

ELIMINATION
OF
RIBA
From The
ECONOMY

Edited by
Khurshid Ahmad



INSTITUTE OF POLICY STUDIES

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ECONOMY

Edited by
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Institute of Policy Studies

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Foreword

*E*limination of Riba from the Economy is in your hands. It contains papers and proceedings of a workshop held at the Institute of Policy Studies in April 1992. The workshop was held in the background of the historic judgement of the Federal Shari'ah Court on Riba which came in December 1991 and was to be enforced from July 1992. It is unfortunate that the federal government chose to go in appeal to the Supreme Court and this led to the deferment of the implementation of that historic judgement. The IPS organised a workshop on the problems and challenges of elimination of riba from the economy. Seventeen papers were presented at the workshop. Two oral presentations were also made. Every paper and presentation was thoroughly discussed. A lively concluding session was held in which a number of speeches were made, the communiqué of the workshop was announced and there was a concluding speech by the then finance minister, Senator Sartaj Aziz.

As Part Two of this book, we are including two articles by Dr Ausaf Ahmad which review the evolution of Islamic banking during the last two decades and the present state of the experiment. These studies give the message that interest-free banking is not merely a theoretical concept but also a reality that is blessing faith.

An effort has been made to publish in these proceedings most of the papers, presentations and key points for discussion. Our apologies to Dr A.M. Irfani and Mr M. A. Chishti, Mr Zaigham Rizvi and Mr Mohammad Yousuf as their papers could not be included due to administrative difficulties. Dr M. Fahim Khan and Dr Munawar Iqbal made valuable presentations on indexation but these could not be included as the topic deserves to be taken up separately. However, we take this opportunity to thank them for their cooperation and contributions.

We are sorry it took our editorial team more time to prepare the final manuscript than was originally visualised. These proceedings have been edited by an IPS team. Dr Waqar Masud Khan reviewed the papers. Brother Khalid Rahman and Mr Zahed A. Valie edited these and also went through the transcripts of discussions so as to distill long discussions into condensed points for inclusion in the proceedings. Besides, help also came from Brothers Dr Rizwan Tahir, Tarik Jan and Arif Sultan.

I would like to thank these brothers profusely for the very difficult job of culling out material from hundreds of miles of footage of tape recording containing discussions spreading over 30 hours. The team deserves our very profound thanks for preparing the material for publication in the form of this book. May Allah give them best of the rewards for the effort they have put in.

Some of the comments and questions have been included in the discussions without naming the participant due to lack of voice identification. We hope participants will ignore our lapse.

We have taken the liberty of adding one contribution to this volume which was not part of the workshop, yet is very relevant to its theme. The Supreme Court of Pakistan (Shari'ah Appellate Bench) had issued a questionnaire on riba, in connection with the government's appeal against the FSC judgement. These questions relate to some of the themes discussed in the workshop. The present writer's response to the Supreme Court's questionnaire has been included because of its relevance.

Finally, I would like to once again thank all the paper writers, discussants and participants of the workshop for their valuable contributions and the staff of the IPS for producing this valuable book on a challenging subject. I am sure it will help all those who are seriously interested in getting rid of the curse of riba and strive towards establishing a just and self-reliant economy.

PART I

Inaugural Address

PROF KHURSHID AHMAD

Distinguished participants, friends and colleagues:

It is my privilege to welcome you to the Workshop on the Elimination of Riba from the Economy. I am grateful to all of you for responding to our request. I hope we are going to have a meaningful dialogue during these three days and if the presentations, the discussions that follow, the questions that are raised, the responses that are developed help in removing some of the fog and clarifying some of the issues then Allah be praised, we would have made our contributions and achieved the immediate goals of this workshop.

Institute of Policy Studies is a nongovernmental research and educational institute. By the grace of Allah, we have been working for the last thirteen years in a very humble way and have tried to promote policy-oriented research with professional integrity, our commitment to our ideals, values and the interests of the Muslim Ummah notwithstanding. Over 700 reports and about 100 publications, books and booklets have been published since then. For a private institute which has not sought support from any government or international agency, its continuance to be productive owes more to Allah's mercy than anything else. This workshop has been organised with a view to having national debate and discussion on issue of prime importance, i.e. elimination of riba. We cannot address ourselves to all the relevant ques-

tions in a short working period like this one. Thus, let me make a few submissions at the very outset about what we are aiming at and how we propose to make this working group a useful exercise.

You are aware that prohibition of riba is an article of faith with the Muslims, and as such we cannot challenge its prohibitory nature. But what is the rationale behind its prohibition and what repercussions it will have on the economy if it is eliminated are valid areas of inquiry which have been probed in the past and similar efforts would continue in the future as well; and on that count also we are open for discussion. Yet, as far as the present effort is concerned, we are starting from the premise that in Islam riba is forbidden. Pakistan as a nation, no matter how grossly the Islamic provisions of the constitution were violated, the people and the Ummah are committed to the establishment of the Islamic order.

National Commitment

Starting with the first major policy speech the Quaid-i-Azam made at the inauguration of the State Bank of Pakistan (July 1948) which committed itself to the abolition of riba and the introduction of riba-free system, all the three constitutional documents produced in Pakistan's 40-year history affirm that elimination of riba is an objective of the state policy. All the reports of the Council of Islamic Ideology starting from the first report in 1962-64, unanimously called for eliminating riba. The final report of the council, based on the report of the Panel of Economists and Bankers, came in 1980, also proposed a three-year programme. Case law at the levels of High Court and Supreme Court is also available and the most important judgement, which could come only after the constitutional ban of ten years on the Federal Shari'ah Court to examine the legality or otherwise of laws relating to monetary and fiscal issues, was pronounced in December 1991 and rightly affirms that it is a national resolve and a commitment to abolish interest from the economy. We thus start from this premise that elimination of riba is a national commitment which has to be honoured.

The Challenge

Second, what is riba? Lately, this has generated a lot of discussion. Let me submit that as far as the question of interest on monetary transactions, money lent or borrowed, is concerned, there has never been a difference of opinion on its definition. Any addition to the loan amount related to the time of loan constitutes riba regardless of the term used for it or the language in which the concept is translated. This comes from the Qur'an itself which makes it very clear that whatever is above the loaned amount one has no right to charge it or pay it. As far as financial dealings are concerned any increase on the original loan money which is predetermined, whether it is simple or compound, is riba. Again, any increase whether it is on loan borrowed for business purposes or production and consumption purposes, whether it is among the individuals or between individuals and institutions, whether it is between people and government or government and government, is riba and forbidden in Islam.

There had been some side diversions whether bank interest and interest given or charged by individuals is same or different. I would not go into the debate presently, but I submit that the consensus of Muslim scholars and economists, as has also been affirmed by the judgement of the Federal Shari'ah Court, is that bank interest is as much riba as interest charged by other persons or institutions provided it falls in the category of a predetermined return on money lent. There can be a large number of other services the banks are engaged in and where service charges are not based on this premise. They may not invoke the mischief of riba, yet all those bank transactions that relate to this particular area and are undertaken on this pattern are riba. So the second premise on which we are starting is that as far as concept and definition of riba is concerned the consensus of the Islamic Ummah is that we treat all such revenue as riba.

Thus the challenge we are facing is:

- a) How to eliminate riba in all these forms?
- b) How to evolve a riba-free system of financial and economic dealings?

Third, I would also submit that Islam is indivisible. Its whole socioeconomic programme comes from its core (faith) in the same way as tree grows from the seed. The whole tree is one organic unit, each part supporting the other and drawing sustenance from each other. Any effort to implement only one part to the exclusion of the rest is not going to produce the results. Thus, the isolationist approach would not be a realistic one. This, however, does not mean that everything can be done at the same time. There can be a gradualism in the implementation process starting from building faith to education, social motivation, individual motivation, institutional and legal changes. It is only through an all-embracing effort that a real change can be brought about. So when we are dealing with a specific area for an indepth understanding of an issue, there is no *harm* in it provided we do not lose sight of the fact that there is a vital frame to the issue of riba that must be kept in mind, i.e. Islam's objectives, its principles, values, ideals, laws and spirit. This perspective, therefore, should always remain before us despite the fact that we might be examining only one particular aspect or even certain aspects of one issue only in this working group.

Fourth, even at the level of elimination of riba perhaps, this is my personal submission, we are faced with a three-tier situation. How to avoid what is *haram*? What is explicit and categorical that our moral, spiritual and social conscience abhors? But this would be only in the negative aspect. From there we have to proceed to the second phase, i.e. what is our positive vision of economic and financial dealings? What is the alternate basis on which Islam wants to organise it? While we may start from eliminating riba from the economy in its explicit forms and may devise certain financial instruments which would be interest-free, the need for moving to the next stage of building the economy on Islamic foundations and in the pursuits of Islamic socioeconomic objectives would beckon us.

Unfortunately, during the last two centuries the evolution of economic financial relationship has been engineered towards a debt-based economy and this includes both consumption and production spectrum of economy. As against this as a basic value, Islam abhors a debt-based life. Islam presents a vision of life free from the constraints of debt and

where economic cooperation and activity takes place on the basis of equity-sharing and risk-sharing, so that capital, labour, expertise and entrepreneurship operate within the framework of their rules and limitations. Doubtless, this is a different vision and for that a new positive thrust would be needed.

And last, of course, elimination of interest is not the be-all and end-all of Islamic economic programme. It is one of the key elements of the Islamic economic programme, but it would be incorrect to assume that this is the whole of Islamic socioeconomic programme. Islamic programme of restructuring has its own objectives and ideals which includes the prophetic mission of establishing justice at all levels: the concept of individual and his rights, of property and the whole approach to civil contracts, economic contracts and economic organisation; how cooperation and collaboration between individual and society is to take place and on what basis; the mechanism of market, the need for arrangements so that the market could play its role efficiently and judicially and the role of the state in fiscal system. All these taken together provide the unique Islamic approach to man's economic problems and that would be the third stage to which we have to move. Yet, as I said, in this working group we are trying to concentrate only on limited areas cleansing the economy of all the forbidden (*haram*).

In this respect, a landmark decision has been made by the Federal Shari'ah Court. This has created an urgency — an impetus to do something for our interest-based economy. It is in this context that we thought expedient to have a get-together, a union of minds to look into this issue. The purpose is not to dole out anything; it is in the true spirit of dialogue that we are meeting here. Our effort has been to invite those economists and bankers who have, particularly in the last twenty years, addressed themselves to the issue of *riba*. Also, we have invited people who are knowledgeable in the Islamic Shari'ah. Besides, we have invited the finance ministry to send its representatives. Though this is not a government-sponsored or government-related exercise, yet we wanted them to come and share their difficulties with others — the practitioners, the bankers and the academics, without putting any shackles to anyone's thoughts or approaches.

It is in the true spirit of dialogue that we have tried to organise this workshop. We are not engaging ourselves in an exercise to convert the converted; instead, the idea is to share the work already done so far and identify the problems that are yet to be resolved and face critical questions. There are a number of areas that perhaps remain underdeveloped. There are apprehensions from external agencies, and I am happy that World Bank, IMF and other international agencies have also responded positively to our request and are attending the workshop. Thus the idea is to sit together and instead of simply talking *about* each other let us make an effort to talk *to* each other. Not necessarily that we would be able to resolve all the problems, yet a get-together of this kind where we could frankly and without questioning anybody's intentions discuss each others' judgement. If we are able to move a few steps in that direction and continue our efforts to further discuss and resolve the remaining problems, I think that would be a worthwhile exercise.

Would the Economy Collapse?

Let me submit that there are certain people who feel that perhaps elimination of riba may lead to the collapse of economy. Everyone has a right to his opinion, still I think we should not go by scare-mongering. Instead, we should try to analyse things in their perspective. After all, elimination of riba does not mean zero-return on capital. What Islam has forbidden is a fixed predetermined return for a certain factor of production — one party having assured return and the whole risk of entrepreneurship to be shared by others. Islam has not denied the productivity of capital. This does represent a fresh approach in which the factors receive variable return based on actual performance. Capital entrepreneurship shares both the real contribution and the real profitability.

This is not something as novel or naive as some people are trying to project. After all, if one looks into history, one finds that capital, as loan capital as well as venture capital, has played the role in promoting industrialisation and economic development. Also, we find that their relative roles have been rather different in different parts of the world, in different periods of time. For example, in the British model of banking,

the role of deposit banking in promoting economic development was dominant while equity-based investment was limited. But as against that, in the French tradition, Investment banks had played very important role throughout 19th and even in 20th centuries. Similarly in Germany, we find that commercial banking was not allergic to equity-based investment. They were simultaneously working as commercial banks in the limited sense of the word and as investment banks. We are aware that in 18th-19th centuries even in international field equity and venture capital played a much more important role, while in post-World War II phase we find that loan capital, particularly through the aid agencies, became much more important. We are also aware that whenever banking crisis has overtaken the western world, like the Great Depression in the '30s or the banking crisis in the '80s, proposals for banking reform were made even to the extent of a two-tier banking, i.e. hundred percent deposit banking and the equity-based investment banking.

With the advent of Islamic banking in the '70s we find that a number of international institutions or organisations had shown an openness that we expect from international organisations, bankers and investors. In a number of studies, IMF, World Bank and IFC have shown interest in the alternate arrangement for participation of capital and entrepreneurship. Some of the economists have been voicing great concern over the distorted proportion between loaned capital and equity capital even in the western economic system. The German economist Albach has produced a number of studies, demonstrating that even the western economies are not getting enough equity capital. New instruments and institutions are needed to put in equity capital. So when we say that equity-based banking and finance are possible, we are not talking in a language foreign to the professionals.

International Scenario

We are discussing these issues at a time when very important changes are taking place in the world. We find that there is a lag of seven to eight years in debt recovery. Inflation has dug its teeth deep and unemployment is still a menacing phenomenon. All these are causing worry to economists, policy-

makers and politicians. With the collapse of socialism there is a perceivable optimism for the alleged "final victory of the market liberalism." Still, we find that the World Bank in its latest report on the challenge of development cautions that while market economy should play very important role, the state's positive role should not be totally neglected. Realities have to be faced. After four decades of developmental experiment in over 120 developing countries, we find that the developmental efforts have not borne real fruits, not even a predominant success. As to a few success stories like South Korea, Taiwan and Singapore, there is no evidence to suggest that their developmental efforts owe much to loaned capital or aid in the form of loans; instead, each represents a particular case with a critical entrepreneurship and effective utilisation of a number of factors.

We are also meeting at a time when the ecological crisis in the world is assuming grave proportions and the Earth Summit at Rio de Janeiro is addressing for the first time perhaps to problems which have been raised by dissenting voices in the last three decades, including the two reports of the Club of Rome. We are also meeting at a time when international distribution of income and wealth and consequently of opportunities has reached a stage affecting the political system and prospects in this part of the world. Assuming that the developmental strategy based on the Harrod Domer model, emphasising two major gaps: the savings gap and the balance-of-payments gap; and the deficiency to be met through foreign aid, is the guarantor for development, will be an exercise in futility. This is time we should address ourselves with all professional integrity and an open mind to these fundamental questions.

This is the background in which we are meeting. Our effort on the one hand is to share and survey whatever efforts have been made particularly in the Muslim world during the last two decades both at the intellectual as well as operational levels; and on the other hand, to address ourselves to specific sectors: commercial banking, central banking, government transactions, public debts, international dealings, both trade as well as aid-based development or exchange-support programmes. Each of these areas has to be cleansed from riba-based operations and alternate operational instrument or institutions have to be developed.

The Spectre of 'Fundamentalism'

We do not claim that all the questions have been answered. Human effort must always continue and commitment must always be made. We should be pragmatic to face the problems as they are and not a prisoner of certain biases. My main concern is that some of the western intellectuals, journalists, scholars and politicians instead of trying to understand us in our effort to seek our identity and build our society in accordance with our own moral and ideological ethos are casting us in the role of adversaries. I want to emphasise that we are part of the contemporary world and want to make the world a better place to live in for all. If the NATO had treated a certain part of the world painted into *red* as threat for four decades, the secretary-general of NATO has to say that in future the *red* may be replaced by the *green*.

If you read *Ronald Reagan: An American Life*, the autobiography of the former US president, you will find that the spectre of "fundamentalism" seems to be haunting him page by page. Richard Nixon has also come out with a book, *Seize the Moment* and the Frankstein of "fundamentalism" is very much there. Even those who are talking of the end of history are searching a new enemy in the Japanese corporate model and in the Islamic fundamentalism. What I want to submit is that we are not afraid of titles. People are free to dole out whatever names and titles they want. Yet the Muslim world is going through a period of creative tensions.

Tensions, because we are still trying to rediscover ourselves. The decolonisation process that began with political freedom is still incomplete. We are in the process to seek cultural, intellectual and economic de-colonisation in the same way as we have been able to achieve at least partial political de-colonisation. There is also tension because of the tension between leadership and the people. By and large the leadership is a hangover of a long period of our own weaknesses and colonialism. But as I said this is a creative tension because there is a very strong urge not only to rediscover our identity but also to rebuild our life not as a threat to anyone else but as a blessing to ourselves and all others. To be powerful, to be great politically and economically are facts of history. There is no denying them but to extend that political

hegemony or cultural and economic imperialism would produce real friction and even wars.

So our effort is that let the world leaders realise that bipolar or unipolar may be the concepts of international relations but when we are dealing with human beings, nations, civilisations and cultures, we have to adopt a much more pluralistic approach. We accept their right to have their own vision of individual and society, faith, culture, polity, ideology, but would it be too much if we also seek to have a right to be our own self, to have our own values, to develop our own lifestyle? The West can claim to have its own lifestyle in the name of liberty, then why is this liberty denied to other people? If democracy is the greatest achievement of mankind, then why does it become irrelevant to the Algerian people? Our effort is not, as I said, merely to talk *about* each other but talk *to* each other. This is the background in which this dialogue takes place.

Review of the Federal Shari'ah Court Judgement on Riba

MUHAMMAD AKRAM KHAN

The Federal Shari'ah Court (FSC) of Pakistan announced a historic judgement in December 1991 on the legality of interest on financial transactions. The court, presided over by Mr Justice Dr Tanzilur Rahman, decreed that the provisions of interest in a number of fiscal laws came under the definition of *riba* and thus these legal provisions were repugnant to the Shari'ah. The court fixed June 30, 1992, as the day when this decision would come into effect and these legal provisions would be null and void after that date. It has built a pressure on the Government of Pakistan (GOP) to take appropriate action to amend or substitute these laws in the light of the Shari'ah by that date.

The FSC disposed of 115 petitions challenging the legality of "interest" in 20 fiscal laws besides three *suo moto* Shari'ah notices. The FSC got the mandate to admit petitions challenging fiscal laws on June 25, 1990, before which the fiscal laws were out of its jurisdiction. The GOP, by making successive amendments in the constitution, kept these laws out of the jurisdiction of the court for over 10 years. The FSC admitted the first petition challenging "interest" on December 11, 1990, after which a number of other petitions were filed. The hearing concluded on October 24, 1991. The FSC announced the judgement on December 7, 1991.

The FSC judgement is a voluminous document. It consists of 564 foolscap pages (triple-spaced). The text of the judgement consists of 298 pages. It has two appendices. Appendix A contains replies to the questionnaire issued by the FSC to 12 distinguished scholars, economists, bankers and jurists both within Pakistan and abroad. Appendix B gives extracts from the report of the Council of Islamic Ideology of Pakistan on *Elimination of Interest from the Economy*, published in 1980.

The objective of the present paper is to give a brief resumé of the judgement and to highlight its distinctive features. Since the judgement has raised and exhaustively discussed several vital issues, we shall give a brief review of the conclusions of the FSC and mention the evidence on which it based these conclusions. We shall also discuss some of the replies of the scholars to the FSC questionnaire.

Distinctive Features

In a number of ways, the judgement is epoch-making. It will be remembered in the history of Islamic economics as a landmark of intellectual integrity, an example of analytical acumen and a piece of unmatched scholarship. It has several distinctive features.

First, it has declared all the fiscal laws containing provisions on interest as null and void and has fixed a date (i.e. June 30, 1992) beyond which these laws will become ineffective. There is no example of such a decree in the history of Pakistan.

Second, the judgement did not mince any words nor did it try to avoid the contentious issues pertaining to interest. Instead, the court, on its own initiative, raised all the issues so that the matter is decided once and for all. In this way the judgement is, perhaps, the most comprehensive legal document to discuss all the questions at one place.

Third, it is a unique document in the sense that it combines evidence from primary sources, history of the Muslim people, juridical texts, opinions of the renowned scholars and

economists, all at one place.

Fourth, although it was not the responsibility of the court to discuss the question of alternative system, yet it raised this question and provided a lot of valuable material which can become basis of an interest-free economic system.

Fifth, the judgement has taken note of the dissenting opinions of the counsels of some respondents and discussed them threadbare. The discussion of the dissenting opinions is exhaustive and leaves little room for their plausibility.

Main Conclusions

NATURE OF RIBA

The FSC has decreed that a "transaction which contains excess or addition over and above the principal amount of loan, which is predetermined in relation to time or period to be conditional to the payment of predetermined excess or addition, payable to the creditor (such a transaction containing the said elements) constitutes riba and any sale, transaction or credit facility, in money or in kind, has been considered to be a transaction of riba, which is unlawful (*haram*) in the territory of Islam and in Muslim society. There is a consensus (*ijma*) of the Muslim jurists on it." (p.104)

It does not make a difference whether the loan is for consumption purpose or for commercial purpose. Similarly, it does not matter if the rate of interest is low or high, simple or compound or for short or long term, between two Muslims or between a Muslim and a non-Muslim or between a citizen and a state or between two states. Any excess which is predetermined over the principal sum in a loan transaction will constitute riba in all circumstances.

The FSC has based its conclusions on various Qur'anic verses, Ahadith of the Prophet (peace be upon him), opinions of the jurists and various Arabic language dictionaries. It quotes from *Lane's Lexicon*, *Taj al-Arus*, *al-Nihaya* by Ibn Athir, *A Dictionary of Islam* by Patrick Hughes. From *tafasirs* of the Qur'an, it quotes from Tabari, Ibn Arabi, al-Jassas, Sabuni, Syed Qutb, Mawdudi, Mufti Shafi and *al-*

Muntakhab fi Tafsir al-Qur'an al-Karim by Committee of the Supreme Council of Islamic Affairs, Egypt. From the scholars of Hadith, the judgement quotes from Imam Malik, Muslim, al-Bayhaqi, Ali al-Muttaqi, Abu Dawud and Ibn Hanbal. It cites from *Hedaya*, the famous book of Hanafite *fiqh*. Other *fiqhi* sources are the resolutions of Fiqh Academy of India and Islamic Fiqh Academy of OIC countries. From contemporary scholars, the judgement quotes Hamidullah, Fazlur Rahman Ansari, Maulvi Fazalur Rahman of Aligarh and Abraham Udovitch. The judgement brings ample evidence from historical sources that the loans in vogue in the days of the Prophet (pbuh) were of commercial nature. It examines and rejects the point of view of those who profess that the Qur'anic *riba* was mainly on consumption loans. Of economists, it refers to the report of Panel of Bankers and Economists issued by the Council of Islamic Ideology in 1980.

The judgement has examined the point of view of a counsel which tried to confuse the issue by saying that the question of *riba* falls into the category of *mutashabahat*. It referred to the legal methodology of Islam and proved beyond doubt that the matter falls in the classification of *muhkamat*. Similarly, those who tried to justify the bank interest on the basis of *maslaha* became the subject of examination of the court. The court took up the principles of Islamic legal methodology and showed that something which is prohibited by the text of the Qur'an cannot be made the basis of *ijtehad* and justified on the basis of *maslaha*.

INDEXATION OF LOANS

Some people argue that in a period of secular inflation, the purchasing power of the money erodes over time. Therefore, the creditor should be compensated for this erosion in the real value of money. This can be done, goes the argument, by indexing the interest-free loans with the price level of a basket of commodities. It would be fair and equitable so far as creditors are concerned. The court discussed this issue at great length. Besides quoting from the contemporary economic texts, it brought evidence from the classical Islamic legal sources to show that in case of price increase, the principal sum lent will have to be returned in the same quantity and in same currency in which the loan was taken in the first in-

stance. There are various reasons for this.

First, it is so similar to interest that it would be impossible to differentiate one from the other. Second, the erosion in value due to inflation has not been caused by the debtor or by his use of the money, therefore, it seems inequitable to ask the debtor to compensate for it. At best, the state can be asked to do so. But in practice it would be difficult to implement such a proposal as the number of transactions taking place everyday is so large that the state will not be able to examine each case and make payment. Moreover, it would turn the flow of resources from the taxpayers to the wealthy class which itself is against the objectives of the Islamic economic system. Third, demanding indexation of loans gives a privileged position to capital as compared to other factors of production which are also affected by inflation in one way or the other. Fourth, it is difficult to agree on one such basket of commodities which affects all types of creditors uniformly. Fifth, indexation would tend to induce the savers to shy away from risk capital which has been emphasised in the Islamic value system. Sixth, the supporters of indexation do not recommend a reduction in the debt during times of deflation which is inequitable.

While examining the issue, the court also took up the point raised by Mr Justice Wajihuddin Ahmad in *Aijaz Haroon vs Inam Durrani* (PLD 1989, Karachi 304) in the light of a 13th century jurist Ibn Abidin Shami's argument. The FSC judgement reproduced from the original text of Ibn Abidin Shami's book, *Tanbih al-Raqud ala Masa'il al-Naqud*. It showed that the original text did not support the point taken by Mr Justice Wajihuddin Ahmad. The jurist Shami had argued quite clearly that in case the value of the currency undergoes a reduction over time, the debtor will still pay back the same quantity of money in the same currency. It was only in case the currency in which the money was lent becomes altogether useless or is demonetised by the government that the debtor can claim his debt in the currency in use at the time of payment. But then too the value of the loan will be the same as at the time of lending. (p.193)

The court has cited the opinion of various authorities in support of its conclusion. Some of the scholars are: Dr Umar

Chapra, Dr Hasanuz Zaman, Abdul Rahman al-Jaziri, Mawlana Taqi Usmani, Ghulam Rasool Saeedi, Dr Munawar Iqbal and Afzalur Rahman. From among the jurists, the court has brought evidence from al-Kasani, Zaila'i, al-Sarkhasi, Ibn Qudama, Fatawa Alamgiri, Council of Islamic Ideology of Pakistan, Islamic Fiqh Academy of OIC countries, Islamic Fiqh Academy of India and the resolution of the seminar on indexation held at Jeddah during 1987.

The court, however, recognised that: "there should be a means of redressing these evils (of inflation), and indexation is claimed to be one such technique. But an evil, as already discussed above, should not be redressed by a similar or a bigger evil. Muslim economists should try to explore the ways of fighting inflation within the sanctions provided by the Shari'ah" (p.177). We shall take up this question in the next section of this paper where we shall present a solution to this problem within the Shari'ah framework.

MARK-UP

The court discussed the legality of the mark-up system introduced by the Pakistani banks in the wake of Islamisation in the '80s and concluded that it is nothing but interest and should be abolished. The court quoted from Mawlana Taqi Usmani extensively to argue that the mark-up is the price of time allowed on a debt which is interest, pure and simple.

The court touched on the question of increase in the price of a commodity due to deferred payment of its price. It mentioned that there is a difference of opinion among the jurists (p.224). It did not dilate upon it further. But it has reproduced in Appendix A the replies given by different scholars. We shall take up this question further in the next section.

LEASING AND LEASE-PURCHASING

The court has discussed the question of financing on the basis of leasing. It has accepted it as lawful within certain conditions. (p.330)

Similarly, the court has accepted lease-purchasing as lawful, within certain conditions.

RELIEF IN CASES PENDING BEFORE THE COURTS

Some petitioners prayed that they should be given relief from payment of interest on the loans taken by them in the past. The court remarked that all such petitioners being Muslim were aware of the illegality of interest at the time of contracting the loans. Anyhow, the FSC expressed its inability to grant any relief to such petitioners since such an examination was outside the jurisdiction of the court. We shall take up this question as well in the next section.

INTEREST IN INTERNATIONAL TRANSACTIONS

The court took up the question of interest in international transactions. It quoted from a note by Dr Syyid Tahir. The note argued that the financing of export can be done by banks acting as trader rather than financiers. This is being done by other Islamic banks. For the future, the government should do all financing on the basis of equity. Foreign exchange markets will continue to operate as usual. There is a support for them in the Shari'ah in the law of *bai' salam*. The court also quoted from Anwar Iqbal Qureshi's book, *Islam and Theory of Interest*.

Some Unresolved Issues

We shall discuss here some unresolved issues relating to the debate on interest which were either outside the scope of the court or the court felt that some more research was needed to resolve them. While discussing these issues we shall, in all humility, like to present some tentative thoughts which may help pave way for future policy formulation.

PROTECTING THE VALUE OF MONEY

The arguments against indexation, both from the Shari'ah and economic point of view, are well taken. But the question remains: how can we protect the value of money over time against fluctuations in prices, which is a fact of life and which at times is also desirable? The question will keep on nagging the creditors. The fact is that if a satisfactory solution to this problem is not found then the creditors will shy away from lending money on the basis of *qard-e-hasan*, while in an Islamic society the system should be such as to

encourage people to lend money as *qard-e-hasan*.

One suggestion is that the government should float a new currency under a new nomenclature, say, Pakistani dinar. The value of the Pak dinar should be equal to a basket of commodities. The price of these commodities should be announced everyday on the basis of the market price of these commodities. Those who want to hedge themselves against price fluctuations should deal in Pak dinar rather than Pak rupee. Thus, all loans, salaries, wages, contracts, etc. should be denominated in Pak dinar. While borrowing, the debtor should accept Pak dinars and return the same number of Pak dinars on the maturity date. The Pak dinars should be available from all banks at the declared rates. There should be one single rate of the Pak dinar for buying as well as for selling so that the exchange dealers do not make any commission from its purchase or sale. It will also take care of speculation in this currency. The proposal has the following merits:

- It is covered by the Shari'ah rules. There is no excess in borrowing or selling. The loans are taken in Pak dinars and returned in the same currency.
- It is equally applicable both in time of inflation and deflation. So it does justice to all irrespective of the trend of the general price level.
- It is applicable to all such contracts which mature over time, such as wages, salaries, contracts for construction or supplies, etc. It provides protection to everyone and not to wealthy people only.
- It is easy to use. The government announces daily rates for foreign currencies. It can do so for Pak dinar as well. Since the new currency will be available at all banks, there will be no problem of its liquidity.
- There will be one rate for buying and selling, therefore, the problems of speculation and earning commission by sale and purchase of Pak dinars will not arise.

