bank, including savings products withdrawable at any time and time deposit products
Qard al-hassan, Qard ol-hasaneh	Unremunerated deposit products, usually for charitable or social purposes

(3) Insurance products

Takaful, Tadamun تضلمن - تكافل	Islamic insurance with joint risk-sharing

(4) Selected Islamic banking terminology

Kafil كفيل	Guarantor
Infaq إنفلق	Expenditure
Mud(h)arib, مضارب	The project, managing partner or trustee in a mudarabah contract
Riba	Interest, usury
Shirkah مشاركة - شركة	Partnership
Rahn رهن	Collateral agreement
Sadaqaat صدقات	
Sharia Shar'iah, Syariah ع شريعة	Islamic law
Shirakah fi al-uqood شراكة في العقود	Voluntary contractual agreement for joint investment and the sharing of profits and risks.
Takaful تضلمن	Solidarity, mutual support as the basis of insurance
Wakil وكيل	Agent
Zakat زكاة	Obligatory charity, Islamic tax

Annex 3:
Project Summary and Recommendations: Rural Micro Finance Support Project (RMFSP)
By Hans Dieter Seibel

A. Project summary

The Rural Micro Finance Support Project, funded by IFAD from Italian supplementary fund resources, is a joint project of International Enterprise for Development of Rural Micro Finance Services (DRMFS-International), an international NGO, with Bank Keshavarzi (BK), the agricultural bank of the Islamic Republic of Iran. The overall **objective** of the project is to expand the microfinance services in poor and deprived regions of Iran by leveraging the resources and institutional capacity of BK in partnership with civil society organizations. The **core target group** are the rural poor in general, rural women and young adults (referred to as youth); in phase I women actually constituted 53% of the borrowers.

Based on the results of a socio-economic survey in some sample villages, which revealed that only 1.5% of women and young adults had access to bank credit, the project has been **implemented during Phase I in four provinces** (Ardebil, East Azerbaijan, West Azerbaijan, Kurdestan), with the assistance of four Iranian NGOs. DRMFS-International has provided technical assistance in the form of development services; BK has provided credit and supervision; the NGOs, without any experience in microfinance, have provided basic social mobilization and group guidance services. The NGO facilitators have resided in the respective provincial capitals; in the future, their function may be supplemented by local community facilitators, among them energetic young graduates found working as farmers in the villages.

BK has approved credit amounting to Rls 4.96 billion ($620,000) to 50 groups; actually disbursed were Rls 4.44 billion ($555,312) to 48 groups, averaging Rls 103.33 per group with an average of 13.9 members, or **Rls 7.42 million ($939) per member**. BK also provides crop and livestock insurance. As the first annual instalment has not yet been due, the amount disbursed is equivalent to the amount of loans outstanding.

The groups have served as **channeling groups**, acting at the same time as **solidarity groups** of mostly 10-20 members who guarantee each others' loans; the bank has therefore waived physical collateral requirements. As channeling groups, they onlend to their members on the same terms at which they receive the loans; to-date there is no financial intermediation or transformation of size and duration by the groups. The group members receive loans up to Rls 8million (US$ 1000), repayable in annual instalments, up to a maximum of 5 years. While there is some variation in loan terms, ranging from Rls 6-9 million and 1-5 years, there appears to be a tendency (at least in some areas) to standardized loans of Rls 8 million for 5 years, regardless of loan purpose, cash flow and repayment capacity.

There is some variation in **lending rates** (ie, profit rates, interest rates). In Ardabil Province, the loans were granted at the usual agricultural lending rate of 13.5% effective p.a. In the Azerbaijan provinces, 75% of each loan were granted at a nominal rate of 13.5% p.a. and 25% at a rate of 4% p.a., averaging 11.125% effectively p.a. At an inflation rate of 17.5% during 2003, the real interest rate is thus negative, at –4.0% in Ardabil and –6.375% in Azerbaijan: hardly an inducement for a bank to vigorously expand lending.

There is a **limited range of actual loan uses**. The loans have been mainly used individually for livestock, particularly sheep-raising, and dry-land agriculture. There are a few group projects, eg, for buying a tractor, which need close monitoring and would probably be better financed through BK's regular instruments. An earlier, erroneous interpretation of solidarity group lending as lending for group projects has been corrected. Opportunities for other

income-generating activities (IGA) in the villages visited in remote areas appear to be very limited.

All group members have to open **savings accounts**; but there are no mandatory savings. The group members have deposited a total of Rls 124.6 million ($15,770), or Rls 0.19 million ($24) per member, which is equivalent to 2.8% of the loans received. During the first year, they were deposited in interest-free Qarz-ol-Hasaneh accounts; but this is expected to be changed into interest-bearing accounts. Propensities to save vary considerably between the pilot project areas.

