

Agency Adaptation with Islamic Contracts in Iran Banking System in Order to Fulfill the Country's Financing Goals

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Abstract

Since Islam never left humans without guidance in any aspects of life, a reasonable expectation is that Islam has issued guidelines on economy in order to enhance life. Unfortunately, religion was on the margin before the Islamic revolution and extracting economic affairs from the religion was impossible and impractical. But after the revolution a situation was rectified whereby economic-Islamic affairs and consequently Islamic contracts in banking system gradually drew attention. In the process of agency, providers of goods or services for banks or credit institutions (as the agent) receive cash and the discounts through invoices and solve their liquidity problems. The purchasers for goods or services obtain their needed products; the agents receive the amounts of invoices from the purchasers on the due date and make profit. Accordingly, agency is defined as 'selling the receivables accounts or (receivable documents) to agent companies in order to provide cash and reduce credit risk'. This article examines the principles of agency concerning Islamic contracts intending to fulfill the financing purposes of the country.

Keywords: Agency, Islamic contracts, Islamic banking

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Introduction

Since a long time ago the banking system of the country has made impressive strides in improving the performance efficiency; and in this regard, mechanizing the bank branches can be mentioned and the effectiveness of such proceedings in people interactions and bank activities is tangible. However, we have a long way to go before achieving the desired levels of performance and efficiency, in addition, opacity of impact scope of monetary policies is one of the challenges that banking system encounters with and “Agency” irons it out. Agency, based on the function, has remarkable variety and according to its approach to resource supply fluctuates between private agency (invoice discount) and agency with the right of withdrawal (management of debtors) and management of sales offices or a combination of them (comprehensive agency), whichever will be discuss in detail. From a legal perspective, agency is adaptable to Islamic contracts stipulated in the interest-free banking operations including debt purchase, Jo’aalah (unilateral contract), forward contracts and installment sale and its mode of activity whether in terms of independent agency and non-bank financial relation or in terms of bank services. Agent companies by checking the invoices and documents and after conducting essential researches on goods and the purchasers’ credit provide the sellers with some percent of the invoices; then the agent companies collect them from the purchasers of goods or services on the due date. In fact, the purchase of invoices and financial documents means purchasing the risk of initial debtors’ failure to pay. Therefore, this risk will determine the percentage of invoice discount. (Akhlaaghi, 2007)

Sales representatives are entirely responsible for received goods from manufacturers and they are bound to defray the cost of goods or return the unsold goods until due date. The representatives also took the responsibility for bad debts resulted from installment sale. Hence, cooperation with them was considered as a guarantee for manufacturers. Nonetheless, this method had some problems such as ambiguity in provisions of contracts established between agencies and manufacturers, the risks arising from operation and difference in national laws. With increase in demands for manufacturers’ goods as export goods in all of the world, the profit of agency and brokerage operations increased to the extent that in United States the profit of brokerage operations overtook the manufacturers’ profit. Huge and occasionally unfair profits and consequent troubles led to approval and implementation of “Agent Law” in some states of America. According to this law the relationship between agent companies and manufacturers was specified and whichever possessed certain rights. (Eskini, 2008)

Agency is based on transfer of ownership of sold goods. In this regard, sellers of goods or services transfer the ownership of goods to purchasers by invoicing and purchasers take the ownership of goods by paying in cash or by issuing documents as cheque and promissory note; which in the latter credit purchase is made. In case of need for cash to supply essential current for cash flow, sellers of goods might sell this documents to agent.

Examining invoices and documents, agent companies after carrying out necessary researches on goods and purchasers’ credit provide purchasers with some percent of amounts of invoices and companies collect them from purchasers of goods or services on the due date. In fact, the purchase of invoices and financial documents means purchasing the risk of initial debtors’ failure to pay. Therefore, this risk will determine the percentage

of invoice discount. The higher risk of failure to pay, the lower price would be paid for purchasing documents by the agent. Thus, to put in a nutshell, agency is a short-term resource supply with high rates.