DIFFERENCE BETWEEN CASH AND CREDIT PRICES

The court has not dealt in detail with this question. It has

mentioned that there is a controversy on this issue and it has reproduced the replies of various scholars to this question. This question deserves a detailed examination and can be dealt at two levels: legal and economic. Let us examine it from the legal point of view first.

If we look at the Hadith literature, we find that the companions of the Prophet (pbuh) understood by *riba* a transaction in which a lender will charge an increment in the loan if he extended the time limit. Thus, *riba* was effectively a price for time only. Therefore, there is hardly a difference of opinion that in loan transactions if an increase is charged against time, it is *riba*. The confusion has arisen only from the fact that in case of a credit sale, some people think that the price of time which appears in the form of a higher price is lawful because the transaction is not that of a loan but of trade. In trade, both the parties are free to agree to transact a business at any price provided they agree to it by their free will. In this case, goes the argument, both the parties agree at a price, which may be higher than the cash price. Therefore, there should be no objection if the credit price is higher or lower than the cash price. But this argument leaves out of focus the Shari'ah condition that the price should be agreed by free will of the two parties. We understand that in this case there is a hidden coercion. Why would a person like to pay a higher price if he can buy a certain thing for a lower price? In this case he agrees to do so because he does not have ready cash. It is the same situation in which a person agrees to return a higher sum for his loan, since he does not have ready cash. In essence there is no difference. The free will is only in appearance and not in reality.

Some people have tried to argue that the difference in the cash and credit prices is allowed since the Shari'ah recognises *bai' mu'ajjal* by a consensus. In fact this argument is misplaced. *Bai' mu'ajjal* means that the sale can take place on the condition that the buyer will pay the price later on. It does not necessarily mean that the seller has a right to sell the commodity at a price which is higher than the price he is charging for a cash sale. Similarly, some people confuse it with the Shari'ah injunction that one is allowed to quote a price for today and another price for a later date. It also does not have to do anything with the issue at hand. It only means

that a person can sell his commodities for two different prices at two different points in time. It does not mean that the Shari'ah allows him to quote two prices for a sale which is taking place at one point of time.

If we go deep into the economics of this question we shall note that there is little difference in charging interest on the money lent and in charging a higher price for a commodity being sold on credit. In both the cases the increase is being charged for the time allowed by the creditor. From economic point of view it is immaterial whether a person borrows Rs 100 or takes a commodity worth Rs 100 on credit. If we allow an increase in the latter case, we are leaving a door wide open to allow re-entry of interest.

EXISTING INTEREST-BEARING LOANS

The court did not discuss the question of existing interest-bearing loans as it was beyond its jurisdiction. But in real life, this is a vital question. On the one hand, we need to abolish interest from all transactions and on the other, we know that some people who have benefited from the banks' money now want to escape scot-free without sharing their benefits with the financiers. If we abolish interest in one go there is a likelihood that some very rich people will get an undue advantage. To handle this situation we can proceed as follows:

PRIVATE LOANS FROM BANKS

- All interest-bearing loans taken by business firms should be made interest-free on a particular date. Any accumulated interest should be written off as the Prophet (pbuh) did and as the Qur'an so requires.
- The outstanding debt should be converted into equity of the business of the borrowers for the future. It will also force the owners of the businesses to declare dividends. Because if they do not do so they will also not get anything by way of profit.
- If this arrangement is not acceptable to certain firms, they should be forced to return the sum borrowed in lump sum within a specified period.

- If the banks do not find it beneficial for them to become equity holders of a certain firm, they may go in arbitration and request for settlement of their debt out of the assets of the borrowing firm.
- Those debts which were given for non-productive purposes, there is no solution except the banks ask for their return without interest. Whatever interest they have earned on these debts should be considered final for them.

DOMESTIC PUBLIC DEBT

- On the cutoff date, the government should revoke interest from all domestic debt. The government should, however, own all the principal sums borrowed.
- The repayment of the principal sums should be rescheduled in such a manner that they match with the receipts from the sale of public enterprises which is going on these days.
- The government can also convert some of the domestic debt into equity of public enterprises which are profitable, such as Wapda, Pakistan Telecommunication Corporation, Sui Gas Corporations, etc. The holders of this equity will have the option to sell it on the stock exchange.

FOREIGN DEBT

- The government should take up the matter of foreign debt with its creditors on case-to-case basis. Some of the lenders, especially those who lent money for certain commercially viable projects, may be willing to convert their loans into equity of those projects.
- In certain cases, the government may like to get into some of the debt-equity swap arrangements in vogue. For this purpose, it may invite expatriate Pakistanis to make a contribution. For example, the government may offer to convert the loans into equity of certain existing or newly-established projects if its foreign debt is picked up by expatriate Pakistanis. These Pakistanis will become owners of these corporations. The ratio of con-

version of debt into equity can be such as provides them an incentive to accept this offer. The management of these corporations can be with professionals and not with the government bureaucrats. Those who invest may also like to come and manage these corporations in certain cases.

- In cases where nothing can be worked out, we may have to honour past commitments with the non-Muslims as an expediency. But in case of any debts taken from Muslim states, nothing will be payable by way of interest in future. This is the verdict of the Qur'an and Sunnah of the Prophet (pbuh).

SAVING SCHEMES

The court has declared all saving schemes as repugnant to the Shari'ah but has not proposed any solution. The fact is that it is one of the most ticklish issues. The abolition of the present saving schemes will not only create a problem for the government which is a major beneficiary of these funds; it will also create a void for the savers. The answer seems to be the establishment of large number of such institutions as national investment trust, mutual funds, saving societies.¹ These institutions should collect household and business savings and invest them in equity of joint stock companies, business and trade, and also provide them to banks which will channelise them to investment activities on the basis of profit-and-loss sharing.

Some people raise the question: the proceeds of the national saving schemes are used by the government to meet its deficit. How shall we provide this finance to the government in the future, since the government activities do not lend themselves to PLS arrangement? The question is ticklish on the face of it. But on deeper examination we find out that one of the major causes of government deficit is interest itself. For example, the budgetary deficit of federal government for 1991-92 is Rs 58 billion and the interest payable on domestic and foreign debt is Rs 63 billion (47 bn + 16 bn rupees, respectively). If we abolish interest, this deficit will go away immediately. The government will not have any need to

¹ For a detailed treatment see writer's *Islamic Banking in Pakistan: The Future Path*, Lahore: All Pakistan Education Congress, 1992.

borrow from the national saving schemes. However, one may still ask that the government's need to borrow will remain, anyway then what are possible options? The fact is that where the government needs money to perform its traditional functions of civil administration and social welfare, there is no other option except to levy taxes and user charges where possible. However, in government programmes which are commercial in nature, the government can enter into PLS arrangements. Some people have also suggested that the government can raise interest-free loans by giving incentive by way of relief in taxes. But the Shari'ah permissibility and economics of this proposal is doubtful.

In certain exceptional cases where the government has to borrow from the State Bank, as at present, the State Bank should provide such loans to the government on interest-free basis. It may recover, if necessary, its actual expenses.

INTEREST ON PROVIDENT FUNDS

The court has not directly discussed this question. But some of the scholars have dealt with the question in detail. The classical opinion propounded by Mufti Shafi and other scholars of his school is that the interest on compulsorily-deducted provident fund provided by the employer or government is not unlawful on the following ground.

The provident fund which is deducted compulsorily by the employer never becomes the property of the employee until his retirement or final payment by the employer. Since the ownership of the employee on the provident fund deducted is defective from the Shari'ah point of view, any increase on it by the employer will not be interest. It will be a sort of an addition into the wages or other perks by the employer. This is so even though the employer himself may call such a benefit as interest.

The fact is that this position needs rethinking. Increase on the provident fund deducted by the government compulsorily is interest for all practical purposes. First, the provident fund deducted is the property of the employee. He can claim it as a matter of right even by going to the court of law. Secondly, the government itself treats it as debt in its books of account. Third, the interest on it is calculated by using the compound

interest formulas in the usual manner. Fourth, even if we accept that the ownership of the employee on the sum deducted is defective, it still does not make interest lawful for him. For example, if two persons share ownership of a fund and one of them lends it to a third person without the permission of the other partner, it does not entitle the lender to receive interest on the sum lent, although in this case his title was defective. The defect in his title of ownership does not waive off Shari'ah prohibition.

The fact is that the system of deduction of provident fund compulsorily has its roots in the traditional concept of state governance. It is founded in the traditional notion that the state can force its citizens to undertake certain activities in their own interest. This has been accepted traditionally in all civilised societies. The state can restrain a certain person from utilising his own property if the state thinks that this person will waste it. The law for the compulsory deduction of provident fund is also based on this philosophy. It is not by way of depriving the individual from its lawful earning; it is to force the employees to do some saving for themselves so that they can use them in the old age. The state feels that in the absence of such a coercion the employees would waste their earnings and become destitute in the old age. In no case such an action by the state entitles the individual to earn interest on his savings.

What are then the options for the government? Some of the possible suggestions are as follows:

- The government should write off all interest from the existing provident fund balances. The employees should be entitled to receive only the principal sums deposited by them.
- At the time of retirement each employee should be given a retirement grant to be decided by the government. The grant should have no relation with the provident fund balance. Instead, it may have some relationship with the grade, length of service and the state of an employee's needs at the time of retirement.
- Alternatively, the government may decide that in future

every employee will get a bonus of certain days salary (say 30 days) every year. This will be credited to his provident fund and will be payable on his retirement. This bonus could vary for different categories of employees according to social policies of the government.

- Still another suggestion is that the government may entitle every employee to draw an interest-free advance from government funds twice or thrice during his career. The amount of the advances could be worked out in the light of time and provident fund balance and the time and number of instalments of the advance.

Conclusion

We have summarised the main conclusions of the Federal Shari'ah Court on the legality of riba. We have also discussed some unresolved issues and given some tentative ideas to resolve them. The fact is that interest is so deeply entrenched in our economy that it will be yeoman's task to abolish it. Its abolition requires, of all the things, political will of the nation. So far this will has been lacking. The nation has been postponing this issue for the last 46 years on one pretext or the other. The FSC judgement has created, for the first time, a real urgency. Even now, this problem will require a sincere desire on the part of the people of this country to uproot this evil.

One reason why the process of tackling this problem has been extremely slow is the ignorance on the part of bureaucracy, politicians and financial managers that possible solutions do exist to abolish interest. Therefore, it is of paramount importance that a campaign should be launched to create awareness among the elite of this country about possible alternatives of interest. Similarly, all educational institutions beyond high school should educate the students with varying degrees of elaboration about the negative effects of interest and possible solutions to abolish it. There does not seem to be any alternative to mass awareness on this question.

DISCUSSION

NAWAZISH ALI ZAIDI: The Federal Shari'ah Court judgement has left many issues unresolved. The first issue relates to existing interest-based loans and mark-up-based loans worth about Rs 100,000 million taken under a buy-back agreement. Ever since this judgement has been given, many people have slowed down in making their loan payment thinking that they might get some benefit out of it. Also, what is the present position of the contracts entered into by borrowers with the banks before this judgement came and what will it be after June 30, 1992, deadline?

Second, what is the legal Shari'ah position of a contract between a Muslim country and a non-Muslim country as Pakistan may be the only country which will be following the Shari'ah position? Other Muslim countries are not following strictly this principle in their foreign dealings.

Third, what causes worry to the people is that the court has examined sections 79 and 80 of the Negotiable Instruments Act. The court deals with bills of exchange and promissory notes and has struck down the words "interest" and "mark-up." My question is that if an exporter is exporting goods, he draws a bill of exchange, will he draw a bill of exchange only for the principal sum, i.e. the price of goods? And what will happen if an exporter in another country sends goods to Pakistan and the bill of exchange is drawn on the Pakistani importer? What will be the position of that bill of exchange if the word "interest" appears there?

This is not a simple matter because while exporting most of our bills are users bill payable after 3 months, 6 months and 12 months. The question is whether we will be able to persuade our importers abroad to have that margin built up in the price that exists between the cash price and the credit price. Although in the judgement the court is silent about international borrowings, there is already an oft-cited case of Hub Power project. People are being sent abroad to explain

This session was chaired by Prof Khurshid Ahmad. During the discussion, a participant asks a question or offers a comment followed by the explanation from the speaker. In the end, the session chairman sums up the discussion.

certain things like foreign currency bearer bonds. Why don't they tell them that the judgement has not made any reference to international transactions?

ABDUL JABBAR QASIM: The section 3.4 of the judgement says that in the Shari'ah leasing transactions are valid within certain conditions. What are those conditions? Secondly, can an Islamic country continue to pay interest on foreign loans out of necessity until it becomes economically independent?

ISRARUL HAQ: The judgement suffers from a number of serious deficiencies. What will happen to the rights and obligations created under the existing laws after July '92? The judgement is silent about that.

To get over the problem of indexation, you have suggested two currencies. Suppose today I take this dinar from you and after 10 years, I return the same dinar to you. Since the legal tender will continue to be the rupee, the dinar will have to be converted into rupees. Won't I be paying more by way of getting it converted to dinar?

DR ARSHAD ZAMAN: First, in terms of unresolved issues there is a need to distinguish *fatwa* from *taqwa*. *Fatwa* sets the minimal limits within the Shari'ah. It is the task of the Mufti when presented with any *istasna* (exception) to make his best effort to find permissibility. After he fails, he declares it *haram*. So *fatwa* merely sets the lowest limit. As long as we have a *fatwa* on the provident fund, for example, it sets a minimal limit of permissibility until the *fatwa* is retracted. It is a separate issue whether in the interest of *taqwa* you wish to forego that, and for *taqwa* there are no limits. That applies to all the unresolved issues that have been mentioned in Mr Akram Khan's paper.

The legal points that have arisen from the institutional setup within which the Shari'ah is being implemented. We need to distinguish deficiencies in judgements made by English courts based on common law behind them and deficiencies in judgements which arise from the impact on the judgement in achieving an entirely different set of objectives, namely those of the Shari'ah. Now this is a formidable problem when you try to impose Shari'ah on the basis of an

English constitutional setup.

What the Federal Shari'ah Court is doing is not giving a *de nova* judgement on the 1973 Constitution; it is merely endorsing a judgement delivered some 1400 years ago. The impact of the judgement is very clear. Now the question whether the judgement is deficient by not prescribing is not a deficiency of the judgement itself; this can be further referred to the court.

What the court will argue is that given the constitutional limitations on interest rates, the interest-based contracts were invalid to begin with. Similarly, if there are the kind of contractual obligations forbidden by the Qur'an and the Sunnah which the constitution recognises as a superior law, then it could be argued that no rights and obligations have been created and the court will acknowledge the position.

In terms of the mechanics of banking, what is to be done on interest or mark-up on existing loans? What is the Shari'ah position of contracts for Muslim and non-Muslim countries? How do we deal with sections 70 and 80 of the Negotiable Instruments Act? As we know that a contract may be declared *ultra vires* and the entire obligation as of that date is due and payable. Now if I and another person have contracted an interest-based loan and the Supreme Court has struck it down, the issue is that I owe whatever the principal sum as of date. Now, we have a strictly financial difficulty to overcome — that is, I cannot pay Rs 100,000 million today. This is not a new problem; this is a problem that bankers have faced for 200 years. And it, therefore, falls upon the lender and the borrower to renegotiate the discharge of this financial obligation that the court recognises in a manner mutually acceptable. There will be cases where there will be need for adjudication. But I do not see this as a fundamental difficulty. I think the judgement is historic.

ABDUL JABBAR KHAN: The solution suggested by the speaker about introducing Pak dinar would create more problems. When there are two currencies at the same time, one currency will vanish from the scene and the other would operate. The weaker one can't stay. We will have to think something else rather than introducing Pak dinar. Second issue is the

difference in cash and credit price. When in Dr Arshad Zaman's words *fatwa* permits difference in cash and credit price, I think we should go by the *fatwa*. Third, look at the saving schemes. The author has spoken about the creation of certain institutions. Fine! But the main problem is that the government is using money. I feel that if we apply an increase in the difference in cash and credit prices many of our problems could be solved.

COMMENTS: I refer to Mr Akram Khan's suggestion on having Pak dinars. This means all the Muslim countries who have problem of interest will have dinars related to their own currency. Then why not have Islamic dinar for all the Muslim countries.

COMMENTS: I have to make two points. First, I want to elaborate that fixing a deadline for the government is a constitutional requirement. It is for the Supreme Court to increase or reduce the period and the Shari'ah Court is bound by the constitutional requirement. Second, the concept of Islamic Pak dinar should be explained. Whether it will be a national currency or actually a unit of account to be used as a medium of exchange in all transactions of purchase and sale, borrowings and contractual payments. Only then the pros and cons of the proposal can be examined.

ARSHAD JAVED: If we make Pak dinar a currency, probably our problems will be compounded, but if it is NIT units, the problems may be resolved.

SHAUKAT KHAN: May I ask that in a corrupt society how can you correct the financial system?

MUHAMMAD AKRAM KHAN: The question about the amount of loan that the government takes from the saving schemes has been bothering me. Look at the budget documents: the latest operative budget shows that the deficit is Rs 58 billion and the interest payments are Rs 53 billion. If you don't have to pay interest, you don't have to borrow from saving schemes.

Concerning Pak dinar, there have been two currencies, gold and silver, in early periods. For centuries, this system operat-

ed and perhaps we may try this here, too. It will be actual currency used for all contractual payments. Say if one goes to buy eggs, butter and bread, the denomination of Pak dinar will be so high that he may not use it. A dinar may be equal to say Rs 10,000 at the moment. This will remain operative in the case of only loan transaction. Salaries and wages and other such time-related transactions will be conducted in rupees.

The question of *fatwa* and *taqwa*? Well, the issues like the interest on GP Fund and the difference between cash and credit prices do not fall in the category of *taqwa* but in *fatwa*.

To question on how we will introduce Islamic profit-sharing in corrupt society, if you tie Islamisation with an honest, pious and truthful society, then you are talking of impossible situations. We will have to find out a method where despite living in a society with such procedures, controls and mechanism we can minimise the element of corruption and still live within the Shari'ah framework. This is the real challenge.

PROF KHURSHID AHMAD: Mr Khan's paper is a very scholarly document and I hope if we spend some time to go through it, the concept of riba would cease to be a problem. Second, the court has to operate within the framework of the constitution and legal system. The failure of legal system could not be attributed to deficiencies of the solution. Third, the legal and constitutional responsibility of the court is not to give alternatives. It has the constitutional right to strike down any state law against the constitution. But it is not its obligation to tell them what should be the alternate legislation, or what will be the consequences of the legislation being struck off.

To expect court to take upon itself the responsibility of resolving all the questions would not be fair. A lot of work has to be done by others and the court cannot be held responsible for negligence. For the provident fund I have reservations. Unfortunately, it was a definitional difficulty which prompted the *fatwa*. And once it is admitted that the contributions of the provident fund are the property of the persons from whose salary they have been deducted, the *fiqh* difficulty on which the *fatwa* is based will go.

The government is free to make its contribution. It is not obliged to invest in riba-based corporations; it can invest in equity and NIT units to safeguard any erosion of value. We are aware that venture funds investment entry is presently the only major source of investment banks, we should not confuse the two. I think the provident fund has to be invested in venture funds.

Elimination of Riba: Concept and Problems

RESPONSE TO THE SUPREME COURT QUESTIONNAIRE

PROF KHURSHID AHMAD

Riba: Definition

The Holy Qur'an has prohibited riba. What is meant by this term? What is its true definition and connotation in the light of the Holy Qur'an and Sunnah of the Holy Prophet (pbuh)?

1.1. Riba is the Qur'anic term for usury or interest, and the definition of riba as given in the Qur'an is very clear and unambiguous. It categorically forbids riba as any claim in excess of the principal sum lent.

The Qur'an has not left any ambiguity in respect of the concept and definition of riba. It explicitly and categorically lays down that:

“O believers, fear God, and give up the interest (riba) that remains outstanding if you are believer.” (al-Qur'an, 2:278)

Although this response to the questionnaire of the Supreme Court was written after the workshop, it is being included in the proceedings in view of its relevance to the theme of the workshop. In fact this questionnaire was issued by the Supreme Court in preparation of hearing of the government's appeal against the judgement of the Federal Shari'ah Court which prompted holding of the workshop. It is hoped this response will help the readers in having a clearer understanding of some of the issues that are being raised in connection with the elimination of riba from the economy.

The next verse completes the concept by clearly stating that your just claim is confined to the principal amount of loan and nothing in excess of that:

“If you repent, you can have your principal amount. Neither should you commit injustice nor should you be subjected to injustice.” (al-Qur'an, 2:279)

The Qur'an makes no distinction between loans given for consumption purposes or productive ventures. In fact, the Qur'anic reference to *hai'* (trade) in contradistinction to *riba* speaks volumes about the commercial nature of *riba*-based loans that the Qur'an forbids.

The Prophet (pbuh) and his companions have expounded and endorsed the above concept. Brief quotation from the late Mufti Muhammad Shafi from his article on *riba* in the *Urdu Encyclopaedia of Islam*, (Lahore, vol. 10, pp. 172-174) would substantiate the above submission:

(۱) یا ایہا الذین امنوا اتقوا اللہ و ذرو ما بقی من الربوا ان کنتم مومنین (۲ البقرہ

(۲۷۸

اسے ایمان والوں اللہ سے ڈرو اور رہا کی جو کچھ مقدار رہ گئی ہے اسے چھوڑ دو اگر تم مومن ہو۔

(۲) و ان تبتم فلکم رؤوس اموالکم لا تظلمون ولا تظلمون (۲ البقرہ ۲۷۹)
اور اگر تم توبہ کرو تو تمہاری (قرض کی) اصل رقم تمہارا حق ہے، نہ تم کسی پر ظلم کرو اور نہ تم پر ظلم کیا جائے۔

ان دونوں آیتوں میں رہا کی تمام رقم چھوڑ دینے کا حکم دیا گیا ہے، نیز تنبیہ کی گئی ہے کہ رہا کو چھوڑنے کا مطلب یہ ہے کہ قرض خواہ کو صرف قرض کی اصل رقم واپس ملے، اس سے زائد کچھ نہیں۔ دوسری آیت میں لا تظلمون ولا تظلمون کے ذریعے اس پت کی وضاحت بھی کر دی گئی ہے کہ اصل رقم پر ہر اضافہ، خواہ وہ کتنا ہی کم کیوں نہ ہو۔ قرآن کی نظر میں ظلم ہے، چنانچہ حضرت قتادہ بن دعامر اللہوسی اس آیت کی تفسیر میں فرماتے ہیں:

ماکان لهم من دیس فجعل لهم ان یاخذوا رؤوس اموالهم والا یزدادوا علیہ شیئ (ابن جریر، جامع البیان، مصر، ۲، ۶۷۱)

یعنی جس شخص کا کچھ قرض دوسرے پر ہو اس کے لیے قرآن نے اصل رقم لینے کی اجازت دی، لیکن اس پر ذرا بھی اضافہ کرنے کی اجازت نہیں دی۔ آنحضرت ﷺ کے ایک ارشاد سے بھی آیت کا یہی مفہوم سمجھ میں آتا ہے ابن ابی حاتم اور امام الشافعی نقل کرتے ہیں کہ

آپ ﷺ نے فرمایا:

الا ان كل ربا كان في الجاهلية موضوع عنكم كله، لكم رؤوس
اموالكم لا تظلمون ولا تظلمون، واول ربا موضوع ربا از عباس بن
عبدالمطلب كله (ابن كثير، مصر، ۱۲۵۶ھ، ۱۱، ۲۲۱)

سنو کہ ہر وہ ربا جو ایام جاہلیت میں واجب تھا تم سے پورے کا پورا ختم کر دیا گیا، تمہارے
لیے صرف قرض کی اصل رقم ہے، نہ تم غلام کرو، نہ تم پر غلام کیا جائے اور سب سے پہلے جو
رہا ختم کیا جاتا ہے وہ عباس بن عبدالمطلب کا رہا ہے، پورے کا پورا۔

(۳) صحابہ کرام کے متواتر عمل سے ثابت ہے کہ وہ سود کی ہر مقدار کو حرام سمجھتے تھے اور قرض
پر معاہدہ میں طے کر کے لیا جانے والا ہر اصلہ ان کے نزدیک رہا تھا، چند مثالیں درج ذیل
ہیں:

(الف) امام البخاری نے

كتاب القراض، باب اذا قرضت الى اجل مسمى
بين حضرت عبد اللہ ابن عمرؓ کا یہ قول دیا ہے:

قال ابن عمر القرض الى اجل لا باس به و ان اعطى
افضل من دراهم مالم يشترط (الصحيح، اصح المطابع
دہلی ۱۲۵۷ھ، ۱۱، ۲۲۲)

معیّن مدت تک قرض دینے میں کوئی حرج نہیں خواہ قرض وار اس کے
دراہم سے بہتر دراہم ادا کرے بشرطیکہ (یہ بہتر دراہم ادا کرنا) معاہدہ
قرض میں شرط نہ کیا گیا ہو۔ اس سے صاف ظاہر ہے کہ اگر معاہدے میں
یہ طے کر دیا جائے کہ قرض کے دراہم سے بہتر دراہم ادا کیے جائیں گے تو
وہ حضرت عبد اللہ بن عمرؓ کے نزدیک رہا ہیں داخل ہو کر حرام ہو گا۔

(ب) ابو بردہؓ سمجھتے ہیں کہ حضرت عبد اللہ بن سلامؓ نے مجھے نصیحت کی کہ تم ایک ایسی
سرزمین میں آباد ہو جہاں رہا بہت عام ہے، لہذا اگر کسی شخص پر تمہارا قرض
واجب ہو اور وہ تمہیں بھوسے، جو یا ہارسے کا کچھ بوجھد یہ دینا چاہے تو تم اسے
قبول نہ کرو کیونکہ وہ ربا ہے (الصحيح، مناقب عبد اللہ بن سلام، دہلی ۱۳۵۷ھ،
۱۵۳۸:۱)۔

حضرت عبد اللہ بن سلامؓ کا یہ حکم یا تو تقویٰ اور احتیاط پر مبنی ہے یا
پھر اس قسم کے نئے کام رواج اتنا ہو گا کہ اسے معاہدے کا جزو سمجھا
جانے لگا ہو گا، اس لیے تقویٰ قاعدہ "المعروف کالمشروط" کے مطابق انہوں
نے اس نئے کام کو بھی "ربا" قرار دیا۔ ہر حال اس سے اتنا ضرور ثابت ہوتا
ہے کہ ان کے نزدیک قرض پر لیا جانے والا ہر اصلہ "ربا" تھا۔

(ج) ایک شخص نے حضرت عبداللہ بن مسعود سے کہا کہ میں نے ایک شخص سے پانچ سو درہم اس شرط پر قرض لیے ہیں کہ اسے اپنا گھوڑا سواری کے لیے دوں گا، حضرت عبداللہ بن مسعود نے فرمایا کہ جتنی سواری وہ کرے گا وہ سود ہوگی (البیہقی: السنن الکبری، دارہ السلف، دکن ۳۵۱:۵، ۱۳۵۲)

(د) ایک شخص کے کسی پرہیز دارم واجب تھے، مقروض اس کے پاس بار بار مختلف تھے لاتا رہا، قرض خواہ ہمیشہ ان تھنوں کو بیچ دیتا، یہاں تک کہ تھنوں کی قیمت تیرہ درہم تک پہنچ گئی، قرض خواہ نے حضرت عبداللہ ابن عباس سے مسئلہ پوچھا تو انہوں نے کہا کہ "اب تم اس سے سات درہم سے زائد نہ لینا" (کتاب مذکور، ۱۵: ۳۵۰)

سنن بیہقی میں حضرت عمرؓ اور حضرت انسؓ کے بھی اسی قسم کے واقعات ذکر کیے گئے ہیں۔ اس قسم کی روایات سے یہ واضح ہو جاتا ہے کہ قرض پر ہر قسم کا اضافہ جو معاہدہ میں طے کر لیا گیا ہو عہد رسالت ﷺ اور عہد صحابہؓ میں "ربا الفسوسہ" شمار کیا جاتا تھا، بلکہ اہل تقویٰ کے نزدیک طے نہ کی ہوئی کوئی رقم یا تھن وصول کرنا بھی مذموم سمجھا جاتا تھا اور وہ شبہات سے بچنے کے لیے اس سے بھی پرہیز کرتے اور کراتے تھے۔

اس طرح قرآن و حدیث میں ادنیٰ طور و کھر سے یہ بھی واضح ہو جاتا ہے کہ "ربا" کے معاملے میں یہ بات قطعی غیر متعلق ہے کہ قرض کس غرض کے لیے حاصل کیا گیا ہے، عہد رسالت اور عہد صحابہؓ میں ہر قسم کے قرض پر اضافہ وصول کرنا "ربا" کہلاتا تھا اور اسے حرام سمجھا جاتا تھا، خواہ قرض کسی عام صرفی ضرورت کے واسطے لیا گیا ہو یا کسی تجارتی یا پیداواری ضرورت کے لیے۔ ہمارے زمانے میں بعض حضرات نے یہ خیال ظاہر کیا ہے کہ جو قرض تجارتی اغراض کے لیے حاصل کیا گیا ہو اس پر مقروض سے معین شرح پر سود وصول کرنا "ربا" میں داخل نہیں، کیونکہ عہد رسالت ﷺ میں صرف صرفی اغراض کے قرضے راجح تھے، تجارتی قرضوں کا رواج نہ تھا، یہ خیال درست نہیں۔

اول تو اس لیے کہ جب قرآن و حدیث اور آثار صحابہؓ کے رو سے "ربا الفسوسہ" کی یہ تعریف کہ ہر "وہ قرض جس پر معاہدہ کے ذریعہ کوئی اضافہ مقرر کیا گیا ہو" معین ہو گئی تو اس کے بعد یہ تحقیق بالکل غیر ضروری ہے کہ قرض کس مقصد کے لیے حاصل کیا جا رہا ہے اور اس میں تجارتی اور صرفی اغراض کا فرق ٹکانا قرآن و حدیث کے مفہوم میں ایک بے دلیل زیادتی کے مترادف ہے۔

Mawlana Sayyid Abul A'la Mawdudi has also discussed this concept in his book *Sood*, (Lahore, Islamic Publications Ltd, 9th edition, 1978, pp. 150-155). Similarly, a clear and definitive exposition of the concept is given in Dr Muhammad Umar Chapra's *Towards a Just Monetary System* (Leicester, The Islamic Foundation, 1985, chapter 2, pp. 55-66 and Appendix I, pp. 235-246). It may be added that Dr

Chapra was awarded on this book the Islamic Development Bank Award and King Faisal International Prize.