Credit is disbursed by the nearest BK branches, where the group members also open their savings accounts and repay their loans. However, during the pilot phase, loan decisions and loan supervision are carried out by the respective provincial offices of BK, which are far from the villages which all have been chosen from remote areas. As the project expands and turns into into regular operations, lending decisions, disbursement and monitoring will have to be brought together at branch level.

Actual accomplishments during phase I have exceeded project targets of 30 groups (*actually:* 48 groups) and loans disbursed of US$150,000 (*actually:* ($555,312) by a wide margin. **Outreach** (*actually:* 667 members) could easily have been larger, had the project not limited the number of groups in the larger villages to four or five.

Phase II has started on 5 July 2004, with an expected duration of 28 months. The main thrusts of the second phase are to consolidate the achievements of the first phase; to expand coverage to an additional 300 groups; and to test self-help groups (SHGs) owned and managed by local people, as an alternative to channeling groups, in partnership with civil society organizations. (PCR 2004; DID 2004; Seibel 2004-8)

B. Summary of recommendations

1. Objectives, targeting and decision-making authority

- Agreeing on BK as the ultimate decision-making body of the project, in joint consultation with DRMFS
- Strengthening the decision-making and monitoring role of local branches, through which credit has been disbursed
- Including the poor, near-poor and non-poor through self-targeting
- Putting a special emphasis on young adult men and women as a promising market segment
- Shifting the emphasis during the initial years on larger, high-potential villages and inclujding villages from remote and deprived areas over time as BK capacities permit
- Adding rural towns with their demand for finance for new opportunities of income and employment generation, including employment for the poor from surrounding villages
- Lifting the restriction on the number of groups per villages, thereby increasing outreach and lowering average transaction costs per group
- Financing predominantly individual projects; group projects bear special risks of management and moral hazard and should be examined and monitored with great care
- Examining the feasibility of linkages with business development services (BDS), with the objective of promoting new business opportunities and value-adding off-farm and non-farm activities in villages and rural towns, particularly for young adult women and men
- Recognizing, and strengthening, the expertise of DRMFS-International in the field of microfinance, while seeking and promoting linkages with other agencies, specialized on microenterprise development and value addition.

2. Terms of financial contracts

2.1 Savings

- Encouraging groups to build up a reserve fund for delayed payments and bad debts by deducting up-front a percentage of the loan amount The reserve fund may either be deposited in a profit-sharing bank account or used as an internal loan fund for small short-term loans. A member's payments into the fund will be refunded upon leaving the group after having settled all obligations. If the group is dissolved, the loan fund will be distributed among the members.
- Encouraging member savings in their personal accounts from regular income to build up resources for the repayment of annual instalments.
- Offering two options of profit-sharing (or interest-bearing) accounts: (a) savings accounts withdrawable at any time; (b) terms savings with maturities as desired by each member
- Examining the feasibility of offering special incentives for regular savings towards payment of annual instalments.

2.2 Credit

- Adjusting loan sizes and loan periods to the exigencies of each member's investment
- Offering small-size short-term repeat loans, with the possibility of increases in size and maturity depending on investment opportunities and repayment performance
- To minimize transaction costs, short-term loans may be automatically rolled over upon satisfactory repayment, with an optional increase of the loan amount up to ~30%.
- Examining the feasibility of instalment schedules adjusted to project cash flow or, alternatively, of a scheme of regular savings from investment income for the accumulation of resources to meet repayment obligations
- Handing over the repayment plan to the group leader, who will monitor the repayment and perhaps organize the transfer of payments from the members in the village to the branch
- Unifying lending charges at the usual 13.5%; avoid Qarz al-Hasaneh loans, which undermine sustainable access to rural finance
- Facilitating access of members with a satisfactory track record to individual loans for investments which exceed the scope of solidarity group credit.

2.3 Insurance and loan protection

- Include crop and livestock insurance in loans with such purposes (*as being done*)
- Include insurance premiums in the lending charges or interest rates (*as being done*)
- Facilitate the listing of non-formal collateral or additional personal guarantees as internal security within each group.

3. Strategies of expanding outreach and financial deepening in rural areas: channeling groups, self-help groups and community financial institutions

3.1 Channeling groups

Loan channeling by BK to solidarity groups is an innovation in Iran, fully within the mandate of BK. It must be considered a major accomplishment that BK has adopted loan channeling through solidarity groups as a new outreach strategy in a difficult policy environment. *Further expansion may proceed in several phases:*

(1) Expanding outreach in the pilot provinces to all villages, on the basis of operational plans of the branches and provincial directorates

(2) Testing solidarity group lending in pilot villages in other provinces
(3) Expanding outreach to all branches in all provinces.