Literature review

Nature of agency

Agency is based on transfer of ownership of sold goods. Basically, ownership is verifiable when owners of goods possess the associated documents. From legal perspective the ownership of immovable properties is verifiable through documents, though in case of extending this rule to movable properties, the ownership of movable properties is also verifiable through documents of ownership such as “invoices”. In this context, sellers of goods or services transfer the ownership of goods to purchasers by invoicing and purchasers take the ownership of goods by paying in cash or by issuing documents as cheque and promissory note. (Eskini, 2008)

History of agency

Existing documentation implies that agency has a long history in commerce and even it is traced back to Babylonians, approximately 5000 years ago; although today’s modern agency operations were established in the late 19th and early 20th century. England could be considered as the origin of agency. Seemingly, agency came into use due to two reasons:

- Brokers, sales representatives and English goods speculators activities in other countries.
- Widespread activities of banks in Europe. (Khal’atbari, 2011)

In the late 19th century, goods manufacturers used agency or sales brokers intending to sell their products beyond the geographical areas of the respective state. The agencies would receive goods on consignment and would sell them. In the early 20th century, particularly by telecommunication developments and faster and more effective connections between purchasers and manufacturers, basically manufacturers did not need to send goods on consignment any more. Instead, the idea of producing in accordance with market demand was put forth. But manufacturers, more importantly, were in need of a guarantee to collect receivables from customers so that they could protect their interest (specifically against dishonest customers). Moreover, some manufacturers required cash before the due date of the sold goods to eliminate their immediate need for liquidity. In modern agency, agent companies collect sellers’ receivables from purchasers. (Eskini, 2008)

Types of agency

Being flexible and negotiable, Agency directly depends on the agreements between agents and customers. Types of possible agreements are:

- Agreement on recourse or non-recourse to customers.
- Agreement on agency with or without prior notice to debtors.
- Agreement on financing through early payment by agent.
- Agreement on direct fund-raising by agents or customers, in favor of agents (Khal'atbari, 2011).

Ergo, types of agency can be divided into several main categories:

- Agency with the right of recourse. This agent is just related to financing customers during the sale, operations of accounting records of sales and fundraising from debtors, meanwhile, it is not responsible for dishonest debtors at all. In this regard, the agent has full authority to receive compensation from customers if debtors failed to pay. In that case, compensation would be received by giving authority to the agent for restoration or sale of invoices after expiration date and failure in settlement with debtors. In such conditions, the paid amounts by agents to customers would identically be returned against above invoices and customers transfer would transfer goods to receivable accounts (doubtful receivables).

- Private agency or invoice discount which is widely used and was established as invoice discount by agents for customers who are more in need for debtors' credit supply and do not mind the services of collection and sales accounting. Previously, invoice discounting was through selling them to agents below par. But agents act upon two general approaches nowadays and avoid simply discounting various invoices.

- Contract of discounting the invoices related to all selling operations of the company.

- Contracts of discounting all of the invoices issued as certain debts.

Briefly, in this approach the agent of evaluation of customers' sales invoices addresses customers' financing. On the other hand, customers likewise are responsible for recording the operations of sales accounting and fundraising from debtors in favor of the agent. In this approach all of the collected funds would directly be deposited to the agent's bank account.

- Due Agency is another type of agency which is presented by agents under the title of "Due Agency" and has no financial facilities. In this type of agency, customers would not be prepaid and these two approaches would be used for paying to customers instead :

- Customers' viewpoint: Relatively accurate calculation of cash flow after invoicing was an attractive criterion in customers' point of view. However, agents often can change the due date according to their previous experience or they can calculate it too long. In fact, customers establish contracts with agents intending to reduce the risk of their anticipations and agents profit from the financial resources arising from the advance payments of invoices by customers' debtors.

The second approach is flexible and allows the customers to control the payment of certain debts. The below table briefly illustrates the comparison of types of agency (Monetary Agency Eds, 2002).

Table 1: the comparison of types of agency

Type of Agency	Collecting the Amounts of Invoices	Management of Sales Offices	Declaration to Debtors	Protection against Bad Debts	Possibility of Financing
Comprehensive	Always	Always	Always	Always	Always
With recourse right	Always	Always	Always	Never	Always
Private	Never	Never	Never	Never	Always
Due	Always	Always	Always	Always	Never

Conditions of using agency

The main usage of agency is solving the liquidity problem in short-term, usually 120 days at the most. One of the other services of agency offered nowadays (especially in United States) is collecting receivables from debtors to department stores who are mostly retailers and highly demand for this service. However, this service has not been spread vastly because the problems of financial information privacy and fear of disclosure are barriers to spread of the service (Monetary Agency Eds, 2002).

Compliance of agency function with legal principles in Iran

In accordance with article 292 of Civil Code, conversion of obligation is realized in these cases.