1.2. In economic terms, this means that Islam prohibits predetermined pricing of capital. Briefly, the Islamic position is that if a loan is given or taken for moral or humanitarian reasons, the principal amount should be protected and any excess on that is forbidden as immoral and exploitative. If loan or investment is made for economic reasons, then the owner of capital has no right to demand a fixed rate of return. One cannot legitimately ask for any additional payment without sharing the risk of business. Thus if a simple loan is advanced without risk-sharing, any additional payment, small or large, in excess of the original amount of the loan, constitutes riba and as such is forbidden.

1.3. As far as the question of riba on money-based transactions is concerned there has been complete unanimity on its prohibition throughout Muslim history. All major authorities have claimed *ijma* on this. (See Mufti Muhammad Shafi, *Mas'ala-e Sood*, and Shaikh Yusuf al-Qardawi, *Fawa'id al-Bunuk Heya al-Riba al-Haram*. Also see: the resolution of Islamic Fiqh Academy of India (1989) and resolution 3 of the Islamic Fiqh Academy of the OIC (December 1985). Even though there have been some dissenting voices, yet literature produced during the last 50 years bears witness to the fact that there is a near consensus amongst the ulma and the economists on the definition and concept of riba as given above.

This position has been acknowledged in an article on *Islamic Interest-Free Banking* by a leading economist working as assistant director, Research Department, IMF. The author says:

“Riba is the Arabic word for the predetermined return on the use of money. In the past there has been dispute about whether riba refers to interest or usury but there is now consensus amongst Muslim scholars that the term covers all forms of interest and not only “excessive” interest. Thus in ensuing discussion the term riba and interest will be used interchangeably, and an Islamic banking system will be one in which

a payment or receipt of interest is forbidden." (IMF Staff Papers, Vol 33 No 1, March 1986, pp 4-5)

1.4. Some people have made an effort to differentiate between interest and usury in the context of discussion on the nature of riba. Three caveats have been thrown into the debate:

(1) that riba means usury and as such interest, particularly bank interest, does not fall into the ambit of riba;

(2) that usury or riba relates to loans contracted by the poor and the needy persons for consumption purposes while interest constitutes reward on commercial, productive and profitable loans; and

(3) interest stands for a reasonable rate of return on capital while usury represents an excessive, exorbitant and exploitative rate of interest.

It is submitted that all the three premises are totally incorrect, theoretically inadmissible and empirically baseless.

1.5. There cannot be any economic or Shari'ah justification for confining riba to usury and excluding interest from its jurisdiction. As far as economic analysis is concerned there is no technical difference between interest and usury. Whether we look upon the phenomenon from the demand side of economic analysis or the supply side, the rationale developed in economic theory for interest and usury are the same. If it is a reward for waiting or time-preference, there cannot be any differentiation between interest or usury. If the question is examined from the productivity approach, again there cannot be any differentiation between the two. That is why whatever differentiation has been introduced in the literature comes mostly on moral grounds alleging that one is high and exorbitant (usury) and the other is low and as such reasonable and secondly that usury deals with loans to the poor for consumption purposes while interest deals with profitable commercial advances. There is no economic substance in any of these excuses.

As far as Islam is concerned it has laid down very clear

and precise criteria: if the loan carries a predetermined fixed reward related to time of loan-use and decided upon as a condition of loan it is riba, pure and simple. There is no difference between consumption loan or production loan or high rate or low rate or loan taken by a poor person or rich. Both the caveats are inadmissible. Interestingly enough, the Shari'ah and economics have no quarrel on this count.

William L. Miller, drawing upon J.M. Keynes, defines interest in *A Dictionary of the Social Sciences* (London: Tavistock Publications, 1964, p. 341):

"Interest, in economics, denotes the price or rent paid on money in exchange for the use of a sum of money, the premium, obtained on current cash over deferred cash. (J.M. Keynes, 'The Theory of the Rate of Interest', *The Lessons of Monetary Experience: Essays in Honour of Irving Fischer*, ed. by A.D. Gayer, London, Alen and Unwin, 1937, p. 145)."

Don Patinkin, a leading British authority on monetary economics, explains interest as follows:

"Interest usually originates in the payment for a loan of money over a period of time — although it can also arise from loan in kind. Interest is essentially measured by the difference between the amount that the borrower repays and the amount that he originally received from the lender (which is called the principal)." (Article on "Interest", *International Encyclopaedia of the Social Sciences*, London, 1968, vol. 7 & 8, p. 471.)¹

This differential between the amount received by the borrower and the amount paid by him is interest. And that is exactly what riba is, notwithstanding the rate of interest or the use of borrowed funds.

Historically, interest and usury were always treated as one and the same thing. It was only in the post-Christian, post-

¹ See also Don Patinkin's major work: *Money, Interest and Prices*, Evanston, IU, Row, Peterson, 1956; Allred Marshall, *Money, Credit & Commerce*, London, Macmillan, 1923; D.H. Robertson, *Essays in Monetary Theory*, London, P.S. King, 1940.

Renaissance period of European history that the term interest was used as a substitute for usury to wriggle out of the religious and moral prohibition.

Henry W. Spiejel, in his entry on "usury" in *The New Palgrave: A Dictionary of Economics* (London, Macmillan, 1987, vol. IV, p. 769) says:

"Usury, in the scholastic economic thought of the Middle Ages, referred to a lender's intention to obtain more in return than the principal amount of the loan. As a general rule this meant that any interest-taking was usurious and forbidden, whereas in modern parlance only exorbitant interest is considered usurious."

Raymond De Roover tries to clarify the confusion about interest and usury in his article on "Economic Thought: Ancient and Medieval Thought", in *International Encyclopaedia of the Social Sciences* (London, 1968, vol. 3 & 4, p. 434):

"A great deal of misunderstanding exists about usury. According to modern concepts, usury is an exorbitant, oppressive interest rate; but definition given by the schoolmen was quite different. Usury was any increment, whether excessive or moderate, beyond the principal of a loan."

This is also supported by Professor Hany who has this to say about usury in *History of Economic Thought*:

"The term was used to cover what we designate as interest, and in a broader sense, to include any price in excess of the *Justum pretium: qui plus quam dederit accipit, usures expelit* — he who receives more than he gives, demands usury... As late as 1311 it was declared absolutely illegal. The broad simple ground for this action was the belief that to take interest for a loan of money was, like charging more than the just price, unjust." (p. 101).

Encyclopaedia Judaica also makes the following observation:

"The prohibition on interest is not a prohibition on usury in the modern sense of the term, that is, excessive interest, but of all, even minimal interest. There is no difference in law between various rates of interest, as all interest is prohibited." *Encyclopaedia Judaica* (Jerusalem, 1972, vol. 16, p. 28)

As to the Islamic view, leading western scholars have also accepted that riba covers both interest and usury. T. B. Hughes in *A Dictionary of Islam*, (Lahore, Premier Book House, 1985 reprint, p. 544) defines riba as follows:

Riba/Usury. A term in Muslim law defined as an excess according to a legal standard of measurement or weight, in one or two, homogenous articles opposed to each other in contract of exchange and in which such excess is stipulated as an obligatory condition on one of the parties without any return.

Andy Mullineux of the University of Birmingham discusses the concept of interest in the context of the current debate in the Muslim world. Three short extracts from this entry on "Interest" in *The Social Science Encyclopaedia* (edited by Adam Kuper and Jessica Kuper, London, Routledge & Kegan Paul, 1985, pp. 405-406) are as follows:

"The charge made (or price paid) for the use of loanable funds is called interest. The rate of interest is the amount payable, usually expressed as a percentage of the principal sum borrowed, per period of time, usually, per month, quarter or year.

"The reasons for condemning interest rate charges, given by the fundamentalists include: their role in reinforcing the accumulation of wealth in the hands of the few, and thereby reducing man's concern for fellow man; the fact that Islam does not permit gain from financial activity unless the beneficiary is also subject to risk of potential loss; and that Islam regards the accumulation of wealth through interest as selfish compared with that accumulated through hard work...

“The rate of interest, being the contractual income expressed as a percentage of the nominal value of the security, is to be differentiated from the yield of a security which is a percentage relationship of its income to its current market price.”

Let us sum up the above discussion by clearly identifying what Islam has forbidden, i.e. any premium or excess, small, moderate or large, contractually agreed upon at the time of lending money or loanable funds, fixed as rate or datum for the use of money or loanable funds over a period of time, is riba. And this is what has been described as interest or usury in economics and banking over the centuries.

1.6. The distinction between consumption loans and commercial loans or loans taken by the poor or by the rich can have no basis in economics. Economics is not concerned with the end-use; it is concerned with the facts of:

- waiting and sacrifice or call it liquidity-preference;
- lending; and
- expected usefulness or productivity of the funds lent.

Morality and religion are concerned about the end-use as well as the quality of the user (poor or otherwise), not economics, as it has been developed in the western tradition. Islam is concerned with ethics as well as economics. That is why it has provided for helping the poor and the needy, in the form of *sadaqaat* as well as *qard-e-hasan*, one is outright gift, the other a loan without interest. But if funds are to be utilised for commercial purposes, then they should be advanced or borrowed on the basis of equity-sharing or profit-sharing. This would negate the possibility of a predetermined fixed interest and open up the avenues for variable rate of return on capital's actual productivity and profitability. Instead of a fixed and assured return from an anticipated gain, there would be a variable return, based on actual performance of the project or investment.

1.7. The question of the volume of the rate of return, i.e. interest being 'moderate' and usury being 'exorbitant and oppressive' is also irrelevant. Every predetermined excess on loan is looked upon by Islam as unjust. Empirical evidence

on this count is also very revealing. Rates of interest have varied between 0.1 percent to over 10,000 percent in different periods of time. What was looked upon as 'exorbitant' at one time was regarded as 'normal and moderate' at another time. A very interesting study has been made by Sidney Homer on interest rates called *A History of Interest Rates* (2nd edition, New Brunswick: Rutgers University Press, 1977). The author comes to the conclusion:

"A bird's eye view of the history of interest rates will unsettle most preconceived ideas of what is a high rate or a low rate or an average rate. Each generation tends to consider normal the range of interest rates with which it grew up; rates much higher suggest a crisis or seem extortionate, while rates much lower seem artificial or inadequate. Almost every generation is eventually shocked by the behaviour of interest rates because, in fact, market rates of interest in modern times have rarely been stable for long. Usually they are rising or falling to unexpected extremes. A student of the history of interest rates will not be surprised by volatility. His backward-looking knowledge will not tell him where interest rates will be in the future, but it will permit him to distinguish a truly unusual level of rates from a mere change.

"It is easy enough to cite seemingly fanciful interest rates. In fact, we do not have to look beyond our own century to find the highest and lowest rates in the entire span of this history: 10,000 percent high in Berlin; .01 percent low in New York. Both rates were quoted on standard money-market credits under very unusual circumstances. This is a range of one million to one.

"Hammurabi's legal limit of 20 percent per annum on loans in silver cannot be usefully compared with today's money-market interest rates. It was well above twentieth-century rates on prime business loans, savings bonds, savings deposits and the like, but was below 30-42 percent per annum legal limits and actual charges in many states of the United States for small personal loans. It will be very diffi-

cult, throughout this history, to compare like rates with like rates. There are more types and varieties of credit contracts in ancient and modern history than are dreamed of in the philosophy of the modern bond salesman." (p.6)

The variety of interest rates is baffling even today. Current interest rates (December 1992) in Switzerland (Swiss franc) are 2-3 percent, in Germany for D-mark are 8-10 percent, for \$ in the US are 4-5 percent, for pound sterling in the UK are 10-14 percent, for Turkish lira are 70-80 percent and in some of the Latin American countries and Israel have been (1980's) from 200 percent to 1,000 percent per year. Even in the UK, base rate is 7 percent, but market rate is between 10-14 percent. Rates on credit cards are from 24 to 36 percent. The whole idea of relating rate-differential to interest and usury has no theoretical or empirical basis in economics.¹

Riba and Contemporary Transactions

What is the true scope of the transactions to which the bar of riba is applicable? Can the term riba be also applied to the commercial or productive loans advanced by the banking and financial institutions and to the interest charged thereon?

2.1. All transactions, commercial or non-commercial, individual or corporate, private or public, which involve a predetermined rate of return on loan, in money or kind, fall within the scope of riba and as such are forbidden. Advances, loans and interest-based financial instruments used by banking and financial institutions are forbidden in Islam and as such Islamic banking must evolve alternate instruments of financing. Muslims have evolved dozens of such instruments in their business transactions during the last 14 centuries. The State Bank of Pakistan circular 13 dated June 20, 1984, entitled "Elimination of Riba from the Banking System" contains some of these modes. A revised version of the same is included as appendix to the Report of the Prime Minister's

¹ For further reading, see (i) Dr Umar Chapra, *Towards a Just Monetary System*, chapter 2, The Nature of Riba, pp. 55-66 and Appendix I-A, pp. 235-246 and Appendix I-B. (ii) Muhi Muhammad Shafi, article on riba, *Urdu Encyclopaedia of Islam*, Appendix-II.

Committee on Self-Reliance. Pakistan Economic Survey 1984-85 devotes a full chapter to this subject. I hope the government and the State Bank remain committed to that position as no new "revelation" is expected to have come from high heavens ever since!

It is very significant that the Qur'an prohibits riba and permits trade in one and the same verse (al-Qur'an, 2:275). This provides internal evidence on relevance of riba for commercial and production loans. There is incontrovertible evidence that commercial transactions were part of the economic life of Arabia during the life of the Prophet (pbuh) and he enforced ban in case of riba on both types of transactions. The riba on loans given by the Prophet's uncle was abrogated by the Prophet (pbuh) in his farewell address. These loans were commercial loans given to Bani Saqeef (see: Mufti Muhammad Shafi, *Masala-e Sood* and article on riba in the *Urdu Encyclopaedia of Islam*; Sayyid Mawdudi, *Sood*; pp. 239-300). Article on riba in the *Shorter Encyclopaedia of Islam* (Leiden, Brill, 1953) begins with the following:

"Riba - lit increase, as a technical term, usury and interest, and in general any unjustified increase in capital for which no compensation is given. Derivatives from the same root are used in other semitic languages to describe interest.

"Transactions with a fixed time and payment of interest as well as speculation of all kinds formed an essential element in the highly developed trading system of Mecca." (p. 471)

Any effort to exclude fixed increase on commercial or productive loans as outside the pale of riba is conceptually unacceptable, historically untenable and morally outrageous and rebellious.

2.2. It is to be realised that modern capitalistic system is based on the institution of debt. Both consumer economy and productive economy are debt-ridden. Islam on the other hand allows loan-giving and loan-taking under certain circumstances on ethical and philanthropic grounds. Islam does not visualise an economy that is debt-based. For the consumer,

Islam wants every individual to live within his means and desires the society to ensure that everyone is given a just wage, which is enough to fulfil genuine needs of a family.

The whole concept of a debt-based economy is alien to Islamic approach and as such the model of economy which is to be evolved under an Islamic aegis would be equity-based. Self-financing, cooperative financing, indirect financing and financial intermediation have a role to play in an Islamic economy yet all of them have to be on the basis of risk-sharing and not on the basis of a predetermined fixed return. What is forbidden in Islam is this fixed and predetermined return for one factor. Variable return on the basis of actual productivity and profitability of a venture is perfectly legitimate. As such it deserves to be emphasised that the view that the price of capital in an Islamic economy is zero is erroneous. Capital has a price and this is to be determined in the light of the real productivity and profitability of capital. However, there cannot be a predetermined fixed price of capital. As such all modes of financing have to be risk-sharing and consequently profit-and-loss sharing.

Recently, an Egyptian scholar has tried to differentiate between consumption loans and bank loans. But the fallacy of this approach has been thoroughly exposed by over a hundred ulema of Al-Azhar, and the most profound rebuttal has come from Shaikh Yusuf al-Qardawi, in his book: *Fawa'id-al-Bunuk Heya al-Riba al-Haram*, Cairo, Dar al-Sahwa lil Nashr wa al-Tawzih, and Dar ul Wafa, 1992.

Pakistani banks and some financial institutions finance their clients on the basis of "buy-back on mark-up" agreements. According to this method, the client of the bank purports to sell a particular commodity to the bank and simultaneously buys it back on a higher price on deferred payment basis. A certain rate of mark-up (percent per annum) is applied to the second sale. Does this arrangement fall within the ambit of riba?

Murabaha (cost-plus financing) and *bai' mu'ajjal* (sale with deferred payment) are permitted in the Shari'ah under certain conditions. Technically, it is not a form of financial mediation but a kind of business participation. The Shari'ah assumes that the financier actually buys the goods and then sells them to the

client. Unfortunately, the current practice of "buy-back on mark-up" is not in keeping with the conditions on which *murabaha* or *bai' mu'ajjal* are permitted. What is being done is a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Shari'ah injunctions.

While I would not venture a *fatwa*, as I do not qualify for that function, yet as a student of economics and Shari'ah I regard this practice of "buy-back on mark-up" very similar to *riba* and would suggest its discontinuation. I understand that the Council of Islamic Ideology has also expressed a similar opinion.

Riba and the Non-Muslim World

Is there any difference between a Muslim and a non-Muslim in the matter of prohibition of *riba*? Can the prohibition of *riba* be extended to the loans obtained from non-Muslim, or for that matter, from Muslim foreign countries whose laws and national policies, together with international monetary laws and policies, are not within the control of the state of Pakistan?

4.1. To the best of my knowledge and belief, the Shari'ah does not differentiate between a Muslim and non-Muslim in the matter of prohibition of *riba*. It had been a Jewish practice that interest or usury was forbidden amongst the Jews yet a Jew could charge interest from a "gentile". The far-reaching consequence of this kind of duplicity and discrimination have been explored in an interesting study, *The Idea of Usury: From Tribal Otherness to Universal Brotherhood*. This type of discrimination is abhorrent to Islamic moral values. Islam regards interest as exploitative (*zulm*) and prohibits it amongst the Muslims as well as between Muslims and non-Muslims. In fact, Islam wants to build a just economic order for the well-being of all human beings: a new model for the mankind.

4.2. As far as the Islamic state is concerned, *riba* should be forbidden by law and as such would be a part of the public law, binding on all Muslims and non-Muslims, residents and non-residents, citizens and aliens, doing business within

the Islamic state, or with the Islamic state. Even in Saudi Arabia today, all interest-based agreements including those between Saudis and foreigners are not enforceable through courts of law, as technically, interest is forbidden and this ban is part of the law of the land.

4.3. There cannot be any justification for interest in international monetary dealings only because interest is permitted in the legal system of other countries and states. The question of their monetary laws being or not being under the control of the State Bank of Pakistan is irrelevant because these dealings are voluntary and optional. However, I do not rule out circumstances in which a Muslim individual firm or state might find it totally unavoidable to deal with foreigners, individuals or corporate bodies, which refuse to deal on our terms and conditions and as such in such situations there can be certain cases where under the law of necessity for a certain specified transitional period, transactions of a certain character, despite the fact that they involve interest, may be condoned or tolerated but this has to be as an exception specifically provided for and also only under certain clearly identified circumstances and subject to some specific conditions. *Iztiyar* cannot be used as an excuse to open the flood-gate of interest-based relations with the outside world. The whole question of international transactions, commercial as well as financial, has to be re-examined in great depth and with great sensitivity.

It may, however, be mentioned in passing that the FSC judgement on *riba*, which is presently under appeal, to the best of my knowledge and belief concentrates on the domestic economic issues, and the laws which have been affected by the judgement also are mainly concerned with the economy of the country and not with the problems of international financial transactions and capital movements.

The Government of Pakistan and some Institutions under its control acquire loans by issuing bonds, certificates, etc. and pay a fixed period-wise profit to the holders of such securities. Does this *profit* fall within the definition of *riba*?

To the best of my knowledge and belief these bonds and certificates are *riba*-based and the use of the term *profit* in their

context is a misnomer, in fact a misuse of the term.

Riba, Inflation and Indexation

It is evident that the value of the paper currency has a trend of decrease in the inflationary situation. If a debtor who has borrowed a particular amount of paper currency repays the same amount to his credit after a substantial time, the creditor can suffer the effects of inflation. If he demands his debtor to pay more in order to compensate him for the loss of value he has suffered, can this demand be treated as a demand of riba?

6.1. This is a very complex issue. The real cause of erosion in the value of money is to be sought in the wrong monetary and economic policies which result in wide deviations from a state of price stabilisation. One of the major objectives of Islamic monetary policy is stabilisation of the value of money. In the Islamic context, money is primarily a medium of exchange and a measure of values. It is also a measure for deferred payment and as such its value has to be protected.

6.2. There is no substance in the thesis that interest is a reward for erosion of the value of money. The discussion in economics relating to the nominal rate of interest and the real rate of interest must not confuse us, because rationale for interest is one thing and the phenomenon of inflation and various ways to reduce, if not to mitigate, the evil consequences of inflation is a different matter altogether. While the challenge from inflation is a real issue, it should not be mixed up with the problem of interest which is multidimensional and must be addressed to separately in its own right. It is illogical to argue in favour of interest on the basis of inflation. Indexation is one of the many ways suggested to fight some of the effects of inflation but the results of such a policy are mixed and inconclusive, if not adverse. In fact, a lot of empirical evidence about movements in interest rates and rates of inflation leads to conflicting hypotheses. It is difficult to find out a positive correlation between the two in all parts of the world and even in the same country over a long-period time horizon. That is why under a regime of inflation even negative rates of interest have prevailed over certain time pe-

riods. The trends that emerge from empirical and econometric studies remain inconclusive, if not erratic. The remedy for erosion in the value of money lies in a monetary policy aimed at price stabilisation and not in bringing in the red-herring of interest. If in an inflationary situation there can be any "justification" for asking the debtor to pay more in order to compensate the creditors for the loss of value of money why the same should not be applied in the case of deflation and ask the borrowers to pay less? Moreover, why shouldn't there be an equal concern for the consumers, wage-earners, pensioners who suffer even more than the creditors in periods of inflation? Why this selective concern?

6.3. The issue of indexation has been dragged into this controversy over interest, but the two represent independent situations and should not be confused. Moreover, limited indexation would produce new anomalies and inequities and total and overall indexation proves meaningless over a medium and long period. As such all the evidence based on indexation experiments in different parts of the world suggest that the remedy does not lie in indexation but in curing the disease at its source, that is, monetary policy geared to price stabilisation.

Riba Elimination and Foreign Loans

If all the forms of interest or mark-up are held to be repugnant to the Islamic injunctions, what modes of financing do you suggest for: (a) financing trade and industry; (b) financing the budget deficit; (c) acquiring the foreign loans; and (d) similar other needs and purposes?

7.1. I am submitting two short studies which shed light on modes of financing in an Islamic framework: *Islamic Banking* by Abdur Rahim Hamdi and *Islami Bankari: Nazariyati Bunyadain awr Amlī Tajurbat* by Prof Ausaf Ahmad. These two documents¹ cover problems of financing raised in (a) and (d).

7.2. As far as (b) is concerned, budgetary deficit is not a

¹ The two studies have been published by the Institute of Policy Studies, Islamabad, 1993.

healthy policy and good economic management must ensure mobilisation of resources enough to meet the genuine needs of the society and state. Proper control on expenditure and mobilisation of resources with equity and accountability would ensure balanced budget. In certain circumstances and for certain time horizons budgetary deficit can be met through what is known as 'deficit financing'. This must be under the limit of the rate of growth in the economy to ensure that it does not have inflationary consequences. All efforts to finance budgetary deficit by interest-based borrowings have been a failure. Even the richest countries of the West are now groaning under mountains of debts and are not finding easy solutions. The US is the most indebted country today. Its domestic debt has crossed the limit of \$3 trillion with annual interest payments coming to \$290 billion. This debt mountain has grown in the 20th century only, as in the year 1901, America's total domestic debt was only \$1 billion. As such, a sane economic policy for an Islamic country, rich or poor, would be one based on "living within means."

7.3. As to item (c), even international financial dealings should not be on the basis of interest-based loans. Resources can be contracted on the basis of venture capital and risk-sharing deals. There is a vast scope for these and even non-Muslim western bankers and economists are hopeful about the potential of this new mode of relationship. Turkey, a secular country, has promoted the entire Bosphorus Bridge Project (around \$1 billion) on the basis of participatory capital as against interest-based loan. In fact, the equity-based modes of financing have been under consideration of the World Bank, IFC and other financial institutions. A study by the Development Centre of the Organisation for Economic Cooperation and Development of the European countries (Paris) has discussed this issue. A few paragraphs:

"Interest-free banking is a novel form of finance. Even sceptics have accepted that Islamic banks are not merely trying to give interest another name and that legal instruments within the framework of Shari'ah exist which permit profitability on a different, albeit Koranically acceptable basis.

"About 20 percent of the world's population is

Muslim, many of whom are devout. They would prefer to be sure that their financial affairs are in line with the precepts of Islam, but as is only natural, wish to earn legitimate profits. Here lie opportunities for Islamic banks, both in mobilising and utilising funds.

“The establishment of many new Islamic financial institutions in all parts of the Muslim world has shown that banking according to the principles of Shari‘ah is not only feasible, but also profitable.”

[*Arab and Islamic Banks*, Trante Wohls Scharf, OECD, Paris, 1983, p. 90]

“If the South proposes now, with Islamic banking principles, a new concept of socioeconomic interaction (profit-sharing systems, focus on small- and medium-sized innovative entrepreneurs, with the major objective of economic asset creation, etc.) it could be a contribution to cooperation concepts so far mainly propounded by the countries of the industrialised world.

“Islamic banking is trying to change the relationship between finance on one hand and industry and commerce on the other. This new relationship is the basis of the Islamic economic system being set up. Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic asset creation.

“Islamic banks could make a useful contribution to economic growth and development, particularly in a situation of recession, stagflation and low-growth levels, because the core of their operations is oriented towards productive investments. All countries, both in the North and in the South, need more venture capital. Loan capital is available, particularly in industrialised economies, but at high interest rates. However, even medium-scale entrepreneurs there find it difficult to raise sufficient risk capital for expansion and innova-

tion. This has acted as a brake on productivity and economic growth in the North. Thus, practical and immediate cooperation possibilities exist between Islamic banks and enterprises all over the world. The intermediation process remains to be fully developed."
[ibid, p. 94-95]

Strategy for Elimination of Riba

If you are of the view that all the forms of interest are prohibited by Shari'ah, then what procedure will you suggest to eliminate it from the economy? Will you go for a total switchover instantly, or will you propose a gradual process keeping in view the national economic requirements? If you prefer a gradual process, what strategy do you suggest for the purpose which may fulfill the requirements of the Qur'an and Sunnah?

8.1. This is very important yet very sensitive issue. The prohibition of interest in the Holy Qur'an and Sunnah has been made in such terms that dealings in interest have been described to be war against Allah and His Prophet (pbuh). The crime is so obnoxious that its toleration does not fit into any Islamic scheme of reform. Experience also shows that so-called gradual approaches have only proved excuses for continuity of a system that involves Allah's wrath. There was a clear commitment in the constitution of 1956 that riba shall be eliminated from the economy. A commission was also formed to bring within a period of seven years all laws into conformity with the Qur'an and Sunnah. Even before that, State Bank of Pakistan had established a research department (July 1948) to see how interest could be eliminated and an Islamic economy established. The constitutions of 1962 and 1973 also provided for elimination of riba. In 1979, a three-year limit was prescribed which was extended to 10 years. Yet very little effort was made to change the system. All the reports of the Council of Islamic Ideology, starting with Allama Alauddin Siddiqui's report in 1962 to the 1980 Report on Elimination of Riba from the Economy have unequivocally demanded elimination of riba and have also given very reasonable practical suggestions for switchover to a riba-free economy. Yet, one is constrained to say that all these years gradualism was used only to avoid serious and

sustained effort to bring the system in conformity with Islam. How long are we going to play with Allah's injunctions and our own commitments to the nation?

8.2. I am also aware that we are dealing with a problem that is the result of almost 200 years of foreign rule and a lot of our own mis-rule. As such it is my humble submission that while domestic economy may be cleansed of all forms of interest within a period of one year or so, international transactions may take longer, say two to three years. But I am afraid of making the above suggestion only because in the past such time-based transitional paths have been misused and even abused; they were used as a cloak for inactivity and inaction. There cannot be any justification for that. It was in this context that the committee on self-reliance examined this issue very carefully and came to the conclusion that a radical departure from the past practice was essential. Some kind of a shock treatment to the economy is required. The possibility of a very clearly laid-down transitory path was suggested by the report in respect of the domestic as well as international economic arrangements. But *iztirar* (rule of necessity) cannot be allowed to be invoked to avoid and frustrate the process of Islamisation.

If all the transactions based on interest are held to be violative of the Islamic injunctions, what will be the treatment of the past transactions and agreements? Especially, what procedure should the government adopt with regard to the previous foreign loans?

9.1. Different strategies would have to be developed for the liquidation of domestic debts and international debts. Similarly, intergovernment debts, interpersonal debts and debts between individuals and state would have to be treated differently. Detailed programme of debt-liquidation through (a) debt-remission; (b) rescheduling and restructuring of debt liabilities; and (c) debt-equity swap can be developed. This issue was also examined by the self-reliance committee. Some extracts from the report:

The second area of action recommended by the committee is the passage of a comprehensive self-reliance act by the parliament which would lay down the pattern on which economic transactions would be con-

ducted by participants in the economy. It is the diagnosis of the committee that the private sector is by and large self-reliant. It is the government which provides a framework which leads to private-sector inefficiency. It is the government which would face the greatest difficulties in the adoption of self-reliant ways.