Further progress requires:

- Creating the political will in BK to go ahead with loan channeling at full-force
- Strengthening the capacity of the steering committee by establishing a technical department with national outreach to the provincial offices and branches of BK
- Involving the branches not only in loan disbursement but also in loan decisions and monitoring
- Adjusting the approach based on the recommendations presented in chapter 3 above (ie, strenghtening the role of the groups) and on continual field experience
- Examining the feasibility of a stronger target group emphasis on women and young adults
- Reexamining the roles of the project partners in social mobilization, group guidance, financial intermediation and loan monitoring – particularly of the branches and NGOs, with long-term sustainability of financial services on a national scale as an objective
- Establishing training courses within BK, based on the strategy chosen.

With the initial assistance of DRMFS-International, will be able to successfully expand loan channeling on a national scale:

- Channeling groups may be considered a *minimum tillage instrument* in microfinance, well suited to the operational capacity of BK within the framework of a restrictive policy environment.

However,great care has to be taken that the mistakes made by many agricultural banks during the 1970s are being avoided, among them:

- inadequate loan terms (too big, too long, lump sum repayment instead of regular instalments),
- inappropriate interest rates which failed to cover costs,
- lack of monitoring and supervision (many banks did not know when a payment was due),
- lack of insistence on full and timely repayment;
- lack of staff and borrower incentives,
- lack of emphasis on resource accumulation from savings, thus forcing the farmers to newly borrow every year instead of relying on his own savings.

3.2 Self-help groups

Financial self-help groups (SHGs) are local financial intermediaries, which mobilize their own resources from the members and and re-allocate them to the members, either by transforming them into loans (*credit groups*) or by accumulating them up to an agreed-upon date when they are distributed among the members (*savings groups*). Given the lack of experience of NGOs in Iran with microfinance:

- We do not recommend a full-fledged SHG approach, but to proceed cautiously.
- The channeling approach appears to be the most effective one in terms of outreach to poorer segments of the rural population, particularly young adults.
- It is also fully within the mandate and capacity of BK to lend through solidarity groups.
- SHGs may be promoted on a selective scale in villages where channeling groups show initiative of their own and actively demand their conversion into SHGs with financial activities of their own.

3.3 Community financial institutions (*Deh banks*)

There are two major types of community financial institutions, frequently referred to as community banks or village banks: (i) institutions owned by the community as a corporate body; and (ii) institutions owned by a majority of community members as individual shareholders.

- The feasibility of promoting either type of community institution needs thorough discussion with BK and policy makers as well as sponsoring organizations such as UNDP.
- In a longer-term perspective, community financial institutions might eventually evolve out of the merger of successful channeling groups and SHGs.
- A major emphasis on the establishment of Deh banks in the framework of RMFSP would be premature in phase II.

4. Conclusions

Two factors have to be taken into consideration in deciding on the most effective strategy of RMFSP within the framework of its resources:

- *Weaknesses and constraints:* the lack of a conducive policy environment and the lack of experience in sustainable microfinance among governmental and non-governmental organizations in Iran;
- *Strengths and opportunities* the capacity and willingness of Bank Keshavarzi to expand financial services from its own resources to new market segments in rural areas through mutual guarantee groups, particularly young adult men and women.

We therefore recommend to DRMFS-International for the second phase of RMFSP:

- To focus on the **expansion of loan channeling by BK** through solidarity groups based on mutual guarantees by gradually expanding outreach on a national scale – a focus which is likely to extent into a third phase
- To generate the **political will in BK** to adopt loan channeling through solidarity groups as a regular instrument for reaching previously unbanked people in rural areas
- To put special emphasis on **young adult men and women**, without excluding other rural people willing to join solidarity groups
- To provide loans predominantly for **individual activities** and only under special circumstances for well-prepared and well-monitored group projects
- To **relax restrictions on loan purposes**, with the objective of diversifying the income-generating activities in the villages and financing the most profitable ones.
- To establish a **microfinance unit in BK** to lend operational support to the existing task force;
- To develop capacity in **BK** (rather than in NGOs) **to provide social mobilization services** for the establishment and monitoring of channeling groups, a task for which NGOs do not exist in adequate numbers and quality
- To assist BK in building the capacity of its **staff training system** for solidarity group lending on a national scale
- To cautiously strengthen **self-help group elements** in the groups, particularly participation in decision making, the group's role in creditworthiness examination, and the building of group funds from savings for internal lending operations.
- To **postpone the promotion of full-fledged self-help groups** to a later phase when there is sufficient demand from solidarity groups to be upgraded to SHGs or from communities to establish new SHGs
- To **develop DMRFS into a full-fledged professional micro-finance promotion agency** in Iran

- To communicate and **cooperate with other agencies,** such as MoA and UNDP, with the objective of exchanging experience and harmonizing approaches.

4. Recommendations for exposure training abroad

Decision-makers in BK and RMFSP project staff could greatly benefit from exposure training abroad. Two countries are recommended, each with a particular focus:

- **Banking with self-help groups:** Linking one Million Self-Help Groups to Banks – NABARD's SHG Banking Program in India

- Agricultural bank reform: **Bank Rakyat Indonesia (BRI), Microbanking Division: an Asian flagship of agricultural bank reform**