- Obligation conversion in credibility of debt conversion is achievable in two ways:
 - By converting the case of obligation: for example, if someone owes 1000 Rials and the debtor convert it by agreement and receive 800 Rials.
 - By converting the obligation: for example, if someone owes the seller 1000 Rials for purchasing a car, after the transaction they reach agreement that the mentioned amount as a loan stay with the purchaser for one year.
- Obligation conversion in debtors' credibility: as mentioned in paragraph 2 of article 292 of Civil Code, if a third party with obligee's allowance accepts the payment of obliged debt, this obligation conversion can be with or without the debtor's agreement.
- Obligation conversion in creditors' credibility: Iran's Civil Code equates the obligation conversion by creditors through transferring of debt which is a separate establishment and the third paragraph of article 292 provides: "when obligees transfer the obligations of the obligated persons to someone else, the debtor's agreement is not

essential.” In this type of obligation conversion, the obligees replace third parties with themselves (Callender, 2002).

Permissibility of providing agency services by banks based on the interest-free banking operation law

According to the monetary and banking law and interest-free banking operation law, this question occurs that if banks are likely to provide such banking operations. The answer is that from the perspective of the interest-free banking operation law, granted facilities specified in following of the note of article 3 with debt purchase or a combination of that are able to supply the needs of manufacturing, servicing and trading completely. In other words, these contracts are designed to be able to supply all needs of the society. According to the next descriptions debt purchase and Jo'aalah contracts comply with agency, but as for the transferring process it's better to examine installment sale and forward contract.

- Agency compliance with forward contracts and installment sale: it is believed that one of the important features of agency is that can quickly meet the immediate needs of manufacturing, trading and servicing units, while banks lack such abilities. Hence, there is the ambiguity that HP or forward contracts and installment sale which are mainly for eliminating the needs of working capital of manufacturing units for raw materials, spare parts, tools and so on, are not designed to meet the needs of units; installment sale and forward contracts are designed to supply the working capital, while both contracts are based on dealing the actual goods having the difference that in installment sale the amount would be paid equally and unequally, but in forward contracts it would be paid in cash and goods would be delivered afterwards.

- Agency compliance with debt purchase: debt purchase is one of the instruments that can be applied in Islamic banking system in order to supply the needed financial resources of manufacturing, trading and servicing units through commercial papers belonging to these units. Legal source and base of debt purchase permission by banks originate from the provisional regulation of commercial documents discounting which was approved in the 471st session of Money and Credit Council in 1361/8/26, which consequently was presented to the Guardian Council and the majority votes approved its accordance with Shariah law and the constitution. Debt purchase is an instrument for financing through commercial documents and papers of manufacturing, trading and servicing units. Iran's commercial law has expressed the regulations of bills, promissory notes and cheques, but has not introduce them as all commercial documents.

- Agency compliance with Jo'aalah contracts: these contracts are applicable with resource supply but the only acceptable documents for banks are commercial documents and invoices would be admitted if they are backed by commercial documents. The other important feature of debt purchase contract is that they do not lead to the ownership of goods by banks. Note that agency occurs in various fields (such as Construction, Computer including Software and Hardware, Export and Import, Transportation and the like). Ergo, providing the working capital in such fields is not necessarily possible in terms of documents and invoices discounting, but Jo'aalah could be suitable covers for such cases. According to article 3 of the amendment of the interest-free banking operation

law, all of the contracts exchanged during the implementation of this law shall be in order of the binding official documents and shall be subject to the provisions of executive regulation of the official documents, by the contract established between the parties (Hill, 1992).

Agent company formation

The financing agency in terms of debt purchase contract, and service agency in terms of Jo'aalah or proxy contract shall be achievable. It should be taken into consideration that financing in agency has some features demanding for the establishment of some institutes performing this task. Such institutes are among the "non-banking financial intermediaries" or those financial institutes which are not categorized as commercial banks. Non-banking financial intermediaries just like leasing and agent companies are institutes which do not receive deposits from the public, but finance their own customers (Farimani, 2012).

Islamic banking

The idea of Islamic banking in Islamic and other countries dates back to more than 50 years ago. This idea and sensitivity is the result of the penetration of western banking institutes into Islamic societies. Since banking operations are suspected to usury, Muslim intellectuals were seeking for the alternative solutions during the last 50 years. In this respect, the main method is removal of usury from banking system by applying the Islamic contracts which comply with banking system. Thus, at first the necessity of applying interest-free loan contracts for welfare works and solving the problems of the indigents was emphasized and then the next stage PLS, namely partnership in the profits and losses of economic activities became the next main topic. This method concentrates on sharing the results of economic activities and encourages the parties of contracts in actual partnership in economic activities and gaining shares by partnership. In Iran also, the designers of interest-free banking law have described partnership and avoidance of fixed rates as the spirit of this law and even some Islamic economy theorists believe that any predetermined rate of return is usury. Therefore, the conclusion of the most arguments of Islamic economists was that Islamic economy has the nature of capital market. Hence, any money market was not prescribed in this economy, but practically many barriers raised to the idea and the essential context for development of this method has not been provided (Darvishi, 2009).