These ad hoc arrangements and irrationalities that the government has been led to create have been the result of the absence of durable political and legislative mechanisms for arriving at consensus on decisive issues. We propose, therefore, that legal and institutional arrangements be put in place to enable the government to remove these irrationalities, function more responsibly and take decisions under a more transparent system of decision-making.

Of these, the central recommendation relates to the passage of a self-reliance act. The motivation, rationale and potential impact of this proposal may therefore be spelt out briefly.

Under the Act, unless otherwise specified, with effect from July 1, 1991:

1. The government would not contract interest-based debt, nor accept grants to which any conditionality is attached, except in conditions of war or national emergency, in which case the government would seek the consent of the national assembly. In case of foreign debt, the effective date would be July 1, 1993.
2. Nor would private persons be allowed to contract interest-based debt. In case of foreign private debt, the effective date would be July 1, 1993.
3. The government will establish a mutual fund based on government-held shares of selected public sector enterprises. The fund shall be managed by an independent group of portfolio managers who for the first three years

shall be appointed by government; subsequently, the management of the fund will be chosen by the certificate holders.

4. On the respective effective dates, all principal and interest accrued until the last day on all previous interest-based loans shall become due and repayable; this amount may be settled as follows:
 - a. *Government may immediately begin negotiations on all existing foreign debt, both public (civil and military), on a bilateral and non-interest basis. In so doing the loans bearing nominal service charges will be segregated.*
 - b. *After the effective date, the new foreign capital may be contracted on a non-interest basis.*
 - c. *The existing domestic public debt, other than intergovernment debt, shall be settled by the issue of share certificates in the amount of the debt obligation in the debt retirement (mutual) fund.*
 - d. *All intergovernment debt will be converted into a non-interest bearing debt.*
 - e. *Parties to existing domestic private debt shall be given six months (or some more time) from the commencement date to renegotiate, on a one-time basis, fresh non-interest-based contracts with retrospective validity.¹*

The proposed measures will immediately pose a problem of settlement of outstanding debt. This obviously will affect both public and private sectors. In each case what is needed essentially is to either retire

¹ Some members were of the view that the timing of the proposed changes may pose difficulties in implementation, given the presence of a deficit in the current account, which should be eliminated at the earliest. It was also feared that, given the poor foreign exchange resource conditions, the private sector may not be able to cope with the elimination of interest-based debt. Hence, at least for the time-being, the private sector should be exempted from this provision.

the debt or convert it into an interest-free liability, such as equity. To be sure, in every case where the stock of debt is supported against a portfolio of assets, the stock can be converted. Where this is not possible the debt must be retired within a stipulated time. In this section we discuss in detail various kinds of debts that need to be settled and the alternative methods which can be used for this purpose.

FOREIGN PUBLIC DEBT

As on June 30, 1990, the total outstanding and disbursed foreign debt amounted to Rs 345 billion (\$15.67 billion)¹. The composition of this debt is biased in favour of consortium countries which account for some 86 percent of this amount. However, within the consortium, the debt is fairly diversified with USA holding 23 percent, Japan 14 percent, West Germany 10 percent, multilateral agencies 42 percent, and the rest is held by Belgium, Canada, France, the Netherlands, Italy and UK.

Given the amount of uncertainty involved in settling the matter with the foreign creditors, a variety of scenarios need to be constructed to meet the likely contingencies. In fact, the response of foreigners would depend in large measure on how they perceive our motives. As we will show below, the proposed measures should not pose much difficulties for the foreigners as they are not designed to evade our obligations towards them. It is intended in the perspective of moving towards a self-reliant way of life and hence has no ultra motive, such as a ploy for defaulting on the debts owed by the country.

To ease the process and to ensure that there are no disruptions in economic relations with our creditors, the committee felt that some preparatory time should be given to the government in which it will negotiate with the foreigners, on a bilateral basis, an interest-free-repayment for the existing debt. Unlike the domestic debt, which is proposed to be eliminated with

¹ Now this has increased to approximately \$18 billion.

effect from July 1, 1991, a two-year preparatory period is given for achieving this goal in the case of foreign debt. It is proposed that a committee be formed that would hold negotiations with the foreigners.

Thus, on the effective date all the principal and interest will become due and payable, unless converted into an interest-free obligation. The period of two years is hopefully sufficient to arrive at an alternative basis. There will be no restrictions on capital movements if they are done on the basis of non-interest arrangements.

The elimination of interest-based transactions merely amounts to exclusion of a financing instrument from the market and does not imply a restriction on financing activities.

Moreover, the practice of doing banking on a non-interest basis has now come of age. There is considerable evidence to suggest that foreigners will deal with us on a non-interest basis. In this regard the following factors may be taken into account:

- a) In a report (No. IFC/P-887, dated December 22, 1987) to the board of directors of the International Finance Corporation (IFC), an affiliate of the World Bank, on a proposed investment in the Hala Spinning Mills, the president of IFC (and the World Bank) observed that: "A change to Islamic modes of financing has been considered by IFC but this would be contrary to the government (of Pakistan)'s intentions for foreign loans. Adoption by a foreign lender of Islamic instruments could be construed as undermining government's policy to exempt foreign lenders from this requirement." In the same report, the IFC noted with concern the constitution's Islamic provisions, but recorded that: "We have been advised by senior government officials that steps will be taken to rectify this situation and in all probability a constitutional amendment would be brought forward."

- b) The interest of foreigners in Islamic financing methods is also reflected in the amount of research that the International Monetary Fund is currently undertaking in this area. Recently, the IMF board has also discussed the possibility of its participation along these lines.
- c) Most importantly, the world at large is discovering that the only viable solution to the world debt problem is either a write-off (French President Mitterrand reportedly proposed in June 1988 that one-third of low-income LDC debt should be written off) or its conversion into some kind of equity (a large market in "debt-equity swaps" has already developed and is growing rapidly.)

A number of options are available which can form the basis of renegotiating external debt by the proposed committee, as well as to mobilise resources for cases where conversion may not be feasible. The most significant of these methods is the debt-equity conversions being used extensively by countries facing foreign debt problems. One such method, known as "debt-equity swaps", requires the debtor country to allow a foreign investor to purchase its debt from the creditor at a discount and convert it into local currency for purchasing a local equity-based asset. Typically, the creditor is willing to sell the debt at a discount thus allowing the investor to obtain a discount on purchase of the local currency. The scheme could be preferentially offered to any nonresident Pakistani with foreign holdings, on a simple conversion basis.

Here, a marginally higher exchange rate could be offered to resident purchasers of debt obligations. In addition, no restrictions should be placed on the use of local currency obtained through the conversion. A variant of the scheme could also be offered to resident importers who could mobilise foreign exchange earnings from abroad.

Another source of foreign resources could be disinvestment of shares of public-sector corporations to

resident and nonresident Pakistanis in foreign exchange. Such receipts would be particularly useful in releasing the pressures on foreign exchange resources.

Finally, the creditors can be asked to convert their debt into equity in those projects where the funds are used. This is quite feasible as a sizeable amount of foreign debt has been used for on-lending to private sector through the financial system. Hence, the debt is supported by a portfolio of assets, which can allow a conversion into equity.

DOMESTIC PRIVATE DEBT

This kind of debt is contracted by private parties. Private sector and public enterprises' borrowings from commercial banks and development finance institutions (DFIs) constitute bulk of this debt. A limited amount of such debt also consists of transactions between private parties, such as directors' loans, etc. After the implementation of measures during 1979-85, such borrowings (excluding foreign currency loans) are contracted on the basis of one of the 12 modes of financing approved by the State Bank of Pakistan. The ulema have raised specific Shari'ah objections to these modes of financing. Thus it appears that this kind of debt will pose major restructuring problems. However, we contend that this type of debt is the easiest to settle along interest-free lines.

Given the fact that consumption loans are rare in the country, the entire private debt is supported by a corresponding portfolio of assets. Hence, a conversion of this debt is quite feasible. It is proposed that parties to such contracts be given one month to convert them into one of these modes. The foreign currency loans would be settled on the basis of overall settlement of foreign debt, as discussed above.

DOMESTIC PUBLIC DEBT

Domestic public debt is categorised in a number of ways. The category useful for our purposes is in terms of the holder of such debt. Thus public debt consists of debts between persons and entities, and

between governments and banks, including the State Bank of Pakistan. Since in each of these cases a different method of settlement is needed we discuss them separately.

INTERGOVERNMENTAL DEBT

These loans are rarely contracted on an economic basis nor are such considerations relevant in their settlement. Therefore, it is quite feasible to convert such loans on an interest-free basis. A rationing scheme could be developed in the context of an award by the National Finance Commission.

BANK LOANS TO GOVERNMENT

These consist primarily of government borrowing from banks, including from State Bank of Pakistan, against treasury bills. The government's transactions with the State Bank are of a book-keeping nature. It is proposed that government would no longer pay interest on State Bank holdings of treasury bills; future borrowing will continue as before except that it would be on an interest-free basis. Insofar as other banks are concerned, existing government debt will have to be settled by provision of new non-interest-bearing government paper, which will be redeemed by the State Bank over a five-year period. This essentially amounts to creating additional reserves of the banks with the State Bank which will be released over a five-year period. Accordingly, no undue inflationary pressures will be developed in the economy. This will also be profitable to banks as, in return for losing interest on this debt, its low-yielding funds (government pays substantially lower interest rates on these bills relative to its other borrowings) will be gradually released which could be subsequently used for more profitable investments.

After the commencement day of the ordinance, no new borrowing from banks [except the State Bank] will take place. The commodity operations of the government can be conducted on the basis of trade-related modes of financing. However, if there are losses they should be covered from borrowings from

the State Bank of Pakistan.

NON-BANK LOANS TO GOVERNMENT

This consists mainly of Khas Deposits, Defence Saving Certificates, etc. and is perhaps the most important component of domestic public debt, which needs special care in its settlement, since it is owned by private individuals. To settle this debt, it is proposed that the government create a mutual fund out of its shares in selected public-sector corporations or government-sponsored corporation. This fund would be managed initially (for three years) by an independent group of portfolio managers appointed by the government; subsequently, the portfolio managers would be chosen by the shareholders. Share certificates in this mutual fund would be issued to holders of this type of debt, equivalent to the value of their holdings.

The idea of a mutual fund would be particularly effective in insulating small investors from exposure to risk. The need to minimise risk is important since a part of this debt is held also by widows, retired individuals and other small investors, whose risk-taking capability is minimal. Through the fund, these investors would be allowed to hold a diversified portfolio of shares, thus enjoying the benefits of risk-bearing.

Also, this would be fully in keeping with the government's policy of privatisation and disinvestment, on which there has been no progress. This measure would serve to speed up the implementation of existing government policy. This would also be a step in the direction of deregulation and would help increase the efficiency of public enterprises.

As of June 30, 1989, the book value of the combined assets of these corporations amounted to Rs 800.442 billion and their net equity was more than Rs 100 billion. Given that the market value of the equity is likely to be a multiple of the book value, it should be possible to redeem the full amount of about Rs

155.08 billion of obligations outstanding at the end of May 1990. This portfolio can be expanded to include T&T, Railways, etc. which have presently been excluded.

[Report of the Prime Minister's Committee on Self-Reliance, Islamabad, 1991, pp. 46-50]

Whether a creditor can fix time and rate of profit while the debtor saying *inshaallah*, he will be able to earn and pay the same in time; failing which the guarantor may give profit asked for plus also a bonus or compensation for delayed payment, if any, and also according to other arrangements regarding the loan. What will be the position if the system of insurance for the said profit is introduced?

10.1. I am afraid the question is not very clear to me. Merely by saying *inshaallah* legal and moral obligations cannot be done away with. It is reported that Imam Abu Hanifa was asked whether a commitment with *inshaallah* would be enforceable or not and he is reported to have replied that contracts and commitments in Islam have to be clear and categorical and remain so, whether *inshallah* is said or not. He even said that if the *bai'ah* that the civil servants and armed forces make with the *khalifah* could become avoidable by silently saying *inshaallah* that would destroy the whole system. I am, therefore, not clear what functions would be performed by the insertion of *inshaallah* which is primarily an invocation to Allah Subhanahu wa Ta'ala to enable one to fulfil one's commitment and not a subterfuge to run away from them. If the deal has commenced on the basis of profit-sharing, it has to be direct and categorical. Any compensation when the two parties do not share the risk would bring the deal very close to *riba*.

Third-party guarantee is, however, a different issue altogether and can be profitably invoked in certain financial arrangements, within the country as well as in international dealings. If this guarantee is to come from the government, it can only be in matters in which government is not a beneficiary. In private dealings also, the third party who acts as guarantor cannot be a beneficiary.

Present State of the Islamisation of the Financial System in Pakistan

DR ZIAUDDIN AHMAD

Pakistan embarked on a process of the Islamisation of its financial system in 1979. Though the financial system of the country has undergone significant changes since then, the process of Islamisation is yet to run its full course. The measures adopted for the Islamisation of the financial system have also been characterised by a number of qualitative deficiencies. The deficiencies and shortcomings of the steps taken for the Islamisation of the financial system have been widely discussed in the country in recent years. The stage for a basic reformation of the financial system in the light of Islamic teachings has been set by the judgement delivered by the Federal Shari'ah Court in November 1991 which has declared a number of existing financial laws and practices as repugnant to the injunctions of Islam and called upon the government and other concerned agencies to take necessary action to bring them in conformity with the Islamic tenets by the end of June 1992.

This paper reviews the efforts made so far for the Islamisation of the financial system in Pakistan. The paper is divided into three sections. The first section provides the historical perspective of the Islamisation efforts. The second section describes the steps taken for the Islamisation of the financial system. The third and the final section contains an appraisal of the present state of the Islamisation of the financial system in Pakistan.

SECTION I

CII Report and Strategy

In September 1977, the President asked the Council of Islamic Ideology (CII) to prepare a blueprint of an interest-free economic system in the light of Islamic teachings. To assist it in this task, CII set up a panel of economists and bankers consisting of 15 highly-qualified economists, experienced central and commercial bankers and financial experts. In view of the complexity of the task of eliminating interest from a system in which it was deeply embedded, the panel advocated a gradual approach. It first submitted an interim report which recommended immediate removal of interest from those financial institutions whose transactions were relatively less complex and from where interest could be removed with greatest ease. This was followed by its final report which contained recommendations for eliminating interest from all domestic financial transactions. The panel recognised the difficulty in eliminating interest from foreign transactions all of a sudden and advised reduction in dependence on interest-bearing foreign loans. The CII scrutinised the contents of both these reports, and after making certain changes to ensure complete conformity with Islamic injunctions, incorporated them in its interim and final reports submitted to the government in November 1978 and June 1980, respectively.

The report of the Council of Islamic Ideology (hereinafter referred to as CII report) contained a detailed blueprint for reorganisation of banking practices and procedures on the basis of the principles of profit-loss sharing in consonance with the Islamic legal concepts of *mudarba* and *musharakah*. The CII report emphasised that the ideal Islamic techniques to replace interest in the banking and financial fields are profit-loss sharing and *qard-e-hasan*. However, it gave due recognition to difficulties that may arise in changing the whole system to profit-loss sharing in one step and also the fact that there are certain spheres where it may not be possible to use the system of profit-loss sharing. It, therefore, gave qualified approval to certain other methods being used in conjunction with profit-loss sharing like leasing, hire-pur-

chase, *bai' mu'ajjal*, investment auctioning and financing on the basis of normal rate of return. However, cautioning against the danger that such methods could open a back door for interest, it emphasised that their use should be kept to the minimum that may be unavoidably necessary and that their use as general techniques of financing must never be allowed.

The CII report stressed that lack of proper maintenance of accounts due to large-scale illiteracy and the tendency to conceal true profits on the part of business concerns would act as a hindrance in widespread adoption of the system of profit-loss sharing by the banks. It advocated elimination of illiteracy, moral reformation, a thorough reform of the tax system and improvement in the systems of accounting and auditing to create a favourable environment for the success of profit-loss sharing system.

No change was contemplated in the CII report in the functions and responsibilities of the central bank. However, it recognised that the operating procedures and the contents and substance of its monetary policy instruments would undergo significant changes consequent to the elimination of interest. These were discussed in detail in CII report.

In view of the complexity of the task, the CII report suggested that elimination of interest may be made gradually under a phased programme. It also laid down a plan of action with an order of priority for elimination of interest from different sectors. It recommended elimination of interest from government transactions in the first phase, followed by elimination of interest from the assets side of the operations of the commercial banks and other financial institutions, culminating finally in deposits of the banks becoming interest-free in the true sense of the term. The report argued strongly against starting the experimentation with model banks or opening interest-free counters in existing commercial banks, side by side with interest-based operations.

The CII report set the stage for the phased elimination of interest from banking and financial transactions. In the meantime, a report on the elimination of interest had also been prepared by a committee headed by the governor, State

Bank of Pakistan. The report prepared by this committee did not differ substantially from the CII report in as far as the measures to eliminate interest were concerned. However, the CII report was a more comprehensive document and its special importance lay in the fact that it was prepared by a constitutional body which is specially charged with advising government on matters related to Shari'ah.

Simultaneously, the State Bank undertook the formidable task of overhauling the then existing banking legislation to meet the requirements of an interest-free system. The State Bank of Pakistan Act and Banking Companies Ordinance underwent substantive and far-reaching changes. Amendments were made in a number of other laws having a bearing on banking transactions. Subsequently, as the new system got under way, further appropriate legislation was undertaken.

SECTION II

Phased Elimination (1979-1985)

The actual process of phased elimination of interest from domestic banking and financial transactions was set in motion with the historic announcement by the then president on February 10, 1979, on the occasion of the birthday of the Prophet (pbuh) that government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Within a few months of this announcement, these specialised financial institutions took the necessary steps to re-orientate their activities on a non-interest basis.

The conversion of operations of commercial banks to non-interest basis was a much more complex task and had therefore to be spread over a longer time period. Effective from July 1, 1979, the government introduced a scheme under which the nationalised commercial banks were required to provide interest-free loans to small farmers for meeting their

seasonal agricultural finance requirements in amounts at least equal to specified mandatory targets from year to year. From July 1, 1980, the coverage of the scheme was enlarged to include loans to small fishermen and cooperative societies for water course improvement. Later, a scheme for provision of *qard-e-hasan* by commercial banks to students was introduced under governmental instructions. Under this scheme interest-free loans are provided to meritorious and deserving students for carrying on studies both within the country and abroad.

A major step for progressive elimination of interest from the operations of commercial banks was taken in January 1981 when, in accordance with the government decision, separate counters were set up for accepting deposits on profit-loss sharing (PLS) basis in all of the five nationalised commercial banks. It was announced that the deposits received on PLS basis will not be used by the banks in interest-bearing operations and that these accounts will be maintained quite separately.

The original intention of the government was to eliminate interest from all domestic banking and financial transactions within a period of three years. However, the parallel system, in which savers had the option to keep their money with the banks either in interest-bearing deposits or PLS deposits, continued to operate till the end of June 1985. In June 1984, it was announced by the government that the parallel system would end during the course of 1984-85. Accordingly, the entire assets side of the banks was transformed into non-interest-based modes of financing except for past commitments which were allowed to run to maturity according to the original terms of the contract. The other exception related to on-lending of foreign loans which continued to be governed by the terms of the loans. From July 1, 1985, no banking company was allowed to accept any interest-bearing deposits except foreign currency deposits which continued to earn fixed interest rate. As from that date, all deposits accepted by a banking company shared in profit and loss of the banking company, except deposits received in current account on which no interest or profit was given by the banking company and whose capital sum was guaranteed.

The modes of financing specified in a State Bank circular permitted the use of mark-up technique for financing a wide variety of activities in the private sector. However, in view of the widespread criticism that charging a mark-up over mark-up in case of default was not compatible with Islamic teachings, banks were instructed to discontinue the practice. Other modes of financing specified in the State Bank circular were as follows: loans free of interest but carrying a service charge; *qard-e-hasan* (loans given on compassionate grounds free of interest or service charge and repayable if and when the borrower is able to pay); purchase of trade bills on the basis of mark-down or mark-up in price; purchase of movable or immovable property by the banks from their clients with buy-back agreement or otherwise; leasing; hire-purchase; financing for development of property on the basis of a development charge; *musharakah*; equity participation and purchase of participation term certificates and *mudarba* certificates; and rent-sharing in the case of housing finance.

A beginning in the direction of introducing the *mudarba* technique of financing was made in June 1980 when a law, called the "Mudarba Companies and Mudarba (Floatation and Control) Ordinance" was promulgated and followed up by issuance of enabling regulations in January 1981. Under this law, companies, banks and other financial institutions can register themselves as *mudarba* companies and mobilise funds through the issuance of *mudarba* certificates. Funds obtained through a *mudarba* are restricted for use only in such businesses which are permitted under the Shari'ah and need prior clearance from a religious board established by the government specifically for the purpose. The law contains a number of provisions to safeguard the interest of *mudarba* certificate holders. These include quicker and simpler adjudication of disputed matters by a tribunal specially set up for this purpose and a condition imposed on the auditors to certify that the business conducted by the *mudarba* company is in accordance with the objects, terms and conditions of the *mudarba*. The promulgation of the *mudarba* law has opened the way for the issuance of a new type of financial instrument in the form of *mudarba* certificates and helped in broadening the dimensions of the newly-emerging Islamic financial market. Investment through the medium of *mudarba* companies has of late gained a good deal of popularity and by the end of 1991 over 30 mu-

darba companies had been listed on the stock exchange.¹

The capital market in Pakistan has also witnessed a rapid growth in leasing business in the context of the Islamisation of the financial system. With certain conditions, leasing is an approved mode of Islamic financing along with other forms. Some firms have been registered specifically as leasing companies. The concept of *musharakah* has been made use of in developing another new financial instrument known as participation term certificates (PTCs). These are intended to replace the interest-bearing debentures for financing long- and medium-term requirements of business and industry. PTCs are designed to be in essence a variable dividend security with the return on it linked to actual profit made by a concern and having a specific maturity period.

SECTION III

Achievements and Failures

It is now over a decade that the first step towards the Islamisation of the financial system in Pakistan was taken. The period 1979 to 1985 saw a fairly active policy on the part of the government to Islamise the financial system. The original intention of the government was to eliminate interest from all domestic banking and financial transactions within a period of three years beginning from Rabi-ul-Awwal 12, 1399 (February 10, 1979). Though this time framework did not prove practicable, the government seemed to be in earnest to move speedily towards attaining the goal of an interest-free economy. At first, a parallel system was put in operation in which savers had the option to keep their savings in interest-bearing media or in profit-loss sharing savings media. In June 1984, it was announced by the government that the parallel system would end in the course of 1984-85 insofar as the operations of commercial banks and other financial institutions were concerned. All banking companies were actually forbidden to accept any interest-bearing deposits as from July 1, 1985, except foreign currency deposits. Banks were also instructed to invest their PLS deposits only in interest-free

¹ The number of registered mudarba companies reached to 49 in August 1992.

avenues of investment and financing. Serious consideration was seemingly being given to the issue of eliminating interest from government transactions in 1984-85 as the then finance minister stated in his budget speech that government proposed to consult scholars on the subject. However, the matter was not pursued vigorously and the movement towards a completely interest-free economy lost its dynamism and even its sense of direction after 1984-85.

The movement towards an interest-free economy suffered a serious retardation when in August 1985 banks were allowed to invest even their PLS deposits in interest-bearing government securities. The present position, therefore, is that the return on PLS deposits contains a substantial element of interest. Since 1984-85, there have been no policy pronouncements on the part of the government with regard to elimination of interest from government transactions. To achieve the goal of interest-free economy it is necessary that government should end its dependence on interest-based borrowing. There are no indications so far that this aspect has been given due consideration in formulating government budgetary and other policies. In fact, instead of reducing dependence on interest-based borrowing there has been increased resort to such borrowing in recent years.

The Islamisation process in the field of banking and finance in Pakistan has been marked by another serious deficiency in that no institutional mechanism exists for a continuous scrutiny of the operating procedures of banks and other financial institutions from the Shari'ah point of view. Individual scholars who have examined these operating procedures have pointed out several areas where the actual banking practices show deviation from Shari'ah even in the case of modes of financing which, in concept, are perfectly compatible with Shari'ah. Thus, though *musharakah* agreements which banks ask their clients to sign contain features which have been called into question by several commentators. The provision, for example, that in the event of a company suffering a loss in any accounting year, it would be first adjusted against the existing reserves of the company has been found inconsistent with the spirit of the Shari'ah.

Again, while the idea behind the issuance of PTCs was a

sound one, no legislative framework was provided for standardising the features of this new financial instrument in the light of the principles of Shari'ah. The CII report had provided a broad outline of the features of such financial institutions but the actual form in which PTCs have been issued does not fully conform to the suggested outline. Some features of PTCs as introduced by certain financial institutions have been widely criticised as being inconsistent with the requirements of Shari'ah. Provision made for payment of a pre-production discount rate during the gestation period of a project and stipulation of share in profit equivalent to a percentage of the outstanding PTC funds have evoked strong criticism in this respect.

Among the 12 modes of financing allowed by the State Bank to replace interest-based lending, banks have made predominant use of what has popularly come to be known as mark-up financing. Mark-up financing has taken two main forms. The first form is similar to *murabaha* financing being practised by a number of Islamic banks in other countries. Under this form, a transaction takes place in the following manner: (a) the client approaches the bank with the request to purchase for him certain specified goods; (b) the bank makes the purchase; (c) the bank sells these goods to the client at a price which includes a mark-up over the cost of the goods and agrees to receive payment at a future date in lump sum or in instalments; and (d) the client pays the amount due as agreed in lump sum or in instalments and the transaction comes to an end. The second form involves a buy-back agreement. The practice followed is that a client sells his goods to the bank for cash and simultaneously buys back the same goods from the bank at a higher mark-up price payable at a future date either in lump sum or in instalments. The second form of mark-up financing has been severely criticised by scholars well versed in Shari'ah and the Federal Shari'ah Court in its judgement has held it to be manifestly against the Islamic teachings.

In a country like Pakistan where there is substantial unemployment and under employment there is a vast potential for creating new opportunities for providing employment through the use of the *mudarba* technique of financing. The *mudarb*as floated under the new legislation can be of some help in

this direction. However, for making a really significant impact on the employment situation it is necessary that banks, which are the largest depository of nation's savings, make extensive use of *mudarba* financing. There is little evidence of banks' involvement in *mudarba* financing to any appreciable extent so far. Government has recently announced certain schemes for making bank finance available to unemployed persons and people of small means for setting up or expanding their own business. It seems that significant use of *mudarba* is not contemplated even in these schemes.

It is noteworthy that neither the government nor the central bank of the country provided strong leadership to motivate the banks and other financial institutions to take bold initiatives for breaking away from the traditional banking practices and adopting the Islamic financing techniques based on the concept of profit-loss sharing. Though it is generally agreed that *mudarba* and *musharakah* are the ideal substitutes for interest in an Islamic economy, no special efforts have been made to accord prominence to them in the policies adopted. This seems to have given rise to an attitude of passivity on the part of banks and led them to use mostly such modes of finance, like mark-up, as are more akin to interest-based banking and require least modifications in the old lending procedures.

The picture on the liabilities side of the banking system has undergone a comprehensive change since the introduction of interest-free banking. Savings and time deposits no longer earn a fixed return. Banks declare profits payable on these deposits at six-monthly intervals based on their operating results and these vary from period to period and from bank to bank. The rates of profit are worked out by a formula that determines net profit accruing to a bank and allocates them to the remunerable liabilities according to their maturities. Allocations are based on differential weights assigned to liabilities according to their relative maturities. The system has in general been found to be compatible with Islamic teachings except that, as mentioned earlier, profits declared by banks contain a substantial element of interest.

Other Challenging Issues

This paper has so far noted only major deficiencies and shortcomings of the steps taken for the Islamisation of the financial system in Pakistan. Experts in Shari'ah and other writers on Islamic banking have identified certain other features of the present situation which also deserve attention. Some of these are as follows:

- a) A tendency seems to have developed to replace PTCs by TFCs (term finance certificates). As against PTCs which are based on the concept of *musharakah*, TFCs are based on a system of fixed mark-up. This has been considered a retrograde step as the objective should be to expand profit-loss sharing modes of finance rather than to restrict them further.
- b) Financial institutions undertaking leasing business are making greater use of financing leases than of operating leases. Experts in Shari'ah consider financing leases to be incompatible with Islamic teachings.
- c) Many development finance institutions (DFIs) are mobilising savings through schemes that give a return which is hardly distinguishable from interest. Grey areas are developing even in the operations of institutions like the National Investment Trust which were previously thought of having eliminated interest completely. It seems that there is no agency to oversee the working of the various schemes being employed by DFIs to mobilise savings from the viewpoint of Shari'ah.
- d) Lately, the State Bank has laid down the minimum and maximum rates of profit a bank can share in the case of *musharakah* or purchase of PTCs or mudarba certificates. Such a stipulation is considered incompatible with Islamic teachings by experts in Shari'ah.
- e) Due attention has not been given to eliminating un-Islamic features characterising the operations of several constituents of money and capital market in Pakistan other than banks and DFIs. Nothing has

been done so far, for example, to reform the insurance business and the stock exchange operations in the light of Islamic teachings.

DISCUSSION

MAQBOOL MALIK: Dr Ziauddin's paper presents a very gloomy, disturbing picture. He has criticised the State Bank for not taking active part in the Islamisation process. I would like him to elaborate what steps he would have taken had he been the chief executive of the State Bank of Pakistan.

NAWAZISH ALI ZAIDI: I would invite your attention to the latest scheme under which Nawaz Sharif administration will dole out Rs 20 billion to the unemployed. There is no information on what basis it will be provided and what type of financial charges will be there to the loans made under the scheme. Will they be on the mark-up basis, on profit-sharing basis, or will they be of the *mudarba* kind?

ABDUL JABBAR KHAN: Considering the composite working of leasing or of the *mudarba* company, where do I get the funds after I have finished my equity? Certainly, I go to the bank and borrow it. The difference between the operating and the financial lease is that I give it for three years, I take it back and again give it. But what is my funding? Where is my funding coming from? Is it based totally on mark-up?

ISRARUL HAQ: There has been differences on the definition of *riba*. I would like to know whether there is any *ijma* on the definition of *riba*?

QUESTION: I would request Dr Ziauddin to tell us whether this self-employment scheme can be financed on the basis of service charges.

COMMENT: Dr Ziauddin has quoted the Council of Islamic Ideology saying that lack of proper maintenance of accounts due to large-scale illiteracy and the tendency to conceal true profits by business concerns could hinder the widespread adoption of the profit-loss sharing system. My question is: what steps have we taken to create an atmosphere for profit-loss sharing and the real Islamic banking system in the country?

DR ARSHAD ZAMAN: If we were to start today what would be the action plan we draw to address this issue? Will gradualism work? Whether one can Islamise the financial system independently finding a way to streamline the government finance on non-interest basis? Can there be an Islamisation of the financial system with the budget schemes run as they are?

The public debt as of June 1991 was Rs 840 billion against scheduled bank advances of Rs 217 billion. The size of the debt that the government had versus the private sector was one to four. The annual credit by the banking sector was about Rs 20 billion during the last three years while the government borrowing was Rs 52 billion. Time deposits with scheduled banks were Rs 89 billion and in the government saving institutions Rs 132 billion. So the prime actor in the economy is the government. Therefore, mere attempts to find suitable financial instruments may not be getting to the root-cause of the problem.

I would like to know whether the question of Islamisation is a matter of finding indigenous ways of financing the government's enormous requirements of debt, or whether it is a problem of the budget.

S. AMINULLAH: I would like to ask Dr Ziauddin whether floatation of a *mudarba* is really Islamic because you have to properly define *rabbul maal* and *mudarba*. He holds that banks should undertake *mudarba* operations, while I think banks should not be allowed to undertake *mudarba* operations because they have already failed to mobilise these.

JALEES AHMED FAROOQUI: Don't you think that the borrowers and businessmen should also be included among invitees to such seminars as they are the ones who are considered corrupt and responsible for the failure of system?

S K AMIRUDDIN: I would like to emphasise that in all the government transactions, the funds provided by the government should be based on service charges with the money being treated as a utility, like providing water at a minimum cost.

DR MUNAWAR IQBAL: The actual picture of the government performance is unfortunately gloomier than what Dr Ziauddin has painted. Look at the recent chaos the government has created by floating international bonds, foreign exchange bearer bonds and the mark-up bonds which are already operating in the country. Strictly speaking, the mark-up scheme being used by Pakistani banks is not the mark-up which the Shari'ah allows. The banks are just using the name of mark-up and doing what is almost akin to riba.

There are a number of bonds similar to those the government has floated lately in the domestic market, declaring that you can get 14 percent if it is for one year and 17 percent if it is for two or three years. I fail to understand where does the concept of mark-up come up, for there has been no trade deal between those people who are buying these bonds and those who are floating them. Mark-up is a trading scheme and there is no trading involved in these bonds.

A reference has been made to financing and operating leases. A similar kind of fraud is being practised in leasing ventures, but all financial or operating leases are a kind of riba. We should make a distinction between the true financing lease and true operating lease. The borderline is that in an operating lease the owner has certain rights as well as responsibilities. So the person who is financing keeps the ownership and thereby claims all the rights. But at the same time, he fulfils responsibilities that ownership demands. If that is not done, then it becomes only a way of deceiving others.

DR HUSSEIN MULLICK: I have the feeling that the whole decision-making is so faulty that anything that bureaucrats want to do they can do, and the banks are totally subservient to the system. A section officer can undo all your work even when he has never studied economics. This has to be changed and the State Bank must exercise its sovereignty in its restricted sphere. We are not aggressive enough to challenge the decisions of bureaucrats, they can decide that, say, Allied Bank will pay this much to some other bank, although ABL is an independent institution.

I will even blame some of the economists for not challenging these 12 modes of financing despite their un-Islamic na-

ture. I think some guidelines must be openly issued by the government and within those guidelines the banks should be allowed to have their own innovations. Let there be some new instruments as long as they do not challenge the basic Islamic principles. But banks are just like slaves listening to the circulars of the State Bank, and the State Bank is again listening to the directions of a bureaucrat and the result is that all these decisions go wrong.

I suggest that a new division should be established where all economists, businessmen and others may sit. Let them take over this process of Islamisation of the economy. I hope that will function, though it may take some time.

ABDUL JABBAR KHAN: The Shari'ah Court's criticism of the mark-up is about the buy-back system that we are following. I am making this point because if the mark-up is abolished altogether, certain transactions may not consummate in the bank.

As far as leasing is concerned, there is an obvious difference between it and the *mudarba*. In the case of leasing companies, their major finance is coming from the banks. Again in the case of *mudarba* floatation, if they go for leasing they have to supplement their borrowing in certain cases. I have always advocated *musharakah* rather than *mudarba* because in the latter's case the *rabbul maal* has no say. I think we should be more careful about the *mudarba*.

Concerning service charge, I think the finance ministry will be very happy to accept your advice to raise all their funds on service charge because such a charge would be very minimal.

M AKRAM KHAN: I differ with Mr Israrul Haq that there is no consensus on *riba* being interest. If we look at the literature produced during the last 20 years, the deliberations of the scores of conferences where hundreds of economists and Shari'ah scholars participated, the opinion of the jurists of OIC countries, the verdict of the Council of Islamic Ideology and the evidence quoted by the Federal Shari'ah Court from the Qur'an, Hadith and Fiqh, we will find that there is consensus on *riba* being interest. Moreover, the people who say

that the interest and *riba* are two different things, their arguments have been adequately dealt with in the literature.

SYED SADAQAT ALI: The Islamic banking has failed because it has not been backed by a proper legal system. For instance, the Industrial Development Bank of Pakistan has an equity participation fund which provides equity to projects purely on the basis of Islamic mode of financing. But in spite of that if you look at the accounts of IDBP funds, many are stuck up in different projects. Similarly, there were reasons why PTCs, introduced by the financial institutions, were subsequently converted into DFCs because almost all the companies which had borrowed PTCs declared losses. Therefore, unless the companies ordinance is reshaped and recovery laws made, the Islamic banking system will not make it.

PROF KHURSHID AHMAD: It is a very critical issue. The Council of Islamic Ideology was very right in suggesting that the strategy for Islamisation of banking should start from the government operations. The whole strategy was reversed which, in my view, is one of the major causes of its failure. Second, the supporting legal framework has not been provided. Now with the judgement, the legal basis of interest has been knocked down, yet the alternative system has to be built. Third major failure has been the lack of education, motivation and mobilisation of public opinion. Fourth, no effort has been made to create a whole system of incentives in a way that profit-oriented sector gets all the boost and anything which goes even nearer to interest is dispensed with. Unfortunately, this kind of strategy has not been adopted so far.

DR ZIAUDDIN AHMAD: I am very happy to see that even a background document excited so much interest. As to the future action plan, I have my ideas on how we can achieve the objectives of Islamisation. Nevertheless, I would hesitate to give my views right now because I think after three days of deliberations at this seminar, we are likely to come up with some cogent recommendations for the government.

The newspaper advertisements about the latest employment scheme are not vocal on whether it will employ mark-up or something else. I think the whole trend is seemingly towards

mark-up rather than *mudarba*, even though I feel this would have been the best opportunity for using *mudarba* in employment scheme.

A point was raised that there is little difference between financing and operating leases, for both are un-Islamic. Again the question of *fatwa* comes in here. A *fatwa* says that the financial leases are not compatible with the Shari'ah while the operating leases are.

As to the source of funding for the leasing companies and *mudarbas*, most are being taken from the general public rather than from the banks.

To Mr Haq's question, surely the Ummah has a consensus on *riba*.

PROF KHURSHID AHMAD: The ulema position on the issue has been very clear. A staff paper of the IMF and Dr Mohsin Khan's article on Islamic interest-free banking says:

"The *riba* is an Arabic word for the predetermined return on the use of money. In the past, there has been a dispute on whether *riba* refers to interest or usury. But there is now consensus among Muslim scholars that the term covers all forms of interest, not only excessive interest. Thus in the ensuing discussion the term *riba* and interest will be used interchangeable."

DR ZIAUDDIN AHMAD: A question was raised citing the CII report that the lack of current accounts and concealment of profits are real impediments in the way of greater use of profit-loss sharing. The council, among other things, recommended that unless you reform the tax system, it will be very difficult to make the profit-loss sharing system a success. But nothing has been done. The taxation system remains more or less as it had been. There has been no change in the accounting and the auditing systems, either.

Dr Munawar Iqbal said that I painted a less gloomier picture of the present position. I tried to highlight only the major deficiencies. At the end of the paper, I listed some other deficiencies which I did not regard as major as the ear-

lier ones. But of course, it was not a complete catalogue; the real list is a formidable one.

During the last few years, a wrong tendency has developed. Contrary to previous years, when they were not saying they will charge a mark-up on loans, because anything on loan over and above the principal amount is interest. However, it is now being said that a 13 to 14 percent mark-up will be provided on loans. This is the height of our deviation from Islamic path that being a Muslim nation we are using the word mark-up for interest. It is not a sale-and-purchase transaction. The genesis of mark-up lies in *bai' mu'ajjal*. In this case, there is no *bai'* and still it is being said that mark-up will be charged on loans.

Dr Zaman asked if we can Islamise the financial system without budgetary reforms. Prof Khurshid was very explicit on this, and I fully agree with him. The Council of Islamic Ideology, for very basic reasons, had recommended that in the first phase the elimination of interest from the government transactions should be undertaken. If the government has a high rate of interest structure to attract funds from the public, it should invite the private sector. It is only through this way that the private sector and banks can compete with the government schemes. They can always pitch the mark-up rate to the government rates, while in the case of profit-loss system since it depends upon the actual turnover of a business, they will be more hesitant. Several other reasons can be cited as well. I feel that unless there is a budgetary reform, it will be very difficult to Islamise the financial system.

Another participant observed that he was not in favour of banks engaged in *mudarba*. If you analyse the performance of various parties who have been provided loans by the banks, you will inevitably come to the conclusion that these are the smaller parties which have not defaulted, while the bigger parties have gone in default. Also, take the example of Grameen Bank of Bangladesh; it has been providing funds to persons who were almost penniless. Its performance is very good and repayment record is highly encouraging. I do not agree that if you extend *mudarba* funds to the unemployed, you will have bad loans. In fact, such people would be very much interested to keep themselves in good books with banks

because they can expand their business by getting further mudarba funds.

An International Islamic University working group, which included chartered accountants, bankers and economists, came out with strong allegations against the bankers. The group members were also against the income tax system which they said was making them dishonest. They say: ask any businessman whether he can afford to be in business if he remains honest. This indeed is a very bad situation. In fact, the Taxation Inquiry Commission headed by Dr Qamarul Islam has documented how bad the income tax system is. It seems that we all are to be blamed. I do not want to use the word failure, but we have tried the system half-heartedly and inefficiently.

Dr Hussein Mullick made a stringent attack on bureaucrats. We should not single out a particular group. I think we may extend our blame to the banks and the people in the central bank. Even the general public has shown apathy towards Islamic source of financing. But I agree with the State Bank that greater autonomy should be given to it in such matters.

Mr Abdul Jabbar Khan has very rightly pointed out that the Federal Shari'ah Court has criticised both the mark-up system and the buy-back arrangement. He also made a very valuable point that we cannot afford to give up the mark-up system completely; that we have to distinguish between the mark-up system based on the concept of *bai' mu'ajjal* which according to the *fatwa*, is a permissible mode of financing used by Islamic banks all over the world including the Islamic Development Bank. *Bai' mu'ajjal* and mark-up have to remain one component of the system because there are certain spheres where one cannot apply *musharakah*. For example, people who are illiterate, like farmers who do not maintain accounts, one cannot have *musharakah* with them. I think one has to have a whole range of modes of financing. We should try to give increasing prominence to *musharakah* and mudarba as time goes on. At the same time, we should continue with leasing, hire-purchase and mark-up in consonance with the Islamic teachings.

Finally, is the legal framework adequate for the success of

the profit-loss system? I could not agree more with what has already been said. One of the IMF documents on Islamic banking says that the legal framework is not adequate. I think you have to overhaul the companies act, change banking laws and alter the profit-loss system.

Riba-Free Alternatives in Commercial Banking

NAWAZISH ALI ZAIDI

SECTION I

There are some basic Islamic principles of doing business. First, one has to be honest in dealings. Second, the economic activity to be undertaken or goods to be traded should be *halal*, i.e. socially desirable. Third, the methods and forms of raising finance and investing it in business should be in accordance with the established precepts of Islam.

Very recently a question was put to me as to why a certain bank had gone into liquidation? My reply was that the said bank failed as it did not operate according to Islamic principles. The failures of finance companies, investment companies and cooperative credit societies in Pakistan was also due to non-compliance with the basic principles of Islamic finance. Besides honesty in dealings, another basic principle of Islamic finance is that the return paid on capital raised for business has to be directly linked with what is to be actually earned in business. And this is the essence of *musharakah* and *mudarba* methods of financing.

If the above principle of Islamic finance is followed, then the return on capital paid to a financier can in no case be higher than what the capital has actually earned. This princi-

Section I deals with concepts and Section II deals with their practical application.

ple is not strictly followed under the interest-based system which leads to failure of many financial institutions. We have seen that this Islamic principle was not followed by the finance companies, investment companies and the cooperative credit societies. These institutions went into liquidation as they had committed themselves to pay to their depositors such high rates of return which they were not in a position to earn. They were destined to fail for this reason alone even if cases of dishonesty are ignored.

It might be rightly asked here as to why most of the traditional banks and financial institutions which operate on the un-Islamic basis of interest do not always fail. The answer may be that these financial institutions follow the Islamic principles to some extent. First, they usually operate honestly and do not start with the intention of running away; besides, the governing legal framework also makes such running away difficult. Second, they manage their operations in a way that the promised return to their depositors is usually less than what they are able to earn. But wherever this principle is flouted, either intentionally or through compulsion of circumstances, the institution runs into financial difficulties sometimes leading to bankruptcy.

This ever-present risk in interest-based financial institutions is referred to as the "interest-rate risk" and is the major cause of their failures. The recent widespread failure of savings and loan associations in United States was an outcome of the interest-rate risk. The deposits with the financial institutions are basically for short term even if these are for a long term on paper as the depositors demanding premature withdrawal of their deposits are usually not refused. When interest rates rise, the depositors usually withdraw their deposits for re-depositing the same at higher rates of interest. On the contrary, the borrowers are reluctant to repay their loans when interest rates are rising. The margin available to banks between rates of interest payable on deposits and receivable on loans narrow down leading to a financial crunch. A risk of this nature is non-existent in financial institutions which operate on Islamic principle as there is no contracted rate of return with depositors.

In addition to the cost factor, changes in interest rates cre-

ate their shock waves in many other ways. In the specific context of banking, heavy withdrawals by depositors cause additional problems relating to their liquidity and if financial institutions are unable to meet their commitments due to liquidity constraint, the consequences are obvious.

It is evident that in a riba-free financial system there is no room for interest-rate changes as there is neither a benchmark discount rate nor a bank rate to be periodically announced by the central banking authority. When interest rate ceases to exist, the problems connected with interest-rate risk and of liquidity constraint resulting from interest-rate changes will also become irrelevant.

Islamic Principles of Finance

Let us now examine the Islamic principles of finance and evaluate their consequences which are relevant to model building. There can be no contract for a loan transaction with the stipulation for an addition in the principal sum, because that is riba. If it is a loan contract then it has to be an interest-free loan. Since present-day money markets are based on debt instruments, it follows that in an Islamic financial system there will be a very limited role for the money market. Theoretically, it is possible to have a small role for the money market consisting of instruments based on interest-free debts. For instance, the government might introduce interest-free bonds on which some incentive may be provided by way of reduction in tax liability of their holders. Or the government might issue interest-free bonds specially for banks and financial institutions for the purpose of liquidity or secondary reserves. If these interest-free bonds are traded at par for liquidity replenishment then a restricted money market may come into existence.

Surely, Islam prohibits interest-based dealings but it permits many forms of financing and trading in lawful goods. Permissible forms of financing include many variations based on the principle of profit-and-loss sharing. According to Hadith, profit can be shared as agreed between the parties concerned but loss is necessarily to be shared in the ratio of capital contributed by each one of them. Based on the above

principle of profit-and-loss sharing, many instruments and forms of business relationship can be developed. Such instruments can be traded on the basis of their market valuation. It is to be expected that a capital market will have a major role to play in an Islamic financial system but the financial instruments will have to be free from all ancillary stipulations of interest.

Return on capital raised for financing in a business in the Islamic system is calculated in reverse, starting from the total profit actually earned. The expenses are deducted. Manager's share in profit is deducted. And the remaining profit is distributed among the various providers of funds according to contract. In the interest-based system the rate payable to the providers of funds is first decided and contracted. Estimated expenses are calculated and added. Manager's share is added. All this put together gives the figure which is to be charged from the users of funds. Thus method of calculation in an Islamic system is just the opposite of the one followed under the interest-based system.

In addition to profit-sharing, Islam permits other modes of earning money through real business transactions but not through money-lending as this is totally prohibited. We all know that *musharakah* and *mudarba* are the well-known forms of profit-sharing. Permission is, however, available to earn money by renting out durable assets, hiring services and selling goods with an addition of profit to the cost of goods. Another form of financing is giving interest-free loan with service charge comprising actual out-of-pocket expenses. An interest-free loan is sometimes a safe way of financing as it obviates the risk of loss and the capital of the financier remains intact.

Here, I would like to emphasise that the introduction of interest-free banking on national level in Pakistan and Iran and establishment of a number of Islamic banks in many parts of the world was an acceptance of the fact that present-day bank interest falls within the ambit of forbidden *riba*. Looking exclusively through secular economics, it can be said that interest is externally indexed cost of the capital. As such, interest should have been part of a "command economy." In the Islamic system of profit-sharing, the cost of capital is inter-

nally indexed, i.e. the capital costs what it actually earns. This arrangement is obviously a natural part of a "market economy." Against its own logic and strangely enough the institution of interest has been owned by the market economies of capitalist world. But the natural flexibility inherent in an Islamic profit-sharing system is now being initiated into the interest-based system by making the interest rates variable through frequent prime-rate fine tuning and also by linking the interest rates to LIBOR.

SECTION II

Model of Riba-Free Bank

A riba-free model of commercial banking may take many forms but the unalterable conditions to fulfil are that all the components of the model remain Islamically acceptable, role of financial intermediation is efficiently performed and the needs of the economy are adequately met.

In developing an Islamic model for a commercial bank, the following broad areas need to be taken care of:

- Need for Shari'ah advisory board and Shari'ah committees.
- Modes of financing to be used by banks:
 - Structure of banks' deposits
 - Profit-sharing arrangement with depositors
- Need for Islamic instruments for banks' secondary reserves.
- Central bank's role as "lender of the last resort."
- Inter-bank flow of funds.
- Provident fund balances of the employees.
- Problems relating to foreign branches of Pakistani banks.

Shari'ah Advisory Board

In the past, a great national effort for Islamising the banking system was wasted and the main objective of eliminating riba from the banking system could not be achieved as has been confirmed by the FSC judgement. The manner in which some modes of finance were implemented by Pakistan Banking

Council has been held repugnant to the injunctions of Islam by the court. This has happened because the authorities concerned did not create a suitable framework for imparting Shari'ah advice and for monitoring the system from Shari'ah point of view.

To guard against a similar pitfall in future it is recommended that a Shari'ah advisory board should be established as a permanent body which should work in close cooperation with State Bank of Pakistan. This board should have statutory powers to examine the documents and review the business practices used by financial institutions. The board should also have the powers to issue directives to banks to make changes in the documents and the business practices so as to bring them in conformity with the principles of Shari'ah. A provision for the right of appeal should, however, remain available to the financial institutions.

In addition to a Shari'ah board, each financial institution should be required to establish a Shari'ah committee at its head office. Such committees may consist of three persons, a Shari'ah expert, bank's law officer and a senior officer drawn from banking operations. In case of need, the Shari'ah committees of the financial institutions may seek guidance in writing from the national Shari'ah advisory board.

Modes of Financing

The State Bank of Pakistan had prescribed 12 modes of financing to be used by the banking companies for providing finance to their clients. These modes were circulated through State Bank's circular No 13 dated June 20, 1984. Details are given below:

A. FINANCING BY LENDING

1. Loans not carrying any interest on which the bank may recover a service charge not exceeding the proportionate cost of the operation excluding the cost of funds and provision for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the State Bank from time to time.

2. *Qard-e-hasan* loans given on compassionate grounds free of any interest or service charge and repayable if and when the borrower is able to pay.

B. TRADE-RELATED MODES

3. Purchase of goods by banks and their sale to clients at appropriate mark-up in price on deferred payment basis. In case of default, there should be no mark-up on mark-up.

4. Purchase of trade bills.

5. Purchase of movable or immovable property by the banks from their clients with buy-back agreement or otherwise.

6. Leasing.

7. Hire-purchase.

8. Financing for development of property on the basis of a development charge.

C. INVESTMENT TYPE MODES

9. *Musharakah* or profit-and-loss sharing.

10. Equity participation and purchase of shares.

11. Purchase of participation term certificates and *mudarba* certificates.

12. Rent-sharing.

Keeping in view the past experience, there is need to make changes in the prescribed modes. The following existing modes of financing need to be deleted:

- 1) Purchase of property under buy-back agreement. Widely misused by banks.
- 2) Purchase of trade bills. According to Shari'ah principle banks should purchase goods represented by the said bills, and not the trade bills without any respon-

sibility for the goods themselves.

- 3) Finance-leasing. Practically used by financial institutions as a money loan for purchase of durable goods making the lessee responsible for all liabilities relating to the leased assets.
- 4) Financing on the basis of development charges. Sufficient evidence is not available in support of its being Islamically acceptable.

The following new modes of financing need to be added to the list of the approved modes of finance:

- 1) *Bai' salam*, i.e. purchase of goods and commodities by banks from their clients on the basis of immediate payment of price but on deferred delivery of goods and commodities. This mode can eliminate one difficulty being faced by the manufacturing sector, i.e. while raw material can be purchased by banks and sold to their clients on deferred payment basis, no provision exists for meeting the cost of overheads and other administrative expenses. Financing through *bai' salam* can take care of the value-added portion of the product. However, the banks will have to use this mode with care and caution lest they should be stuck up with unsold goods.
- 2) Financing on the basis of profit-sharing under *mudarba* arrangement. At present, banks can provide finance to clients on the basis of *musharakah* but not on the basis of *mudarba*. What is presently permitted is that banks can purchase *mudarba* certificates issued by companies registered as *mudarba* companies for purpose of floatation of *mudarbas*. As such banks are not permitted to provide finance to a technically qualified person who has the skills but is in need of finance. Also, there is need to make changes in the terminology used in banking transactions. For example, it is suggested that terms like *bai' mu'ajjal* certificate be used for TFC (term finance certificate) and *musharakah* certificate be used for PTC (participation term certificate). Word '*bai' mu'ajjal*' be used

in place of mark-up financing.

It is also recommended that the concept of profit-sharing through *musharakah* arrangements be expanded and new forms of this concept be adopted by the banks. Mode of equity participation be increasingly used by banks and financial institutions. In addition, profit-sharing on case-to-case basis should also be promoted. Import and export consignments may also be financed on profit-sharing basis. For example, a client comes up with a financing proposal to the bank. The cost of goods or project or transaction is estimated. Its sale price or realisable value is also estimated. Profit is calculated on the said basis. Bank's share in profit is estimated on the basis of investment of the bank and the share of client in the light of agreed ratio of profit-sharing. If things proceed as projected, there is no problem. When the actual profit is lower than projected, it will be shared in the agreed ratio. If there is loss, it will be shared in the ratio of respective capital contributions. Lower profit or loss will be thoroughly inquired into for which deterrents will be provided in the contract.

At present great difficulty is being faced by clients for borrowing money even if they have easily realisable securities like shares and NIT units. Some very objectionable methods of financing are being used by banks in which household goods are purchased by banks from clients to provide them money and simultaneously the same goods are sold by banks to same clients on deferred payment basis with addition of mark-up. In all cases these are only paper transactions. To overcome this difficulty it is suggested that the technique of time multiple counter loan (TMCL) be used in the form approved by the Council of Islamic Ideology in its 1980 report at para 1.20.

In addition to TMCL scheme, banks should also be required to earmark a small percentage of their funds for the purpose of granting *qard-e-hasan* to deserving persons.

Structure of Banks' Deposits

Banks in Pakistan started accepting deposits from their customers on profit-and-loss sharing basis but no change was in-

troduced in the then prevailing structure of deposits and it continues as it existed under the interest-based system. This is not to suggest that a change must be introduced just for the sake of change. But the structure of bank's deposit is important for the just and efficient functioning of an Islamic profit-sharing system.

According to existing practice, all categories of deposits held by a bank are treated as one common pool of funds. But the income derived by banks from the use of these deposits is apportioned by banks under two heads of income: (a) non-interest income; and (b) interest income. Interest income is entirely retained for the shareholders while non-interest income is distributed among the PLS depositors of various categories according to the weightages prescribed by State Bank of Pakistan. The consequence of this arrangement is that long-term PLS deposits (say five-year term deposits) and short-term PLS deposits (say PLS savings deposits) are invested in similar assets. Long-term PLS deposits do not earn anything more than the short-term PLS deposits but get a preferential treatment through the system of weightages. Obviously, this is not fair.

Banks in Pakistan are accepting interest-based foreign currency deposits and branches of Pakistani banks established abroad are operating under the interest-based system and this is likely to continue for a long time to come. For these reasons, there is need to introduce some changes in the deposit structure of the banks. There is need to develop water-tight arrangements between the interest-based and the Islamic PLS operations of a bank in a manner which will also improve the profitability of the PLS deposits.

The existing large number of categories of deposits should be reduced and each category of PLS deposits be managed as a separate pool of funds for investment. A new category of PLS foreign currency deposits should immediately be introduced because this option is not available to the foreign currency depositors. The present position is that if someone wants to maintain a foreign currency deposit he also has to deal on the basis of interest.

Another idea is to establish such banks as will not pay any

profit or return to their depositors. They will attract deposits on the basis of the quality of service which they will provide to their depositors. People will keep accounts for the convenience of transactions only. People having surplus funds will then not keep their deposits with the banks as they do now for consideration of a small return. For their surplus funds people will discover new avenues of investment which, in turn, will provide a boost to real investment and growth in economy. Surplus funds kept with banks are not usually invested in the most efficient manner.

Profit-Sharing Arrangement with Depositors

Income derived from the investment of PLS deposits only should be distributed among the PLS depositors according to a contract details of which should be incorporated into the account opening application form. Income earned from foreign branches, current account deposits and the non-fund-based income earned from the services rendered by banks should go to shareholders only. The income earned from the use of PLS deposits only should be distributed among the PLS depositors. According to the terms of agreement, banks should receive a specified portion of income earned from the use of PLS deposits. Banks should meet their expenses out of this portion and the saving should be their profit for managing the PLS deposits.

The existing system is too much open-ended and has been used to the detriment of the PLS depositors. At present, the banks are at liberty to charge all expenses to the PLS income and there is no check on them. They spend as much as they like at the cost of their PLS depositors who have neither any say nor any control in this matter. In fact, there is need to publish the income account of the PLS operations of banks and the PLS depositors should have a right to discuss the PLS income account in a meeting of such depositors.

Islamic Instruments for Secondary Reserves

Under section 29 (1) of the Banking Companies Ordinance 1962, every banking company is required to maintain in

Pakistan in cash, gold or unencumbered approved securities not less than 35 percent of the total of its demand and time liabilities. Since banks are required to maintain cash reserves equal to five percent of the total of their demand and time liabilities in Pakistan in terms of section 36 (1) of State Bank of Pakistan Act 1956, the question that arises is: in which approved securities should the banks maintain the remaining liquidity requirements of 30 percent?

At present, these reserves are maintained by banks in such securities on which interest is paid by the government and this interest is included in the profit paid to banks' PLS depositors.

One over-simple solution is that the entire liquidity reserve be maintained in cash which will not involve any interest. This will no doubt reduce the rate of profit on PLS deposits. Another possible alternative is that banks may be allowed to keep this reserve in the form of profit-and-loss sharing investment like the shares of joint stock companies but this will be a very risky form of investment for secondary or liquidity reserves of the banks. It has also been suggested that since PLS deposits are a form of risk capital, there should be no reserve requirements for PLS deposits and the reserve requirements may only apply to current deposits.

Extreme solutions should be avoided and PLS depositors should not be exposed to unnecessary risk. Secondary or liquidity reserves should be kept in interest-free securities which should be easily encashable with no risk of capital loss. For this purpose, government should create a special category of interest-free treasury bills. The banks and through them the PLS depositors should be compensated as under:

- The present limit of 30 percent reserves against PLS deposits be reduced suitably.
- Some concessions be allowed to the PLS depositors by exempting the PLS profits from payment of certain forms of taxes.
- Banks should be entitled to interest-free discounting or financing facilities from State Bank of Pakistan to

the extent of banks' holdings of interest-free treasury bills. This will not be an encashment of these interest-free treasury bills. What will be discounted interest-free by SBP will be interest-free promissory notes or bills of exchange held by other banks. In effect, it will be a case of mutual *qard-e-hasan*.

Central Bank's Role as 'Lender of the Last Resort'

This can be performed in more than one ways. An arrangement based on mutual *qard-e-hasan* up to a certain extent has been described above. If banks, by compulsion of circumstances, need more financing in excess of their holding of interest-free treasury bills, the central bank may be compensated by treating the funds provided by the central bank as PLS deposits of comparable duration held by the said bank. The third option is that the bank receiving the funds from the central bank may pass on to the central bank the entire income earned by the bank from use of such funds after deducting only the actual out-of-pocket expenses. Another option is that the funds obtained from the central bank may be treated as a special *musharakah* arrangement and the profit may be shared according to the agreement.