One of the main barriers is that participating in these activities would block the liquidity. Therefore, those who devote their cash capital to such activities should wait for years to achieve their primary capital and the expected profit, while such people are infrequent and most entrepreneurs call for liquidity due to their various needs. Then designers of Islamic methods encountered with this question that what alternative solution is offered by Islamic systems for liquidity supply in all times and changing in decision-making in case of relinquishment. In this regard, banks applied the method of internal dividend at first but obviously this solution would not erase the problem of formality of interest-free banking operations and it would not form the secondary market which is one of the necessities of financing system. Recently, Islamic intellectuals use Sukuk or

Islamic bonds in order to solve the above problem. Various types of bonds of western financial system are supersede by this instrument which has 14 type (Azari, 2010).

Foundation of this instrument emanate from the fact that financial system of Islam is only valid with the actual sectors of economy. In Islamic system, money is the reflection of actions of the actual sectors of economy. Thus, money market or monetary policy cannot be applied without relationship with actual and real sectors of economy. The other issue concerning Sukuk is the necessity of hedging of economic activities. This issue is not problematic in nature but the considerable point is that Islamic principles such as ownership stability principle and the following principle, which are legitimate activities, increase the real value added of economy. This principle is considered as the foundation and essence of the Islamic financial system (Farimani, 2012).

In brief, according to statutory and legal laws, the main task of banks is absorption of wandering and stagnant funds of society and designating them to supply the financial needs of people and economic institutes in the framework of the purposes and programs of economic system of the society. In the current banking system of the country, fund absorption and designation are based on the legal principles and legal contracts. Legislators had numerous purposes for fund designation, the main of them was “establishment of credit and monetary system based on truth and justice (by Islamic regulations) in order to regulate the proper cash and credit flow and in order to improve the country’s economy.”

Thus, according to current regulations, granting facilities by banks must be based on the related anticipation, the principles of supplied resources for these facilities, and the expected profit when is achieved must be returnable at specified period.” Determined tasks for banks are based on anticipating the measurements which guarantee the resources and the expected profit. The prevalent traditions in the interest banking and the interest-free banking have augmented the cautious attitudes towards securities and these tasks caused the possibility of applying personal comments and authenticity of securities in admission of examination and approval of bank customers’ applies for facilities. Seemingly, now this factor plays the role of a barrier to anticipated purposes of interest-free banking and it is of great importance (Hill, 1992).

Islamic banking disadvantages

In spite of the widespread development of financial instruments in Islamic countries, the process of evolution of banking system is slow in Iran and encounters with serious disparity and challenges, moreover, the political interference in banking system has raised to apex recently. The proposed solution is that “Besides the uncoordinated actions, some successful consultations are provided for standardizing banking system activities in framework of legal principles and the new model is interest-free banking. In this model, the context of agency with fixed and variable output is based on Islamic contracts and is legally and economically justified new categorization for the country’s banking system based on Islamic contracts.” (Darvishi, 2009).

Islamic banking advantages

- In the country's economic system, central bank has introduced a new instrument called "Conversion Bonds" in order to preserve the value of money in the framework of truth and justice.
- This attitude towards money, monetary policy and financial system has restricted the effectiveness of policy to framework of truth and justice principles (Darvishi, 2009).

Now in our Islamic country, the principle of the new model of interest-free banking is not respected. Regarding loans provided for people by different banks, in exchange for the money they pay to the banks, some percent is added as interest rate that is more than the amount of money itself which must be paid. Applying Sukuk instrument which is substitution for bonds has facilitated the situation and it is responsible for the necessity of hedging of economic activities (Callender, 2002).

As stated earlier, the main task of banks is absorption of wandering and stagnant funds of society and designating them to supply the financial needs of people and economic institutes and granting facilities by banks in the framework of the purposes and programs of economic system of the society.

Conclusion

Considering the specialized discussions, the implementation of agency operations (whether in terms of banking operations by banks or in terms of financial operations by independent non-banking institutes) can be applied in terms of debt purchase contracts. Ergo, in order to applying this instrument in financial and monetary system of the country, providing appropriate structures for compilation of executive regulations as mechanism of such activities seem essential. Seemingly, central bank of Islamic Republic of Iran with cooperation and supervision of Monetary and Banking Institute can achieve this goal. The other suggestion is that obviously we should organize our actions towards preserving our religious principles in addition to achieving interest-free banking and avoiding interest bank relations and operations.

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