Inter-Bank Flow of Funds or Inter-Bank Call Money

Inter-bank call money may be treated in the same way as the funds received from the central bank are treated. Various options have been described above. But inter-bank flow of funds as well as the funds received from the central bank should be handled on shareholders' account and should be separate from the income account of the PLS depositors.

Provident Fund Balances of the Employees

At present, the provident fund balances of the employees of the banks are required to be invested in approved securities. These securities are again the government papers which are based on interest. If the entire provident fund balances are

invested in the shares of the joint stock companies this may amount to exposing the provident fund balances to unnecessary risk. At present, some employees of banks and other departments give an option that they will not receive interest on their provident fund accounts. As a compensation they are entitled to receive certain types of interest-free loan facilities. This system needs to be reorganised so that the arrangements are fair and equitable to everyone.

The provident fund and pension fund balances of all employees (government servants or of other public and private organisations) should by law be required to be deposited with a government agency to be created for the purpose. These balances will be kept on interest-free basis but the government shall give a retirement grant to every retiring employee. The amount of the retirement grant will be worked out according to the length of service and the salary bracket of the employee concerned. Maintaining of the provident and pension fund balances of all employees on a national scale should pose no accounting problems in the present age of computer technology. Certain private organisations are reported to have misused or squandered the provident fund balances of their employees. The proposed arrangement will also obviate such cases of misuse. As experience is gained, part of the provident and pension fund balances may be invested by the concerned agency in profitable ventures.

Foreign Branches of Pakistani Banks

Banks operate according to the law of the land where they are located. For instance, American, British or Japanese banks operating in Pakistan have to transact business according to rules and regulations in force in Pakistan. Likewise, Pakistani banks located in foreign countries have to transact their business according to rules and regulations applicable there. Now the branches of Pakistani banks in most foreign countries will be operating on the basis of interest. What solution can be found for this problem? In the foregoing paragraphs suggestions have been given which will safeguard the PLS depositors in Pakistan against the imported components of interest. But what about the shareholders of the banks who will receive a component of interest included in their

dividend income?

The question is whether branches of Pakistani banks located abroad can work on an interest-free basis? My first reaction is: yes! But doing this will require a very high level of motivation. I studied the banking laws of some countries where banking system is based on interest and found that an interest-free system for such places can be developed. However, an easy option is that the portion of interest income earned by foreign branches of Pakistani banks be surrendered for charitable purposes so that it is not included in the dividend income distributed to the shareholders of Pakistani banks.

DISCUSSION

DR SAYYID TAHIR: It seems that the basic principles are still not clear. That is why certain questionable suggestions are coming up; for example, reserve requirements for all sorts of deposits, demand deposits and profit-loss deposits. Demand deposits are technically the loans to the banks. It is the liability of the bank, hence, there is a need to provide security to those depositors in the form of reserve requirements. We are also ignoring the nature of transaction in the provident fund scheme. I suggest that it continues as it is. It may be invested or retained somewhere in safe custody.

DR KHAIRAT: A suggestion has been floated that interest money earned by foreign branches of Pakistani banks should be used for charitable purposes. I want to know whether any *haram* earned can be given as charity.

MAQBOOL MALIK: Under the conventional banking, banks maintain most of the accounts for export and import transactions. Currently, the banks maintain certain credit limits and enjoy credit limits outside. When the credit limit falls short, the import transactions can be settled through overdraft facility. Now, if the system is switched over to Islamic banking, how will it solve the problem?

DR HUSSEIN MULLICK: Finance companies failed not only because they gave more income to their depositors than what they were earning, in fact, these institutions failed because they were transacting business on non-business lines. They were making money out of transactions, say purchasing a property worth Rs 1 million and showing it worth Rs 2 million on paper. Second, is there an Islamic alternative to opening of L/C for imports and exports?

DR GHULAM RASOOL: I would like to focus on two areas. First, the provident fund. These funds are kept in an organisation which already exists. A large part of these funds at present is kept in the Khas deposits for a fixed return. These funds could be very usefully invested. As regards the *mudarba* certificates there are two types of profits. The one which the *mudarba* companies floated on the stock exchange, at pre-

sent restricted by the amount of funds at their disposal. They are not allowed to generate funds of their own. It restricts them because they have to operate within their paid-up capital. For instance, the leasing companies are not allowed to generate funds by issuing term certificates.

DR ARSHAD ZAMAN: During the last 10 years of the Islamisation efforts, one major approach was the formulation of the modes of financing. I remember sitting in a meeting of the finance ministry with muftis around. There was always a consensus that it was for the government to formulate the kind of modes that can be used. I wonder in retrospect whether you would not consider the view that Shari'ah takes everything as *mubah* unless it is not explicitly in conflict with something which is established as *haram* and therefore we have to have a choice on whether the specification of *haram* should be centralised or we leave it to the contracting parties to decide themselves. If anybody has any doubt during transactions, he can consult the Shari'ah board.

NAWAZISH ALI ZAIDI: Dr Arshad Zaman has made a good point. First, I have not dealt with public finance because my paper was on riba-free alternatives in commercial banking. Second, I am with you to decentralise the matter as far as it helps the economic activity. The very idea of setting up the Shari'ah committees is to work out some good alternatives. They can send it to the national Shari'ah board in order to seek its clearance. I think the board would have no objection if this is permissible on Shari'ah grounds and within the limits of the economic policy. About the *mudarba* basis of financing, at present, the bank cannot finance an individual; banks can only finance a *mudarba* company by purchasing its shares.

As regards the cooperative societies, I agree that the Islamic principle of doing business is honesty; if one collects money and runs away, this is no banking. Another point was about the opening of a letter of credit for import. When purchasing freight bills is continued, the alternative suggestion is to finance imports and exports on profit-sharing on case-to-case bases.

About the foreign accounts, I can give an example. When

the Islamic banking was introduced in Iran, the Bank Milli of Iran was maintaining an account with the Allied Bank of Pakistan, Karachi. They sent a telegram to the Allied Bank, which read:

“Please note that in case there is shortage of funds, ask for replenishment immediately. For any overdraft, we shall not pay any interest.”

This is the spirit demonstrated by one bank. The same spirit can be demonstrated by us.

Dr Khairat talked about charitable purposes. His question is whether a *haram* thing can be given as charity. I think this is the position being adopted by the Islamic Development Bank, Jeddah. They earn interest on their funds kept outside and they give it as charity to *madrassas*, and so forth. We consulted religious scholars in Iran whether money earned in an un-Islamic manner can be given to charitable causes, and their answer also was yes. This is a very recent reply.

As to the question about reserve requirements, I said that an Islamic banking model may take many forms and I suggested only one form. You can suggest some other form. I also said that some writers have recommended that there should be no reserve requirements on the profit-loss accounts, and that there should be only reserve accounts. If the central bank agrees, you can have it. There is nothing Islamic or un-Islamic about that. This is just one way of doing business.

Interest-Free Banking: A Proposal

DR GHULAM QADIR

Each of the three constitutions of Pakistan (1956, 1962, 1973), adopted so far, contains a clause making the elimination of *riba* (interest) an objective of the state. However, the first serious initiative in this direction was taken when the late General Ziaul Haq assumed power in 1977 and the Council of Islamic Ideology, on his directive, constituted a panel of economists and bankers to suggest ways and means for eliminating *riba* from country's economy. In the light of the recommendations of the panel, as approved by the council, the State Bank prescribed 12 different non-interest-based modes of financing which the banks could use for extending finances with effect from April 1, 1985. Similarly, on the liabilities side, all bank deposits, with the exception of foreign currency deposits, were to be on the basis of participation in profit and loss of the banks effective from July 1, 1985.

Two of the modes of financing prescribed by the State Bank, namely financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and were closest to the old interest-based operations. Hence, the banks confined their operations mostly to these modes, particularly the former, after changing the simple buy-back agreement (pre-

The views expressed in this paper are strictly those of the author and should not be attributed to the organisation for which he works.

scribed by the State Bank) to buy-back agreement with a mark-up, as otherwise there was no incentive for them to extend any finances. The banks also reduced their mark-up-based financing, whether through the purchase of client's property or through the sale of goods to clients, to mere paper work, instead of actual buying of goods (property), taking their possession and then selling (back) to the client. As a result, there was no difference between the mark-up as practised by banks and the conventional interest rate, and hence, it was judged as repugnant to Islam in the recent decision of the Federal Shari'ah Court.

As banks are essentially financial institutions and not trading houses, requiring them to undertake trading in the form of buy-back arrangements and sale on mark-up amounts to imposing on them a function for which they are not well equipped. Therefore, banks in Pakistan made such modifications in the prescribed modes which defeated the very purpose of interest-free financing. Furthermore, as these two minimum-risk modes of financing were kept open to banks, they never tried to devise innovative and imaginative modes of financing within the framework of *musharakah* and *mudarba*.

Fixation with Certain Modes of Financing

Besides, problems inherent in the menu of financial assets allowed to banks in 1985, there has been one fundamental problem with our approach to the Islamisation of the financial sector in the past. We seem to have a fixation with certain types of *musharakah* and *mudarba* and do not seem to be willing to go beyond these modes of financing. The fact is that these modes of financing were in vogue in Hijaz even before the advent of Islam and the Prophet (pbuh) approved them. In the present era, if Muslim experts in finance devise some other modes of financing based on profit-and-loss sharing and religious scholars judge them as not repugnant to Islam, these should be as Islamic as various forms of *musharakah* and *mudarba* in vogue at the time of the Prophet (pbuh). The same creativity of the Muslim mind, which invented calligraphy as an alternative expression in the field of creative arts because of the prohibition of painting of human

figure, should be at work in this area. We should come up with a wide menu of financial instruments suiting the preferences of different groups of savers and investors with regard to the mix of risk and return.

In the following paragraphs, an attempt has been made to briefly describe the existing relationship between depositors, banks and borrowers and then propose alternative framework in which the nature of the relationship will be quite different from the present one. Some measures should also be suggested for ensuring the disclosure of actual profits and losses of the units being financed by the bank.

A commercial bank in the present age serves as a financial intermediary between those economic units who have more funds than they want to use, i.e. surplus units and those units who have plans to spend more than what their own financial resources would allow, i.e. deficit units. Surplus units deposit their surplus funds with banks which, in turn, lend these funds to deficit units for meeting their working capital requirements, for financing their investment expenditure and even for consumption expenditure. Some economic units also keep their transaction balances with banks in the form of current deposits and draw upon them as and when the need for spending them arises.

In addition to deposits, which are the main source of financing bank operations, equity of shareholders also contributes to the total pool of funds available to banks for their operations. The two items, deposits and equity, appear as liabilities in the balance-sheet of the bank. On the assets side, the major item is the loans made by the bank besides the physical assets like buildings, furniture and office equipment. Both lending and deposit-taking by banks is done on the basis of fixed interest rate. The banks charge a fixed rate of interest on the funds lent by them irrespective of the actual magnitude of profit earned or loss incurred by the borrowing entity, except in the case of the bankruptcy of the borrower when the bank may lose even a part of the principal amount. Similarly, depositors receive a fixed rate of interest on their deposits which is known at the time of making the deposit.

In a financial market, where the forces of demand for and

supply of loanable funds are allowed to operate freely, there could be a link between what the users of funds (borrowers) earn and what the providers of funds (depositors) receive. Increase in the earnings of borrowers will lead to an increased demand for funds, rise in the rate of interest paid by them to banks, which will eventually be passed on to depositors. But even in the most free enterprise economies, interest rates are manipulated or at least influenced by the central bank through its open market operations and discount rate policy, even when it is targeting monetary aggregates rather than the rate of interest as such. The interest rate is as much a reflection of the state of the economy in terms of the profitability of business as it is a policy instrument for influencing the level of economic activity and for the allocation of funds. Even McKinnon and Shaw, the two leading advocates for freeing of interest rates in formal credit markets from government control in developing countries, advocate an increase in interest rates for improving the allocation of resources and for channelling more funds through financial intermediaries. They do not argue for market-determined interest rates as such.

Suggested Framework

One of the possible frameworks for the working of the Islamic banking system could be as follows:

An Islamic bank like a western bank will mobilise funds for its operations through both equity and deposits. However, unlike a western bank, depositors in an Islamic bank will also be shareholders, but of a somewhat different category than equity holders. This distinction is justified by the difference in the nature of their relationship with the bank. Whereas a shareholder's relationship with the bank is of a permanent nature, a depositor relates to the bank temporarily and hence his or her stake in the institution is much less than that of a conventional shareholder. The implications of this distinction will come out clearly when the allocation of profits or losses of the bank between depositors and equity holders is discussed below.

The primary distinction between a western bank and an Islamic bank is on the asset side and any deviation from the

western practices on the liabilities side is a derived one. Therefore, there is a need to concentrate on the management of assets of banks and make it compatible with the injunctions of Islam. The major flaw in on-the-ground efforts at Islamisation of the banking system so far has been the absence of any fundamental change in this area as all the energy being spent on devising ways for allocating the so-called profits earned by the bank among equity holders and various types of depositors. An Islamic bank could acquire four major categories of financial assets arising out of: 1) equity participation in other business concerns; 2) long-term financing of investment; 3) medium-term financing of investment; and 4) financing of the working capital requirements of commercial enterprises. Commercial banks, raising their own funds mainly by issuing short-term liabilities, will concentrate their financing operations in meeting the working capital requirements and some fixed-term financing of investment. Their involvement in equity participation may be only marginal and major part of that should be coming through stock markets and investment banks which raise long-term funds.

Assuming that these are the only means of financing for business houses, whether funds come through commercial banks, stock markets or investment banks, the total profit or loss of the business concern could be allocated among these categories with weights assigned to each category in accordance with the risk and maturity period (where relevant) of each asset. These weights may be negotiated between the bank and business enterprises availing finances and could vary across firms and over time, reflecting market conditions as well as the circumstances of each individual recipient of bank funds. For instance, a firm with low current profit but expecting a sharp increase in profits in the medium-term will be able to secure bank finances only by offering relatively higher weights for the allocation of profit and lower weights for the allocation of losses to such finances. (The only condition, imposed by Islam, may be that no category of finance can be assigned a weight equal to zero for the allocation of profit or loss.) Firms currently enjoying high rate of profit will be able to negotiate relatively lower weights for bank finances to be used for the allocation of profits.

The allocation of profit or loss discussed above will be for

the pre-tax profit. After that allocation, corporate income tax (if it is to be continued) may be deducted from the part being assigned to the individual shareholders, but no such deduction should be made from the share assigned to the bank. Just like the interest expense of business concerns, this part may be treated as cost for the purpose of taxation, because otherwise these profits will get taxed thrice, which will be regressive considering the bulk of deposits in Pakistan as well as in other countries come from people of small means. Moreover, the taxation of this part of profits at the level of the user of bank funds will mean starting the new system with a disadvantage for the depositors compared to the old system. Besides, no part of profits assigned to the bank should be allocated to reserves of the enterprise, as depositors who are real owners of the funds do not have any long-term stake in the enterprise.

The central bank could still serve as the financier of the last resort for commercial banks. However, its finances will be provided on the basis of sharing in the profits and losses of the banks. It could influence the weights assigned to each category of finance provided by banks to business concerns by changing the weights it requires for its own financing for banks in sharing profit or loss with the latter. For instance, if the central bank wants to pursue an expansionary monetary policy, it could lower the weights for its financing. It will encourage the banks to avail themselves of the financing facility from the central bank. With increase in the funds available with banks, they will be inclined to negotiate lower weights for various types of financing provided by them to business concerns. With larger share of profits remaining with the private businesses, economic activity will pick up.

This way the weights assigned (rather negotiated and therefore determined by market forces) to bank finances for sharing profit and loss with businesses could be used for influencing the level of economic activity. The role of the profit-and-loss sharing in the allocation of resources is obviously there, as the banks being profit-maximising institutions will finance only economically viable projects. Hence, funds will flow to the most productive uses.

Evaluation and Further Suggestions

The arrangement suggested above has all the essentials of sharing profit and loss, but is still different from the conventional *musharakah* and *mudarba* where the ratios in which the profit or loss is to be shared have to be negotiated by parties to the financial transaction or could be specified by the central bank in the case of the banking system. Nevertheless, the idea of ratios for the allocation of profit or loss is embedded in weights assigned to various categories of finance. The arrangement suggested above is essentially a type of *shirakat* (partnership). The better known types of *musharakah* and *mudarba* have been deliberately kept out as these may not be suitable to the bulk of financing undertaken by banks, where assignment of profit or loss to individual credit lines, availed by modern corporate bodies, on the basis of specified or negotiated ratios is extremely difficult.

Because of these considerations, allocation of profit or loss to only broad categories of finances provided by banks and equity holders according to some negotiated weights has been recommended. However, banks could enter into conventional *musharakah* or *mudarba* arrangements with sole proprietorships, the simplest form of business organisation, where the assignment of profit or loss is easier. Besides, the development of venture-capital institutions could be facilitated through proper legislation and these institutions will be most suited to undertaking *musharakah* and *mudarba*. Other modes of financing like leasing, hire-purchase and *murabaha* (trading on deferred payment basis), allowed by the State Bank for commercial banks in 1985, do not seem appropriate to bank financing. Given in their hands, these will get distorted and will degenerate into essentially interest-based arrangements. There are a number of specialised financial institutions which can better handle these modes and the same have been set up in large numbers in Pakistan after the introduction of the process of Islamisation. Provision of *qard-e-hasan* and loans on the basis of service charges is also not the function of a commercial institution like a bank which exists with the sole objective of making profit. Welfare institutions like the Baitul Maal should perform such functions. However, because of the widespread network of branches, banks could be used for the disbursement of such assistance

for a specified fee to be paid by Baitul Maal.

Once the profit or loss has been received by the bank, it can then be assigned to various liabilities of the bank in accordance with appropriate weights assigned to each type of liability. This arrangement for assigning profit-and-loss of the bank to various liabilities has already been there since 1985. Needless to say that the same weights should be used for assigning any loss incurred by the bank as for assigning the profit. Again, reserve building by the bank should have no claim on the part of profits allocated to depositors who have a temporary relationship with the bank unlike equity holders.

Generally a concern is voiced about the viability of the financial system based on profit-and-loss sharing in a society where concealment of corporate profits and siphoning of funds from corporate accounts to personal accounts are rampant. It is argued that in such an environment, banks providing finances on the basis of profit-and-loss sharing will end up in sharing losses only and will not be able to survive. Agreed that malpractices exist in Pakistan's business sector, but the problem is there in all societies, though its seriousness may vary. And everywhere there are laws to address it. Because of the gravity of the problem in Pakistan and also because of the special demands of the alternate banking system being considered for introduction, we may consider some additional measures, both positive and negative, for handling the problem. Some of these measures are listed below:

- 1) One very radical measure that has been proposed is the replacement of income tax by tax on the net worth of corporate bodies as well as individuals. That will take away a major disincentive for disclosing the amount of profit. If the measure is taken, our earlier submission regarding the exemption of profit assigned to the bank from income tax will become irrelevant.
- 2) The State Bank may issue some additional prudential regulations prohibiting the exposure of banks to business concerns which have shown losses or earned no profit during three consecutive years after coming

into full production. After all, none of us is willing to put his money on a losing horse. Why should banks be allowed or required to advance public money to losing concerns?

- 3) If a business concern, being financed by a bank, starts showing losses, an objective and professional inquiry should be immediately initiated to establish the cause of the loss. All the banks may collectively fund the establishment of a professional body to undertake such inquiries on their behalf.
- 4) For upcoming enterprises without any track record, moral as well as professional qualifications of sponsors and the viability of the project in the light of market conditions should be thoroughly scrutinised. For this, banks will have to recruit better qualified professionals specialising in different areas like finance, marketing, engineering and economics to constitute project appraisal committees within each bank.
- 5) Stringent legal measures may be administered against the connivance of auditors with business concerns for the underreporting of their profits, overestimation of costs and other malpractices. On the extreme, an erring auditor could even lose his or her licence to practise the profession.
- 6) To exert moral pressure, members of the board of directors and the CEO of the firm being financed should be required to take an oath on the Holy Qur'an at the time of signing a financing agreement with the bank that they will neither deliberately conceal any profit earned nor exaggerate losses incurred by their firm. Similar oath should be administered to the individual owners of sole proprietorships or partnerships. Every bank official having an input in the process of approval of application for finance should also be required to take an oath at the time of his induction to the office that no consideration other than the economic and financial viability of the venture will guide him in recommending or approving the application.

Below is an illustration of the proposed allocation of profit of a typical business concern where total amount of annual profit is Rs 20 million:

Proposed Allocation of Profit of a Typical Business Concern						
Type of Finances	Amount	Period (in years)	Weight	Product	Ratios	Share of Profit (Rs in million)
Equity	7	1	3	21.	0.344	6.9
Bank-provided equity	3	1	2.5	7.5	0.12	32.5
Bank-provided long-term finance	8	1	2	16	0.26	25.2
Bank-provided medium-term finance	7	1	1.5	10.5	0.17	23.4
Bank-provided short-term finance	12	1/2	1	6	0.09	82

COMMENTS

MAQBOOL AHMAD MALIK: I know the people from business community who are against the profit-and-loss sharing. The reason is that they hate the idea of sharing profits with their depositors, nor do they want to disclose their profits. I think we should do away with income tax system and replace it with network taxation. Perhaps that would banish the fear of the income tax department, which is one of the disincentives for disclosing the actual profits.

HAJI ABDUL JABBAR: By now we have several years' experience in the buy-back system introduced in 1984-85. We are, though, critical of the way in which the banks have operated since then, the experience, nevertheless, is there, and now when we want to shift to a better Islamic system, it is easier to shift rather than to shift from the interest-based system to which we were used to before 1984. The credit should go to the then Pakistani government which, despite the recommendation to have first clean-up exercise, forced the bankers to introduce the system in the liability side.

The second point is the role of mark-up. There are certain transactions where *musharakah* cannot be implemented. Like the House Building Finance Corporation or the Agricultural Development Bank because they deal in development projects rather than short-term financing. Similar is the case of small businessmen. There have to be something other than profit-sharing basis. There the mark-up or *bai' mu'ajjal* is the only alternative. You may call it leasing, because leasing is another mark-up pricing and it can only be done in the case of machinery and equipment and not in the case of supply of fertilisers.

We have to keep in view the liability side of the commercial banks as well as the requirements of clients and entrepreneurs. Their entire need is not for the long or medium term, they need working capital. We have to give them the same facility that they had under the interest-based system. They can operate by depositing when they are surplus in

order to reduce the financial charges of interest or in the form of mark-up. The profit-and-loss sharing is one of the alternatives and the banks can withdraw when they are in need of funds. We have to keep in view the framework of the commercial banking in Pakistan and in most other countries. It will take time to create a model for other countries to follow.

Riba-Free Alternatives for Transactions in Commercial Banking: A Blueprint

ASSET SIDE OF THE BANKING SECTOR

DR M FAHIM KHAN

SECTION I

Islamic Financial System: A Brief Introduction

Briefly speaking, we are talking of a system with the following features:

- a) There is no interest in the economy. Financial capital can earn income only by bearing and sharing risk of losses. All banks, commercial financial institution and development financial institutions will seek and provide finances which will always have some element of risk-bearing. Though there can be several ways to substantially reduce risk-bearing by the financial institutions, yet all of them have to have some risk-bearing in some form by the finance supplier.
- b) If financial capital is not willing to bear and share risk, it can then be advanced on *qard-e-hasan* basis. In this case, financial capital neither earns any income nor bears or shares any risk of loss. Commercial financial institutions, of course, will not indulge in such transactions on large scale. The system will develop special institutions for this type of

financing, either on cooperative basis or in public sector.

- c) There is Zakah and charities in the system, the minimum obligatory levy being 2.5 percent on the ownership of financial capital. Besides, serving as a deterrent to keep the financial capital idle, it also serves as an obligation-free financial support to the low-income population.
- d) Public borrowing is constrained by the absence of interest in the economy. Public borrowing will either come in the form of risk-bearing capital for commercially productive projects or it will come in the form of *qard-e-hasan* to the government. Government securities bearing return can be issued only for such borrowing that are linked to commercially productive activities.
- e) In principle, this is for the government to print money if its benefits outweigh its cost.

Within this broad line, it will be instructive to go into a bit more detail about the modes of financial accommodation in the above-mentioned system where interest is absent and financial capital can earn income only by bearing risk of loss.

Modes of Financial Accommodation

From the Islamic teachings, we can identify two categories of permissible forms of financial accommodation. One, we may call direct financial accommodation and the other indirect financial accommodation.

DIRECT FINANCIAL ACCOMMODATION

The financial needs of someone are allowed to be met by the finance owner in one of the following two ways: One, *qard-e-hasan* system (QHS) and the other, profit-loss sharing system (PLS). Under QHS, a finance owner may provide a loan to someone who needs it. He will have a claim only on the principal amount. He cannot claim any return on it, small or large, nominal or real, directly or indirectly. The finance

owner in this case is also obliged to reschedule or postpone the repayment of principal amount, if the borrower's conditions are such that he does not have the ability to pay. The postponement is required to be allowed until he becomes able to pay.

If a finance owner intends to benefit out of his financial accommodation, then he will have to enter a PLS arrangement with a user of finance in the context of a specific productive or commercial enterprise only. The PLS arrangement is not allowed if the financial accommodation is for consumption or for general purpose where the QHS is the only option.

The principle of PLS arrangement is the following: The finances will be provided for a specific project or productive activity. The finance provider and the finance user will agree to share the profit earned from the project according to a pre-agreed ratio. The profit-sharing ratio may be different from the ratio of the investments of the two parties in the project. In case of a loss, both parties will share the loss in exact proportion to their investments in the project. The loss cannot be shared in a ratio different from that of their investments.

There is no other option for direct financial accommodation.

INDIRECT FINANCIAL ACCOMMODATION

There are several permissible Islamic ways of indirectly providing financial accommodation. Some of these are or have been in practice and some more may be discovered or identified in future. Before explaining some major forms of indirect financial accommodation, let us first be clear of the fundamental principle underlying these forms. The underlying principle, which will always have to be adhered to whether it is direct financial accommodation or indirect financial accommodation is that there can be no return earned on one's finances without subjecting these finances to bearing some part of the risk associated with the activity where finances are being used. The only difference between direct financial accommodation and indirect financial accommodation from the point of risk-bearing (if return is to be earned on financing) is that under direct financial accommodation, risk-bearing is in exact proportion to the investment of two parties and is for

the entire period of the use of finances, whereas under indirect financial accommodation, the level of risk-bearing can be different from the risk-bearing involved in direct financial accommodation. Sometimes it may be possible for the finance provider to substantially reduce his part of the risk-bearing (but he is not allowed to eliminate it) and it may also be possible to substantially reduce the period of risk-bearing (though he cannot eradicate it).

Let us briefly describe some major forms of indirect financial accommodation. These forms can be described under three major categories:

- Trading-based modes
- Leasing-based modes
- Service-based modes

TRADING-BASED MODES

There are two major forms. One may be referred to as deferred payment form and the other as deferred delivery form. To understand this concept, let us call the party needing the finance as A and the party providing the finance as B.

Under deferred payment form, the permissible financing would be as given below:

A needs financing to purchase certain goods. B is not interested in doing PLS arrangement with A. B can offer A that he can purchase the goods, needed by him from the market. A will then repurchase them from B at a predetermined profit (mark-up on cost-plus basis) and B will agree to receive the payment until some pre-agreed date. In this way, the financing needs of A have been met and B also ends up making profit on his financing. The risk that B is bearing is that during the period he is marketing the goods for A and all the goods are delivered to A, the entire loss or damage if any will be that of B. Furthermore, it is also possible that after B has made all the purchases for A, A may change his mind or may not like the goods marketed by B and hence B will end up with the responsibility of disposing of the goods purchased by him. This risk though can

further be reduced if B appoints A himself as his (B's) agent to purchase the needed goods. In this case, of course, A will purchase the goods that he needs and risk of rejection of goods is pre-empted. The risk of loss or damage of these goods, however, will remain with B until A finally makes a contract to repurchase them from B. Until A makes this contract, A also has the option to change his mind. Hence, some risk will still be there. Any attempt to eliminate the entire risk, for example, binding A to repurchase the goods from the beginning of entering into the deal will be against the spirit and fundamental principle of the financial accommodation in Islam.

Under the deferred delivery scheme, A approaches B to provide finances and B agrees to do so only by purchasing at a specific predetermined price certain specific goods that B will produce and/or deliver at specific date in future. The financing needs of A are met and B expects to earn a profit, because he must have contracted the price with some expected margin profit. The risk-bearing for B in this case is that he may not be able to realise the expected margin of profit that he had in mind while agreeing upon the price of the goods. The actual price at the time of the delivery of goods may turn out to be lower than what B paid for in advance. Also, B, after delivery of goods, has to store and market them and in this process he bears several risks.

LEASING-BASED FINANCING

Leasing in itself is an alternate to financing. A needs an equipment or real estate, but he does not have financing to purchase it. B uses his finances to purchase the equipment and leases it to A and charges a rent on it. The need of A is met. B makes a profit out of the rent.

It may apparently seem that B is making a fixed income without bearing any risk (and hence is similar to interest). It may be noted that rent does not reflect a return on finance, at least in Islamic sense. Under Islamic arrangements, B will be bearing the following risks while leasing the equipment to A:

- During the entire lease period, the basic maintenance of the leased item remains the responsibility of B.

The total cost of maintenance during the entire life of the item will always be uncertain.

- The leased item may be damaged or go out of order (without any fault of lessee) before completing its life that was supposed to repay the total investment made in it and a certain return on it. Even if insurance is made, the uncertainty of working life of the item will keep the gains from insurance uncertain.
- The lessor is not certain for how much of its active life the item will remain on lease at the rent he expected to repay him the investment and a certain return on it. All above keeps the profit of the lessor on his investment on the leased item uncertain until the item completes its working life.

Leasing, however, is not financing and is only an alternate to financing. As mentioned above, leasing only met for 'A the need for using the equipment or real estate' needed. But if 'A' wanted to own the equipment or real estate and needed financing for this purpose then the leasing did not meet the financing need.

We have leasing-based financing modes which are modes of indirect financial accommodation to meet financing needs in Islamic ways. The leasing-based modes work in the following way:

A approaches B to finance a certain purchase. If the purchase is of a rentable item then he will like to use the leasing-based mode. B makes the needed purchase and hands it over to A on lease. B also agrees to receive (in addition to rent) the payment of the price of the equipment, etc. in instalments. As the instalments of the price are paid, the rent of the equipment also declines proportionately. When all instalments are paid, the rent to be received by B becomes zero and the equipment comes under complete ownership of A. The financing need of A has been met as he ends up owning the equipment due to the financing from B. Also, B ends up receiving his investment along with some return on it in the form of rent that he had been receiving during the period.

SERVICE-BASED FINANCING

A is a skillful person and can earn substantial income from his skill by producing certain goods, but needs financing to purchase raw material. The trade-based mode which allows for deferred payment is also not suitable, because A is not a trader and does not know how to market his or her goods. Service-based financing mode can help meet financing need of such a person. The procedure is as follows:

B offers A all necessary materials to produce certain amount of goods for B and B offers to pay A on the basis of completed output. A's financing needs have been met (and is also relieved of marketing problems). B expects to make profit by selling the goods, produced by A, in the market with some margin of profit.

SECTION II

Islamisation of Financial System in Pakistan in Retrospect

The first formal attempt in preparing a blueprint for an Islamic financial system for Pakistan was initiated by President Gen Muhammad Ziaul Haq who specifically asked the Council of Islamic Ideology on Sept 29, 1977, to prepare a blueprint of an interest-free economic system. The council submitted its report in June 1980. The report was a product of the combined efforts of the experts in economics and banking and those of the Shari'ah.

The council recommended that a detailed blueprint for the switchover to the interest-free system should be drawn up by the government in the light of the recommendations of the council by the end of December 1980. It also recommended the setting up of study groups for effecting such changes in banking laws and other legislation as may be necessitated by the proposed switchover.

By virtue of its scope and technique, the report of the council is perhaps the first comprehensive document written

in the contemporary Muslim world through joint efforts of experts on economics and banking who possessed both practical experience in the field as well as had deep insight into the theoretical aspects of the formidable task entrusted to them.

The council stressed that with a view to ensuring the success of the new system of banking, it was of paramount importance that the government carry out a thorough reappraisal of the tax system, focusing in particular on greatly simplifying the system of income tax. The need for this measure was earlier also underscored by the council while submitting its report on the introduction of Zakah and it was pointed out in that context that proper collection system was not simplified and made sufficiently easy for the assesseees. The council expressed its deep concern in this regard once again, particularly in view of the fact that a thorough reform of the income tax system was a *sine qua non* for the success of an interest-free banking system. This was because that under the new system, the income of the bank would crucially depend upon the profits of the business firms which receive financial assistance from them. If the existing system of income tax remains as it is, the business firms would be inclined to maintain multiple sets of accounts which would deprive the banks of their rightful share in the profit of these concerns and would thus adversely affect the earnings of the banks.

In regard to the operative aspects of the interest-free banking system, the council considered it of vital importance to make it clear at the very outset that ideally the real alternatives to interest under an Islamic economic system are profit-loss sharing or *qard-e-hasan*. Although the recommendations contained in the report were based largely on the principle of profit-loss sharing, yet some of the recommendations referred to other methods such as leasing, hire-purchase, *bai' mu'ajjal* and investment auctioning in view of the difficulties faced, at least in an interim period, in the practical application of the system of profit-loss sharing in its pure form on account of the prevalent standards of morality in the society. The council had, of course, incorporated the necessary modifications into these alternative methods so as to rule out the possibility of any built-in element of interest in them. However, these alternative methods (i.e. those other than profit-loss sharing and

qard-e-hasan), though free of the interest element in the form in which they were specifically laid down in the report, were declared no more than a second best solution from the viewpoint of an ideal Islamic economic system.

The report clearly warned that there was also a danger that these alternative methods such as mark-up, leasing, etc. could eventually be misused as a means for opening a back door for interest along with other evils. It was, therefore, strongly recommended that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general techniques of financing must never be allowed. The council, therefore, recommended that a basic policy decision should be taken to the effect that with the passage of time the operational field of profit-loss sharing and *qard-e-hasan* would gradually be expanded while that of the other alternatives reduced.

For remodelling the banking system on Islamic lines, the report also recognised that it was indispensable to make the necessary changes in respect of all such matters as have a bearing on the operations of banks. Accordingly, the existing laws relating to sale of goods, mortgage, hire, lease, agency, loans, trust, partnership, etc. were also recommended to be amended to make them conform with the Shari'ah and conducive to the promotion of a financial system based on the principle of profit-loss sharing and *qard-e-hasan*.

The report was required to be followed up by more rigorous exercise by a select group of experts from relevant fields to translate the recommendations into specific and elaborate action and policy measures. Such exercise was not carried out in a true spirit.

Instead, some internal exercises were conducted within the finance ministry and central bank resulting into actions quite different from what was recommended by the CII.

State Bank of Pakistan started the process of conversion in January 1981 (and claimed to have completed it in July 1985). The process was planned to be completed in two main phases. In the first phase, Islamic banking was introduced partially in the sense that both Islamic banking and in-

interest-based banking were allowed to be operative in the country. In the second phase, the interest-based banking was claimed to have been eliminated and non-interest-based banking was claimed to have been introduced throughout the banking system. It may be instructive to review the approach adopted by State Bank in order to make recommendations for future action.

PHASE I

This phase was introduced from January 1, 1981, through a State Bank circular 1. According to this circular, interest-based banking was allowed to continue side by side with interest-free banking. Necessary amendments were introduced in banking laws. Banks were asked to establish PLS counters where the depositors who did not like to earn interest on their deposits could deposit their savings on the basis of a share in the profits and losses that the bank may make on these deposits. Banks were required to maintain separate accounts in respect of PLS deposits as also of investment and financing provided out of the amounts collected in the PLS deposits as well as all income and expenditure relating thereto. Investment or deployment of the funds received in these deposits was placed at the sole discretion of the bank. They were, however, restricted to use these funds only in such avenues where the return did not accrue to the bank by way of interest. Necessary amendments were made in all relevant laws, rules and regulations. Banks were asked to periodically pay to the PLS depositors a share of its profits made on the PLS deposits. In the event of incurring loss, the depositors were made liable to bear the loss proportionately. All these provisions were made in the circular mentioned above. Later on, circulars were issued to gradually eliminate interest from financial dealings of the scheduled banks with the State Bank of Pakistan. Mark-up was, however, introduced as the alternative to interest in such dealings.

From July 1, 1982, the area of interest-free operations was further widened by allowing the banks to use more freely the Islamic modes of financing other than the mark-up mode. They were allowed to finance working capital needs of their selected customers in trade and industry on PLS basis (the option of interest, however, was still allowed to continue). In this case, a certain proportion of profit in a venture was made

payable to client as a good management fee (before claiming a share in the profit of the client); the remaining profit distributable between bank and client on the basis of their respective funds employed in the venture. Complete flexibility was granted by the State Bank to the banks for negotiating the management fee and profit-sharing ratio. Profit-sharing ratio once determined, however, was made unalterable. In case of loss, the loss was required to be borne strictly by the bank and the client in the ratio of their respective funds employed in the venture calculated on daily product basis. Financing of fixed capital investment needs were allowed to be financed on the basis of leasing along with complete flexibility in mutually determining the terms and conditions. The financing in trade and industry on hire-purchase basis was also allowed with full flexibility to mutually determine the terms and conditions of such contract.

PHASE II

The State Bank launched a programme of complete shifting over of the entire interest-based banking system to a non-interest-based system. A circular was issued by the State Bank, announcing this shift. This circular made the following provision:

- No banking company would accept any interest bearing deposits and all deposits would be on the basis of participation in profit and loss of the banking company except deposits received on current account on which no interest or profit would be given by the banking company (these instructions did not apply to foreign loans and foreign currency deposits).
- All finances provided by a banking company to any entity including the individuals would be only in the 12 modes specified in the circular.

The maximum and the minimum rates of return to be derived by the banks for these modes of financing are required to be determined by the State Bank from time to time. With respect to investment type modes of financing, the State Bank circular specifically mentioned that the losses will be proportionately shared by all financiers including the banking company. The circular also specified which modes of financ-

ing could be used in what transactions. In case of lending on the basis of service-charge, the State Bank specified an explicit formula with all necessary details. (This formula can be seen in Annexure I.) It was also announced by the State Bank that in case of lending on mark-up basis, no banking company will charge a mark-up over mark-up if the client of the banking company happens to be defaulting in payment.

The commercial banks and development finance institutions, however, were left free to shape their own procedures and contracts of financing to conform to the above requirements and no Shari'ah guidance procedure was laid down in the above rules.

On the liability side, State Bank required all banking companies and DFIs to declare profits on half-yearly basis. (The institutions are, however, required to take clearance from the State Bank before declaring the profits.) The distribution of profits among PLS depositors, creditors and the shareholders of the banking company is done by using the following weights:

A. DEPOSITS

Type and Maturity	Weightage to be given
I. Special Notice Deposit	
• Withdrawal at 7-29 days notice	0.65
• Withdrawal at notice of 30 days and over	0.75
II. Saving Account	
	1.00
III. PLS Call Deposits from Other Banks	
• For term up to and inclusive of 6 months	1.00+0.05 for each month on the basis of the deposits.
• For terms in excess of 6 months	1.30 for the first 6 months plus 0.01 for each subsequent month of the term of the deposit subject to maximum of 2.08.

B. PLS BORROWING

Borrowing of various maturities will be given weightage as

for term deposits of corresponding maturities.

C. EQUITY

Not exceeding five as may be determined by the concerned bank.

Due credit must go to the State Bank and hence to the Government of Pakistan for making enough provision in the law and legal framework to allow anyone to practise banking in true Islamic spirit. Barring a few minor provisions, which too, of course, can be easily corrected, there is no room to say that the legal framework of the country did not allow establishment of a true Islamic bank. If anyone was committed to establishing a true Islamic bank, then there was nothing in his way as far as the State Bank control is concerned. This was certainly not the situation before 1984.

The main point, however, is that it was not merely the question of allowing the establishment of an Islamic bank in the country but in fact the question of moulding the existing banking structure on an Islamic structure. State Bank did not address itself to the question of conversion when issuing the circular to introduce Islamic banking system.

On the face of it, the approach of State Bank was quite rational. A transition to an entirely new system required time and flexibility. State Bank circulars provided both. It did not force the banks to convert overnight. It allowed them to continue to operate interest-based operations while trying to develop the interest-free systems and procedures. It also did not force any particular procedural setup and instead provided them full flexibility to design their own ways and means to meet the challenge of replacing interest by Islamic alternatives.

No doubt State Bank circular provided full support to true conversion but the banks did not show any enthusiasm to shape their system in line with the spirit of Islamic principles. No safeguards were provided in these circulars to ensure that this flexibility provided by the State Bank may not be used to find out ways and means which may look Islamic in appearance but in spirit they may not be very different from or be rather exactly same as interest. Since there was no compulsion from the State Bank to find true Islamic alterna-

tives, the conversion, therefore, solely depended on the commitment and sincerity of the bankers to the cause of Islamic banking. State Bank did not even force the banks to have their own religious board to get religious sanction for the Islamic alternatives to interest that they would develop.

The State Bank's approach to allow interest-based deposits along with PLS deposits for some years was meant to provide time to the banks to develop Islamic financing techniques to deploy their funds. No concrete steps were taken by the State Bank to help the banks in developing a true alternative Islamic structure. State Bank rather assumed too much of the commitment on the part of the bankers to Islamise their banking operations.

The fact that State Bank assumed too much in this respect is reflected from the fact that soon after the introduction of PLS counters in 1981, the influx of deposits in PLS accounts put the banks in serious problem of how to deploy these funds in an Islamic way and the State Bank started receiving inquiries from the banks about what to do with their surplus PLS funds. The State Bank in response to these inquiries, issued a circular (No 36) on October 12, 1982, which says that:

“A bank having surplus funds would be free to place the same with another bank (receiving deposits on the basis of participation in profit or loss) on call-on PLS basis. The latter shall invest such funds in avenues...”

All banks, however, were in the same boat. In such a case, banks could have no option but to find some easy solution. State Bank was required to play much more positive role during the transition period in order to help the banks convert on correct lines. State Bank did not choose to play this role.

The Islamic spirit of mark-up-based financing required that financing institution must bear some productive risk in order to justify the mark-up profit. This spirit is not prevailing in the mark-up-based financing now in vogue in Pakistan. State Bank circular does not provide any compulsion to ensure that the modes selected by the banks meet Shari'ah requirements

in letter and spirit and the bankers lack motivation to do so on their own. The result is that the banks are now getting mark-up in the same fashion as interest is obtained. This fact can very clearly be ascertained by seeing the documentation being currently used by the banks in connection with the so-called Islamic financing techniques. All banks have to use modes and related documentation that is approved by a committee constituted by Pakistan Banking Council. The procedures and documentation of all banks are, therefore, almost identical. These procedures have serious Shari'ah objections.

Guidelines for An Action Plan

AT THE STATE LEVEL

The efforts done by Council of Islamic Ideology at theoretical level and by the State Bank of Pakistan at applied level leave little room for any further effort as far as a blueprint for the application of Shari'ah in the financial system is concerned. What is needed to be done further is only to fill in the gaps in the way of proper adaptation and implementation of the blueprint by the commercial banks to build a strong edifice of Islamic banking. Hence, we try to identify some basic gaps in the blueprint that are not allowing the desired building to come up in the form of the right structure.

1. The most fundamental lacunae perhaps is the lack of Shari'ah counselling, supervision and control. A Shari'ah control board at State Bank level would have prevented such operations as buy-back arrangements and mark-down arrangements to be introduced as Islamic operations and hence spoiling the whole spirit of Islamising the financial system.

2. State Bank will also have to play a leading role to help the commercial banks develop Islamically valid modes of operation. Mark-up-based financing is something that has gained a considerably long record of successful operation in various Islamic banks around the world. State Bank should collect information about this mode of operation and with the help of Shari'ah board should select (or devise) best module and circulate it to all the commercial banks in the same way as State Bank has done for service-charge-based operations. These modules should replace the existing buy-back-based

and so-called mark-up-based operations.

3. Though overwhelming dependence on mark-up-based operations is not desirable yet as an immediate corrective measure the mark-up-based operations (developed on the lines mentioned above) have to be widely introduced throughout commercial banking institutions. This immediate action is required to quickly convert the *haram* income of deposit holders and equity holders to *halal* income. This measure, however, will not bring a change into the economy that the Islamisation of financial system is expected to bring. Simultaneous policies will have to be introduced to motivate and help commercial banks shift away from overwhelming dependence on mark-up-based operations and make substantial operations on the basis of profit-loss sharing based operations. In this respect, State Bank may adopt following specific policies:

- Give commercial banks every year a specific target to be achieved with respect to the proportion of PLS-based operations.
- Provide some sort of an insurance scheme to commercial banks to cover part of their losses that they may incur in running PLS-based operations. State Bank may select specific sectors to be covered by the insurance scheme. The sectors may be selected keeping in view the national priorities, e.g. agriculture, small business, housing, industries in underdeveloped regions, etc.

4. The motivation at the level of commercial banks to shift away from mark-up-based financing to profit-loss sharing will perhaps be totally eroded by the lower and upper limits imposed by the State Bank on the rates of returns from various modes of financing. State Bank is justified on its own right to impose these limits in order to control the motivation towards extracting excessive profiteering (by exploiting the clients) or indulging into cut-throat competitions through offering lower costs on financing. Yet the State Bank has to realise that by imposing such limits, it leaves no choice for the commercial banks but to opt for mark-up-based financing only because it involves less efforts in terms of evaluating fi-

ancing-worthiness of the clients and involves lesser risk-bearing costs for the banks (compared to the PLS-based modes of financing). The banks can be motivated towards using more and more PLS-based financing only if they are allowed to make higher returns through the application of PLS-based modes of financing.

It is not difficult to reconcile the motivational needs of the commercial banks with the economic policies of the State Bank. It is only a matter of devising viable policy package. Some suggestions for such a policy package are as under:

In the sectors where State Bank does not want the commercial banks to go into profiteering, it will fix:

- An upper limit on rate of return.
- A lower limit on the bank financing in the sector on profit-loss sharing basis.

For other sectors, the State Bank will fix:

- A lower limit on the rate of return.
- An upper limit on the financing through mark-up-based operations.

AT THE LEVEL OF COMMERCIAL BANKS

Since the procedure and operations of commercial banks are almost totally regulated by the central bank and the finance ministry, not much can be done at the level of individual commercial banks in connection with developing any distinct Islamic procedures for their own operations. The procedures will have to come from the central bank.

The banks, however, can have their own policies and strategies to make maximum benefit out of the new system within the regulatory framework of the central bank.

On the liabilities side of commercial banks, no major change perhaps is needed urgently. The State Bank of Pakistan formula for commercial banks to share their income with depositors at least helps depositors not to indulge into a riba contract with their banks. They share income of the bank which is a legitimate way of earning income on one's de-

posits. But if the bank's income that they are sharing is a prohibited (*haram*) income, mere legitimising form of contract or the method of sharing income will not suffice. An urgent action is, therefore, needed to reform the assets side of the bank to legitimise their sources of income.

An immediate action is to replace the buy-back arrangements of financing by the Shari'ah approved mark-up-based financing. In this respect, though we expect that State Bank will take the initiative and provide all commercial banks with the appropriate schemes and modules, yet this is an area where commercial banks should take an initiative as well. The relevant regulations are already in force to cover their action. They simply have to have their Shari'ah advisory board to help them adopt mark-up financing models of existing renowned Islamic banks in order to suit local conditions. This is something that can be done without pains and costs.

As mark-up-based banking operations have already gained a lot of experience and acceptance in various Islamic banks around the world, it is extremely easy to acquire the operational models of these banks.

Next step would be to get prepared for use of other modes of financing, particularly the profit-loss sharing based modes which may come either as a mandatory requirement for the central bank or banks may themselves get motivated to augment their profits through the use of these modes which promise a higher return, though with more risk-bearing.

BUILDING NEW INSTITUTIONS

One thing that must be recognised at all levels of the economy in general and at the level of policymakers in particular is that Islamic banking is not merely a change in legal provisions; it is a change in concept and philosophy. It is a new approach towards financial system and requires a totally different attitude from the financial institutions. The financial institutions may have to attract a new clientele, develop new accounting and documentation procedures and will have to train their staff to meet the demands of the new system. Besides, there may be need to change even the institutional structure of the financial system. Some immediate changes are suggested on the following lines:

SEPARATION OF BANKING AND INVESTMENT ACTIVITIES

In Islamic framework, loan cannot be the basis of banking operations. Investments will have to replace loans. Contemporary structure of banking institutions is not geared to making investments in a way to match them with the deposit maturities and hence earn profit to periodically distribute over the deposits. The mismatch of maturities of liabilities and assets is in fact a serious problem for the interest-based banks also. This problem is multiplied when the banks are barred from advancing loans. The problem of mismatch of assets and liabilities in the conventional banking system is being proposed to be solved by separating the banking from the investment activities. Prof Maurice Alais, a Noble Laureate in Economics, has proposed two types of banks:

- i) Deposit banks
- ii) Investment banks

This proposal would be even more suitable to Islamic financial system. State Bank should consider declaring the existing banks as deposit banks only. These banks will receive demand on very short-term deposits and will perform other banking activities such as transfer of money, exchange of currency, safe deposits, etc. and charge fees for providing these services. For those interested in making income on their savings, investment banks should be established which would receive deposits of varying maturities and invest them in projects of corresponding maturities.

DISCUSSION

DR GHULAM RASOOL: Are you suggesting that the investment banks become equity holder also?

DR ZIAUDDIN AHMAD: I have just a few cautions: you have proposed a sort of insurance to commercial banks against losses in their operations. I think we should consult the Shari'ah experts. Second, you have suggested rather a vertical change that the banking and the investment operations should be separated. We should try to achieve our objective without disturbing present structure of commercial and central banking

Third, commercial banks in our country are the largest depositories of nation's savings; therefore, their resources should be devoted to long-term investments, which may increase the productive capacity of our economy rather than confining to short-term deposits.

Furthermore, setting up new institutions and investment banks may take a long time to get them off the ground. I have serious doubts about this proposal at least in the particular position as we are trying to do the maximum in the shortest time to Islamise the existing structure of the country.

PROF KHURSHID AHMAD: You are right as far as the short-term financing is concerned. If we are thinking of these issues in the overall context of the objective Islamic knowledge, I would invite all of you to deliberate on it.

EHSANUL HASAN: You have given due emphasis to the mark-up system. In fact, you have said that we should move via mark-up to the profit-and-loss sharing system. How could it be achieved when somehow the Shari'ah Court has struck down the current mark-up system? How is the mark-up different from the one that has been struck down by the court judgement? Do you think that different mark-up systems are being followed by different banks? Probably, the prevailing type of mark-up is the same that the court has chosen to

strike down. First we have to make it clear.

Also, you said the deposits bank should be separated from the investment bank and the government financial system from the commercial financial system. At present, 35 to 40 percent of the income of the commercial banks comes from the government as they lend their money to government. So the government and the commercial financing systems cannot be separated. What you have said probably does not take into account the realities of the administration.

DR MUNAWAR IQBAL: The unqualified support to the mark-up system may be very dangerous. Even when the Council of Islamic Ideology was giving its recommendation for a truly legitimate mark-up system, it qualified that it may very well open a back door for interest and that is what the experience confirmed later. In many banks, which are operating on truly permissible mark-up system, the Islamic scholars have expressed their uneasiness with the scheme because even if it is permissible in the Shari'ah, it does not bring in the advantages of the *mudarba*. We should emphasise the diversity of various instruments.

Besides, I would suggest that instead of saying that there should be a distinction between the deposit and investment banks, we should have a more diversified approach. In Islamising the system the basic problem, and this is not peculiar to Pakistan, is the underdeveloped nature of the financial sector.

In advanced countries, the financial sector has a number of institutions. They have investment trust, unit trusts, mutual funds, equity and a very strong stock market. These are the things that are backbone of the venture capital in developing economies. Mark-up scheme cannot provide that kind of venture capital. These are the institutions which have to be there. Instead of saying that we should have deposit banks and investment banks, we should diversify the financial institutions' spectrum.

In fact, the unit trust and investment trust, mutual funds, and most importantly a very diversified equity market — the stock exchange — are very much suited for an Islamic econ-

omy. Your suggested investment bank will not fulfil the need. It will float funds for different maturities which will not be possible.

One of the basic purposes of financial intermediation is that the banks should borrow short-term and lend long-term funds. For these things, it is the stock exchange, unit trust and mutual funds where small savings can be collected and invested on long-term basis and the small savings can be depleted over-time.

ISRARUL HAQ: Mark-up is creating a lot of confusion. Is it not possible for us to suggest that the deposit banks concentrate on transfer of money, exchange of currency, safe deposit and charge fee for the services provided?

AHMAD KAMRAN: The proposal of investment and deposit bank is very practical. Experiencing difficulties to invest on Islamic modes on long-term and medium-term basis, Faysal Islamic Bank has not decided to open an investment bank in Pakistan.

COMMENT: It is quite a regression towards the system that we have condemned and are trying to replace.

JALEES AHMED FAROOQUI: This paper has directed the discussion to a different channel, i.e. changing the organisational structure and operations. When Islamic system was being introduced and a delegation of bankers had gone abroad to study the operation of foreign banks, the delegation should have opted for the German model of banking where the banks invest and appoint their member or representative in the board of directors. I have feeling that as we inherited the British system, we somehow are unable to escape it. If we could restructure the whole thing, we may be able to overcome a large number of problems.

COMMENT: The idea is to divert people from those banks which do not pay a meaningful amount of profits to their depositors to new avenues for investment either through investment bank or through something else depending on their initiative. In the present system by offering 5 or 6 percent on saving, the bank keeps them tied up. This is a very ineffi-

cient system in the sense that the banks have to keep 35 per cent of the deposits as reserves. Suppose a bank has 100,000 million rupees; out of this amount, 35,000 million rupees go back to the government. This is a loss in transmission.

DR M. FAHIM KHAN: Thanks for comments. I have my own reflections on the observations. Dr Ghulam Rasool was wondering whether the development finance institutions are the same as the investment banks proposed by me. No, they are altogether a different category. The DFIs cater to the needs of a particular sector by providing a cheaper capital that would have been in other banks. Investment bank is of course a radical change. My suggestion for the investment bank is not for the short term. After presenting the short-term measures, I gave some institutional suggestions for long-term measures and this is where I said we should consider in a long-term perspective to bifurcate the deposit and investment activities. In fact, it requires a lot more thinking.

Mr Israrul Haq has rightly mentioned that there is too much emphasis on the professional loss system based on mark-up. We have seen that banks convert themselves from interest-based operations to Islamic-based operations through mark-up financing very quickly. Our problem is that we want to do something quickly. Now, there is no bar in taking up this *halal* to Islamise our economy and then in a longer perspective, we can move from mark-up to profit-and-loss sharing system.

The difference in actual mark-up-based operations and buy-back arrangement is that in the buy-back they only say that a thing has been sold. Then in the same contract they buy it back. True mark-up-based contract, to begin with, would not say that something is deemed to have been sold and the actual sale and purchase will be done in due time. Who is the buyer and the purchaser is a different matter. Actual sale and purchase will be done and it is not merely deemed to have happened.

Besides, there are two different contracts. One contract is for sale and the other is for purchase. The bank purchases it on behalf of the client — that is one contract. Another contract relates to purchases from the bank. These are two differ-

ent contracts, though in both a small-time element is involved. The bank will be taking a risk, i.e. during the time, the client may refuse to buy it back and it will be the liability of the bank to sell it in the market and get its profits. That risk, though smaller, justifies the return to the bank.

As for the insurance, you are very right that the climate is changing and that we have insured depositors. You are also right in saying that the government and commercial finances cannot be separated. I was not aware that 40 percent of bank's earnings are coming from the government finance. What I am suggesting for the commercial finance, whether it is government or private commercial finance, is that it is easier to be converted. Initially, we may do it on mark-up basis and later we can gradually switch over to profit-and-loss sharing basis.

Dr Munawar Iqbal objects to what he calls unqualified support to the mark-up system terming it dangerous. I did not give unqualified support to the mark-up system. What I said was that let us first do it in the existing framework of the Islamic banking and later we should find ways to move away from it to the profit-and-loss sharing system. I agree that this does not provide for the real Islamic system and I have admitted that it is not the ideal system.

As a starting point, I have given a proposal that instead of having deposits in the banks, we should have more investment banks and a more diversified approach. There is no disagreement on the suggestion that the banks doing mark-up should be called Islamic financial institutions.

The State Bank should impose certain limits on commercial banks to move them towards the profit-and-loss sharing system. If we put lower and upper limits there is no incentive for the private commercial banks to go for the profit-and-loss sharing. This is so because they would like to go for it only if they are sure to earn more profits. If we fix the upper limit for the rate of return, there is no incentive for commercial banks to go for the profit-and-loss sharing system, either. What I am saying is that in the strategic sectors where the State Bank does not want commercial banks to earn a lot of profit, the government should give a mandatory target of a

certain amount on profit-and-loss basis in these sectors and fix an upper limit of say not more than 14 to 15 percent return, thus deploying 10 percent of its funds on profit-sharing basis in the designated sector.

For other sectors, such restrictions are not needed. There will be an upper limit on mark-up operations. It will be 20 percent on mark-up basis and rest on the profit-loss basis.

Mr Jalces Farooqui has very rightly said that we should study another model, the German model.

HAJI ABDUL JABBAR: I am skipping over my comments. I can only say that I have serious reservation about the separation of deposit banking and investment banking.

Financing Govt Transactions in An Interest-Free Economy: A Case of Pakistan

DR FAIZ MUHAMMAD

Elimination of interest from the economy in accordance with the injunctions of Shari'ah would require that government transactions involving interest are also conducted under some alternative arrangements. This paper tries to examine the nature and magnitude of these transactions in the case of Pakistan and evaluate different proposals to make them compatible with Shari'ah. Government transactions have both domestic and international dimensions. In this paper, however, we plan to focus mainly (but not exclusively) on the domestic transactions as the international dealings involve certain specific issues which should become the subject matter of a separate paper.

In Section I, we analyse different aspects of government transactions involving interest in Pakistan. In Section II, proposals to eliminate interest from these transactions and the likely impact on the economy are evaluated.

SECTION I

Interest-Based Govt Transactions in Pakistan

Before discussing elimination of interest from government

transactions it is important to know the nature and magnitude of these transactions in the overall economic activities. It is only after this type of analysis that the impact of any change in these transactions on the economy can be properly evaluated.

The nature and size of government transactions, interest-based or otherwise, depend on the role of the state recognised in a society. Traditionally, this role was no more than to provide defence services, maintain law and order, provide justice, run civil administration and undertake only those economic activities which were found unattractive by the private enterprise. Most developing countries in the 1950s and 1960s, however, opted for planned development and adopted the mixed economy model. Accordingly, the public sector was assigned a direct role in the development of infrastructure, skills and technology. This required more capital than could be accumulated through traditional means of taxation available to the government. As a result, measures like deficit financing, public borrowing and loan from abroad were more widely resorted to.

In the case of Pakistan, the decade of '70s experienced a new spell of increase in the size of the government activity as a result of nationalisation of heavy industries, banks and insurance activities in 1972. This process continued unabated even in the '80s and now one finds public sector involvement in almost every kind of business activity conducted in our economy. Some efforts, however, have been made in the last few years to reverse this trend and reduce the size of government activity in the economy.

Now as far as the interest-based government transactions are concerned they can take place on the following accounts:

- Different types of loans extended by any government agency to other agencies or individuals;
- Government commodity operations (including imports and exports of material and equipment) involving deferred receipts or deferred payments;
- Government borrowing to finance public goods;

- Borrowing for projects whose outputs can be priced one way or the other to determine their private profitability; and
- Borrowing from the State Bank of Pakistan (which is a part of the government) or from other financial institutions in public sector.

Unfortunately, not all the transactions mentioned above can be systematically categorised to identify the nature of interest payment or receipt involved. The available data also cannot be used to classify the transactions on the basis of their sources of financing. In some cases, interest is calculated merely as a book entry and may not involve any actual transaction. Therefore, to be able to evaluate the nature and magnitude of interest-based government transactions one may have to use more than one indicator. We, however, have used only those indicators for which the data from the secondary sources were helpful to do the necessary calculation. Accordingly, we try to analyse the following:

- The size of interest receipts and payments in the federal budgets;
- The overall fiscal deficit and its impact on interest-based government transactions;
- The size of public debt with special reference to borrowing from the domestic sources; and
- The size of intergovernmental transactions and interest payments.

Size of Interest Receipts and Payments

Table 1* presents estimates of the aggregate interest receipts and payment of the federal and provincial governments. Estimates on the receipts also include intergovernmental transactions which are shown separately in two different tables. In Table 2 we show figures calculated on the basis of a

* See tables at the end of writer's paper.

methodological note on intergovernmental interest in the Economic Survey of 1990-91. Tables 3 (a) to 3 (c) provide details of interest payments by different agencies to the federal government taken from the explanatory memoranda on budgets of different years. Unfortunately, the two sets of data do not provide comparable estimates of intergovernmental and intragovernment interest transactions. Yet both sets can be used to view the issue from different angles. Table 4 provides estimates of loans and grants from federal government to provincial governments and other agencies. These estimates can be used to explain the trends in overall and intergovernmental interest receipts. In Table 5 we present data on interest payment by the government on different sources of debt. Composition of domestic debt is detailed in Table 6. We have put all these tables together as they are interrelated and are needed for elaborating the size of interest dealing of the government. Some of the important observations which can be made on these tables are as follows:

- a) Aggregate interest receipts reported in the revenue account of the federal budget has been one of the important sources of total revenue (Table 1). In 1947-48, they were about 14 percent of the total revenue and about 70 percent of the non-tax revenue. Since then in spite of the fact that a number of heads have been added in the list of non-tax revenue, the share of "interest" has continued to remain very high. In the last ten years it has remained around 60 percent of the non-tax revenue or about 13 percent of the total revenue.
- b) Table 3 (a,b and c) enables us to disaggregate the interest receipts of the government. The estimates show that while in 1970-71, the major source of government interest receipts was public sector enterprises (PSEs) and similar other departments contributing about 80 percent of the total, by 1979-80 the scenario was completely changed. Since 1979-80, about 50 percent of the interest receipts of the federal government has come from provincial governments and local bodies. In 1990-91 the share of both the categories went up to 59 percent.

- c) According to the estimates in Table 2 intergovernment interest payments constituted about 63 percent of the total interest receipts of the federal government in 1979-80. By 1983-84, this figure came down to 50 percent probably because the federal government started providing relatively more funds to provinces in the form of grant rather than loans (Table 4). In 1990-91, we again see intergovernment interest payments soaring to 60 percent of the total receipts by the federal government. This is usually attributed to two reasons:
- Better recovery rate
 - Increase in domestic cost of borrowing which was almost doubled between 1980-81 and 1990-91 (see Table 7).
- d) From Tables 3 (a) and 3 (c) we may also see that the major head on which the provinces paid interest to the federal government was cash loans (83 to 99 percent) whereas for local bodies and financial institutions the major head (90 to 99 percent) was other loans (mainly foreign loans). Unfortunately, it is not clear from the available data what is the source of cash loans. But the fact that other loans including foreign loans, USAID local currency loans and German loans point out that cash loans must have been raised from domestic sources. If this is so then it should have profound implications for eliminating interest on intergovernment transactions. We shall discuss this in the next section.
- e) An interesting feature of estimates in Table 3 is that while the interest payments by provinces to the federal government increased by about 67 times between 1979-80 to 1990-91 for financial institutions, this increase was only about five times and for 'all others' the increase was only four times in the corresponding period. This, in our view, has distributional and efficiency implications for the economy which we shall examine after analysing the estimates on 'interest payments by the government.'

Government Expenditures on Interest

- a) Estimates on government expenditure on interest in Table 1 show that there has been a dramatic increase in this account of public finance in Pakistan. Interest payments of the government which was a trivial amount of Rs 9 million in 1947-48 became Rs 1,480 million in 1970-71. By 1983-84 this amount went up to Rs 14,128 million. In 1990-91, the figure on this account stood at Rs 54.9 billion, i.e. 22.3 percent of the total expenditure or 30 percent of the current expenditure.
- b) When compared with interest receipts the interest payment of the government was only 33 percent of the former in 1947-48 but became 210 percent of the same in 1971-72. Only in 1979-80 this ratio decreased to some extent but once again by 1990-91 it became as high as 220 percent of the interest receipts. This means that there has been greater outflow of resources than their inflow on this account from the government exchequer leading to pressure on its resource position. This pressure is now obviously being felt by the government in most parts of its economic management.
- c) Table 5 shows the major claimant of government interest payments since 1979-80. Accordingly, in 1979-80, about 47 percent of the payments was made on foreign debt and the rest on domestic debt. By 1991-92 this ratio changed dramatically when the domestic debt claimed more than 75 percent of the total interest payments by the government. There are two interrelated factors responsible for the change: (a) In the last decade or so the government has been borrowing heavily from the domestic sources (Table 6); and (b) cost of domestic borrowing as opposed to foreign borrowing has been increasing over time (Table 7).
- d) One of the most pertinent features of the domestic debt is revealed by changes in its composition over time. There are three main accounts on which do-

mestic debt is raised. They are:

PERMANENT DEBT

It refers to long-term borrowing by the government in the form of market loans (for Wapda, OGDC, etc), prize bonds, federal investment bonds (non-bank) and FEBCs. Bearer national fund bonds introduced in 1985-86 were also part of the permanent debt but were discontinued in 1991-92.

FLOATING DEBT

This debt stands for short-term borrowing of less than a year. Treasury bills of different types and cash credit accommodation from commercial banks are notable components of this form of debt which is raised mainly for ways and means to support the government.

UNFUNDED DEBT

This represents the net proceeds of various small saving schemes launched by the government. Details of domestic debt in Table 6 indicate that the floating debt has been the most significant component of the total debt in the '80s. This was mainly due to low interest rate which treasury bills usually carried. Since 1989-90, however, there has been some decrease in the amount of floating debt as the government is being asked by international agencies to raise domestic debt on competitive ground. As a result the amount of permanent debt increased dramatically in 1990-91. But floating debt presents a special problem from Islamic point of view. It is one of the major sources of interest earning of the State Bank of Pakistan. Any effort to remove intergovernment interest should, therefore, take notice of this aspect of the public debt.

The most significant development relating to domestic debt in the last few years is a dramatic increase in

the size of unfunded debt. This debt was only about one-third of the floating debt in 1980-81 but by 1990-91 it became more than the latter (Rs 137.5 billion as opposed to Rs 135.6 billion for the floating debt). Since unfunded debt carries very high rate of interest as opposed to the other two categories the total interest liabilities of the government on this account have been disproportionately high. For example, in 1985-86, when the size of unfunded debt was only 28 percent of the total domestic debt, the interest payment of the government on this head was 48 percent of the total interest on domestic debt (Table 6). This figure became as high as 53 percent in 1988-89 but came down to 33 percent in 1991-92 due to increase in the share of permanent debt in that year.

Distributional Implications of Interest Receipts and Payments of the Government

Estimates in Tables 1 to 7 can be used to analyse the distributional implications of the interest transactions of the government. It is evident from the tables that the major interest receipts of the government came from the provinces. Financial institutions and public sector corporations (PSCs) which received sizable amounts of loans (channelled through the federal government) did not contribute to the interest receipts of the government in proportion to the amounts received by them. This means that the government receipts of interest came relatively more from the projects or individual using provincial loans and less from those benefiting from financial institutions and PSCs. Payments made by provinces most probably came from taxes paid by the people at large whose effective burden is usually shared by low- and middle-income groups. On the other hand, it is now well established that the major beneficiaries of loans from financial institutions are big companies and influential borrowers. The loans provided to PSCs in the first place have not been used efficiently and the major beneficiary of the loans has probably been public bureaucracy.

On the side of interest recipients we can see from Table 6 that the major share went to domestic debt holders (53 percent in 1979-80 and 75 percent in 1991-92). Among them the most prominent beneficiaries are those holding unfunded debt (48 percent in 1985-86, 53 percent in 1988-89 and 33 percent in 1991-92). Within the unfunded debt categories the major share of interest is received by holders of Khas deposit accounts and Khas deposit certificates. Although the information regarding the distribution of investment in these schemes by income groups is not readily available, it is generally believed that majority of investors in these schemes is not necessarily small savers. People with black money and having access to cheap loans through political sources have also been observed to invest in these schemes to whiten their money and earn the differential profit margin offered by them.

This description of the contributors and recipients of interest on public debt points out that the distributional impact of these loans on the economy may not have been very healthy one.

Some Related Indicators of Government's Interest-Based Transactions

Before proceeding further we must refer to two other indicators for assessing the nature and size of government transactions which may involve interest. They are: (a) overall fiscal deficit of the government (Table 13); and (b) the advances by the scheduled banks to different banks of government. Estimates relating to these aspects of the economy are presented in Tables 8 and 9, respectively.

The overall fiscal deficit indicates the total amount which the government will have to raise from sources other than its own to finance its activities. It is the difference between total expenditures and total revenue (including profits of PSCs) and revenue generated through government disinvestment schemes. Table

8 shows that the overall deficit of the government has continued to increase particularly since 1980-81. Although in relation to GDP this amount has been varying between 6 to 8 percent the total need to borrow from different sources has not been constant. This we have already seen from Table 6 that due to increasing demand for public debt the government had to rely more and more on sources of funds like saving schemes. In this situation even if the ratio of deficit to GDP stays constant, the pressure on domestic means to finance the deficit would not come down.

Table 9 shows schedule banks' advances to government agencies between 1982 and 1990. The estimates show that in 1982, the government got as much as 38 percent of the total bank advances. In 1990, this percentage, however, came down to 20 percent showing a shift in the government policy of meeting its requirements from non-bank sources.

SECTION II

Evaluating the Proposals to Eliminate Interest from Government Transactions

Some of the major inferences which can be drawn from our analysis in Section I are as follows:

- The main cause of increase in interest-based government transactions is the budget deficit. Our taxation system and other sources of revenue are not sufficient to meet our current and development needs.
- One of the major factors which has contributed to the enhancement of our budget deficit is the interest payment by the government on domestic and foreign loans. Therefore, if somehow these payments are eliminated our budgetary position can dramatically improve and the process of borrowing can be reversed.

- The government on the one hand pays interest on funds which it borrows and on the other receives interest from those to whom it lends (the borrowed) funds. Similarly, it gives grants to provinces from whom it also receives interest.
- It is not clear from the sources of government borrowing how exactly those resources are used in a given period. Apparently most of the funds are made part of the general consolidating fund in the budget and allocated to development and non-development needs from that account. In this way no account of the return generated by a particular fund upon its use is available.
- The government generates huge amount of funds by selling treasury bills of different types to the State Bank and pays interest on the same. Being the major shareholder in the assets of the State Bank it also gets profit from the earning of this institution.

Keeping the above points in view, we may now examine the proposals which are made to finance government transactions on interest-free basis.

Minimising the Budget Deficit

Since the main reason for government to borrow on interest-basis is the existence of budget deficit, the natural starting point for any reform should be the steps needed to minimise this deficit. In this process all avenues must be explored to enhance the amount of tax and non-tax revenues within the limits of Shari'ah. At the same time steps are needed to be taken to reduce the government expenditures. Reducing the size of the government through privatisation and disinvestment of public sector enterprises could be steps in the right direction.

However, no matter how prudent we try to become in managing our budget it is a fact that for a developing country like Pakistan the need to generate resources from nongovernmental sources will always be there. This means that we

have to develop tools which can be used to attract private capital for financing government transactions. However, as we have seen in Section I not all transactions of the government have to depend on private capital. In most cases these transactions take place within the government. Therefore, apparently, there should not be any problem in eliminating interest from those transactions without causing any serious dislocation in the optimum use of resources. We examine some of these cases in detail.

ELIMINATING INTEREST FROM LOANS TO PROVINCIAL GOVERNMENTS AND OTHER GOVERNMENT AGENCIES

For many years almost the entire development budget of the provincial governments was financed by the federal government. In this situation it seemed illogical on its part to charge interest on cash loans made available to the provinces. The federal government should be in a position to reduce the development grants to the extent that it does not have to charge interest from the provinces. Some of the fears about the misuse of funds by provinces under this arrangement have been adequately addressed in a report of International Institute of Islamic Economics on the subject.

INTEREST PAYMENT TO STATE BANK OF PAKISTAN

Federal government at present pays interest on different types of treasury bills held by the State Bank of Pakistan, particularly the ad-hoc treasury bills, and treasury bills are used by the government as ways and means of support. State Bank charges interest on these advances which in reality is no more than a book entry. It is proposed that no interest be paid on resources generated by the government under this account. State Bank received about Rs 5 billion as interest from the government in 1990-91. This amount was about 33 percent of the total intergovernment interest receipts in that year. Removing this amount from the government budget should reduce the budget deficit by a significant proportion.

Alternative Proposals to Mobilise Resources for Government Transactions on Interest-Free Basis

A number of proposals have been made in the literature for

attracting resources for the government use on interest-free basis. Some of them are discussed below:

CREATION OF DEBT RETIREMENT MUTUAL FUND

According to this proposal, the government should establish a mutual fund based on government-held shares of selected public enterprises. All the funds presently invested in saving schemes can be converted as part of this mutual fund. The fund can be managed by an independent group of portfolio managers who may be initially appointed by the government. Subsequently, the management of the fund can be chosen by the certificate holders. This is a useful proposal and can attract resources for the government to further various projects.

USE OF CURRENT-ACCOUNT DEPOSITS FOR FINANCING GOVERNMENT TRANSACTIONS

Most banks at present make use of the current accounts for profitable activities but do not share the profit with the government. With pertinent legal changes these accounts can be made accessible to the government for financing activities such as national defence.

OTHER DEPOSITS

Besides encouraging people for depositing money with the government as *qard-e-hasan* of which the principal sum is ensured, the government should also accept deposits which are not *qard-e-hasan* but at the same time there is no guaranteed return on them. The government could only guarantee the principal and may announce at its own and without making it a condition some return on such accounts on the basis of their use from time to time. The government may allow concession on taxes to those holding these accounts. While this practice may be consistent with Shari'ah there is likelihood that it is practised like one of the existing interest-based schemes. Therefore, the scheme should be introduced with sufficient precautions.

BUSINESS TRANSACTIONS

As far as those activities of the government are concerned which can be run on business lines the government should raise funds using Islamically acceptable modes of financing. This should be particularly relevant to commodity operations of the government including its import and export operations.

MORATORIUM ON INTEREST PAYMENTS

Finally, I believe that the government needs to take some radical steps to extricate itself from the existing debt, in particular the domestic debt. The present financial situation of the country demands that to the extent of existing domestic debt the government should stop paying interest with immediate effect. This will save huge sum of money for the government which can be used to clear the accumulated liabilities.

Conclusions

Interest-free alternatives to financing government transactions (or for that matter other economic activities) is a concept which would require changes in economic, political, legal and moral spheres of life. Therefore, unless the necessary changes in related spheres are made the full impact of interest-free dealings on the economic arena may not be realised. To begin with, there has to be commitment at the national (political) level that interest as an institution has to be eliminated from the economy. Once this commitment is there, the transition to new style of economic management would become less difficult.

In some cases the legal changes will be required. For example, if interest as an option is available to investors then it will always be problematic to attract capital for government needs where there may not be any return. Similarly, in order to encourage voluntary contributions for public causes the people have to be motivated to make sacrifice for the society. This would require spiritual and moral uplift of the people.

In order to persuade the people to invest in government

transactions, the credibility of the government as a prudent and trustworthy user of public funds has to be increased. For this purpose, efforts to improve the image of the public institutions in our society have to be made.

Table 1

Total Interest Receipts and Payments by Govt. of Pakistan (Selected Years)*(Rs in million)*

Years	Total Interest Receipts	Total Interest Receipt as % of		Total Interest Payments	Total Interest payment as % of total Expenditure	Ratio of Total Interest Payments to total Interest Receipts
		Total Revenue	Total Non Tax Revenue			
1947-48	27	13.6	71.05	9	3.8	0.33
1971-72	699	10.1	48.8	1480	23.5	2.1
1976-77	2471	12	55	3657	20.2	1.5
1979-80	4029	10.5	76	5070	9.3	1.3
1983-84 (R)	7439	10.3	53.4	14128	14.1	2.2
1985-86 (R)	11942	13.3	68.4	19734	14.7	2.2
1987-88	16183	13.8	68.7	33238	18.4	2.3
1988-89 (R)	18485	13.3	64.3	38132	19	2.3
1989-90 (R)	20141	131.1	59.5	45291	21	2.2
1990-91 (R)	24935	14	64.7	54896	22.3	2.2

Source: Pakistan Economic Survey.

(R) Revised

Table 2

**Interest on Intergovernment Transactions
in Pakistan, 1979-80 to 1990-91***

Year	Rs. in Million Inter governmental Interest Receipts	Yearly rate of change (Percentage)	% of total revenue	% of Non- Tax Revenue
1979-80 (R)	2586	-	6.72	48.88
1980-81(BE)	2556	-1.2	5.44	31.34
1982-83 (R)	3009	8.9	5.08	29.64
1983-84 (R)	3720	24	5.15	36.64
1984-85 (R)	4438	19	5.74	27.42
1985-86 (R)	6561	48	7.3	37.59
1986-87 (R)	7078	7.9	6.81	33.79
1987-88 (R)	10494	48	8.97	44.53
1988-89 (R)	9412	-10	6.77	32.71
1989-90 (BE)	10255	9	6.65	30.27
1990-91 (BE)	15072	47	8.4	39.13

Source: Estimates based on Pakistan Economic Survey (PES) data (various issues) and Explanatory Memorandum on the Budget (EMOB) 1980-81, 1983-84, 1984-85, 1985-86, 1986-87, 1987-88, 1988-89, 1989-90 and 1991-92.

* Using data from EMOB on "Interest and Dividends" (included all types of interest receipts) data on "Interest and Dividends" reported in PES (excluding intergovernment interest payments) were subtracted to reach at these estimates.

Table 3 (a)

**Interest Payment to Federal Government by
Different Government Agencies in Pakistan,
1970-71 to 1990-1991**

<i>Selected Years</i>									
(Rs in million)									
	Punjab (1)	Sind (2)	NWFP (3)	Balochistan (4)	Total Provinces (5)	Local Bodies (6)	Financial Institutions (7)	All Others (8)	Grand Total (9) [5+6+7+8]
1970-71 (R)	60	32	14	6	112	34		588*	734
On Cash	48	28	12	5	93				
All Others-	12	4	2	1	19				
1979-80 (R)	1040	410	338	169	1958	286	304	2129*	4677
Cash	1023	404	336	168	1932	25	31		
All Others	17	6	2	1	26	261	273		
1983-84 (R)	1940	921	691	313	3865	460	245	2869*	5479
Cash	1919	902	688	311	3822	37	34		
All Others	21	19	3	2	45	423	211		
1986-87 (R)	4226	2095	1325	642	8287	1025	419	5609*	15340
Cash	4158	2063	1318	608	8146	340	22		
All Others	68	32	7	34	141	685	597		
1988-89 (R)	4990	2113	1862	827	9792	647	1010	7056*	18485
Cash	4890	2077	1854	723	9544	38	14		
All Others	100	36	8	104	248	609	997		
1990-91 (R)	6894	2945	2576	1100	13515	1414	1484	8519*	24932
Cash	6808	2902	2559	1050	13319	48	12		
All Others	86	43	17	50	196	1366	1472		

* Includes non-financial institutions (Wapda, Peco, Federal Capital & Ceramic Corp., State Cement Corp., State Petroleum Refining and Petro Chemical Corp., National Fertilizer Corp., Fauji Fertilizer Corp., State Engineering Corp., Pak Mineral Development Corp., Pakistan Steel, Pak Railways, POF Wah Cantt), government servants (AGPR, Defence, Post Office Departments, T&T Department, Chief Accounts Office (Ministry of Foreign Affairs), Pak Mint, commercial depots (Post Office, T&T) and others

** Includes centrally administered Area, autonomous bodies (Wapda, WPIDCI, WPADC, WPSIC, Associated Cement, PWR), government servants, commercial departments (Post Office, T&T), government investment corporation and others

- According to 1991-92 budget, All others include 'foreign loans,' USAID 'local currency loans' and German loans

R Revised estimates

Table 3 (b)

**Percentage Distribution of Interest Paid by Different Agencies to
Federal Government in Pakistan, 1970-71 to 1990-91**

Selected Years

Year/Loan Type	% Share in Total Payment by Provinces				% Share in Total Payment by All Agencies including Provinces						
	Punjab	Sind	NWFP	Balochistan	Punjab	Sind	NWFP	Balochistan	Local Bodies	Financial Institutions	All Others
1970-71	53.6	28.6	12.5	5	8.2	4.4	1.9	0.82	4.6	..	80.1
Cash	(51.6)	(30)	(13)	(5)							
All Others	(63.2)	(21)	(10.5)	(5)							
1979-80	53.1	21.4	17.3	8.6	22.2	8.8	7.2	3.6	6.1	6.5	45.5
Cash	(53)	(21)	(17.4)	(8.7)							
All Others	(65.4)	(23)	(7.7)	(3.8)							
1983-84	50.2	24	17.9	8	26.1	12.4	9.3	4.2	6.2	3.3	38.6
Cash	(50.2)	(23.6)	(18)	(8)							
All Others	(46.7)	(42)	(6.7)	(4.4)							
1986-87	51	25.3	16	7.7	27.5	13.7	8.6	4.2	6.7	2.7	36.6
Cash	(51)	(25.3)	(16)	(7.5)							
All Others	(48)	(23)	(5)	(24)							
1988-89	51	21.6	19	8.4	27	11.4	10.1	4.5	3.5	5.5	38.1
Cash	(51)	(22)	(19)	(7.6)							
All Others	(40.3)	(14.5)	(3)	(42)							
1990-91	51	21.8	19	8	27.7	11.8	10.3	4.4	5.7	6.8	34.2
Cash	(51)	(22)	(19)	(7.9)							
All Others	(43.8)	(22)	(8.7)	(25.5)							

.. Not Available.

Source: Explanatory Memorandum on the Budget 1971-72, 80-81, 84-85, 86-87, 87-88, 89-90, 91-92
Based on data in Table 5

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Table 3 (c)

**Classification of Interest Received by Federal Government
from Various Agencies (By Category of Loan) 1970-71 to 1990-91**

Selected Years

Years	Punjab	Sind	NWFP	Balochistan	Total	Local Bodies	Financial Institutions
1970-71							
Cash	80	88	86	83	83	NA	NA
Others	(20)	(12)	(14)	(17)	(17)	-	-
1979-80							
Cash	98	99	99	99	99	8.7	10
Others	(2)	(1)	(1)	(1)	(1)	(91.3)	(90)
1983-84							
Cash	99	99	99.6	99	99	8	13.9
Others	(1)	(1)	(0.4)	(1)	(1)	(92)	(86.1)
1986-87							
Cash	98	98	99.5	95	98	33.2	5.3
Others	(2)	(2)	(0.5)	(5)	(2)	(66.8)	(94.7)
1988-89							
Cash	98	98	99.6	87	97	5.9	1.4
Others	(2)	(2)	(0.4)	(13)	(3)	(94.1)	(98.6)
1990-91							
Cash	99	99	99	95	99	3.4	0.81
Others	(1)	(1)	(1)	(5)	(1)	(96.6)	(99.2)

Source: Calculations are based on data from Table 3 (a).

NA: Not available.

Table 4

Total Grants and Loans (All Types) by Federal Government to Provincial Governments, 1971-72 to 1990-91

Years	GRANTS					LOANS					Total Finan. Asstt.
	Punjab	Sind	NWFP	Balo.	Total	Punjab	Sind	NWFP	Balo.	Total	
1971-72	71.9	12	41.2	16.7	141.8	131.7	50.2	73.8	95.9	351.6	987.7
1972-73	256	116.4	44.7	130	548.1	781.9	345.6	176.5	112.7	1416.7	2062.6
1973-74	327.6	156	113.5	224.9	822	1000.1	361.6	176.7	133.3	532.5	2545
1974-75	288.3	235.4	231	107.5	862.2	1202.3	570.6	443.1	344	2560	3432.9
1975-76	241.2	134.8	229.8	142.1	747.9	1647.3	636.7	577.3	255.2	3116.5	3829.4
1976-77	472.5	103.8	382.6	245.8	1195.7	1925.5	862.2	596.5	290.3	3674.5	4870.2
1977-78	877.3	428.3	722	379.3	2406.9	1366	642.2	504.4	197.3	2709.9	5116.8
1978-79	1015.9	595.5	770.1	429.4	2810.9	1633.1	646	415.6	223.9	2918.6	5739.5
1979-80	572.8	513.3	792.2	306.5	2184.8	1535.5	673.5	435.6	252.7	2897.3	5112.1
1980-81	1295.6	583.2	1043.4	335.9	3258.1	124	254.8	352.6	270.7	1102.1	4360.2
1981-82	714.9	310.9	1203.1	363.5	2592.4	—	—	—	—	—	6334.7
1982-83	2470.7	942.5	1039.4	467	4919.6	—	—	—	—	—	7939.7
1983-84	1715.2	1020	1731.8	653.1	5120.1	3672.1	1082.6	888.2	402.5	6045.4	11166
1984-85	3192.5	1787.3	2400.5	983.5	8363.8	3754	1517.9	1232.7	660.7	7165.3	15529
1985-86	5001.4	2309.2	3289.5	1561.4	12162	4460.5	1730.5	1410.7	803.6	8405.7	20567
1986-87	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	11362	
1987-88	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	12606	
1988-89	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	5876	
1989-90	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	12657	
1990-91	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	N.A	14630	

Source: Budget in Brief 1986-87, 87-88, 88-89, 90-91

NA: Not available.

Table 5

Interest Payment on Domestic and Foreign Debt

Interest on	1979-80	1983-84	1985-86 (P.A)	1986-87 (R.E)	1987-88 (R.E)	1988-89 (R.E)	1989-90 (R.E)	1990-91 (R.E)	1991-92 (B.E)
Domestic Debt	2695	8980	12638*	15324*	21098*	26936*	34774*	33562*	46906*
Permanent			(3460)	(3802)	(4768)	(6909)	(11879)	(8332)	(16287)
Floating			(2525)	(3095)	(4610)	(4968)	(5549)	(6862)	(12421)
Unfunded			(6011)	(7631)	(10608)	(14147)	(15641)	(16061)	(15666)
Foreign Debt	2375	5148	6377	7459	8245	9848	11913	13781	15465
Total	5070	14128	19015	22783	29343	36284	46687	47343	62371

* Interest on other obligations and other payments are also included.

Source: Annual Budget statements.

Percentage

Interest on	1979-80	1983-84	1985-86 (P.A)	1986-87 (R.F)	1987-88 (R.E)	1988-89 (R.E)	1989-90 (R.E)	1990-91 (R.E)	1991-92 (B.E)
Domestic Debt of Total	53	64	66	67	72	74	74	71	75
Permanent of Domestic			27	25	23	26	34	25	35
Floating of Domestic			20	20	22	18	16	20	26
Unfunded of Domestic			48	50	50	53	45	48	33
Foreign Debt of Total	47	36	34	33	28	26	26	29	25

NB: Percentages of individual components of domestic debt may not add up to 100 because some components are not included.

Table 6

Composition of Domestic Debt in Pakistan*(Rs in Million)*

Year	Permanent Debt	Floating Debt	Unfunded Debt	Domestic Debt
• 1980-81	13758	31688	12641	58087
• 1981-82	24763	40334	13992	79089
• 1982-83	31761	48395	21571	101727
• 1983-84	36018	56940	29725	122683
• 1984-85	36835	72830	40251	149916
• 1985-86	58229	87265	57625	203119
• 1986-87	68609	104886	74982	248477
• 1987-88	63791	127524	98782	290097
• 1988-89	78827	135238	119145	333210
• 1989-90	98739	145537	136608	380884
: 1990-91	140873	135579	137544	413996

• Pakistan Economic Survey 1985-86, pp. 42, pp. 101 (SA)

• Pakistan Economic Survey 1990-91, pp. 138, 139 (SA)

: Budget 1991-92.

*Table 7****Cost of Borrowing for Domestic and Foreign Debt in Pakistan***

Year	Cost of Borrowing %	Domestic cost of Borrowing %	Foreign cost of Borrowing %	Weighted Cost
1980-81	3.86	5.77	2.6	3.86
1981-82	3.84	5.68	2.35	3.84
1982-83	4.73	6.14	3.57	4.73
1983-84	5.43	6.88	4.03	5.43
1984-85	5.4	6.79	3.98	5.4
1985-86	4.97	6.22	3.56	4.97
1986-87	5.1	6.37	3.57	5.1
1987-88	5.95	7.77	3.62	5.95
1988-89	7.1	10.09	3.46	7.1
1989-90	6.62	9.13	3.68	6.62
1990-91	5.26	8.11	2.84	5.26

Source: Adapted from W.M. Khan

Table 8

**Sources of Financing Overall Deficit in
Pakistan, 1947-48 to 1990-91**

Selected Years

Year	External	Internal Banking (Deficit Financing)	Internal Non-Banking
1947-48	Nil	NA	NA
1960-61	884	NA	NA
1969-70	2001	NA	NA
1971-72	929	441	362
1976-77	5860	6010	960
1977-78	9642	-	-
1978-79	6711	8502	2108
1979-80	6951	6305	1404
1980-81	6977	2355	5286
1981-82	5345	55161	6313
1982-83	5162	6124	14368
1983-84	5001	7866	12280
1984-85	5159	18735	12873
1985-86	8584	6098	26962
1986-87	8424	10915	27371
1987-88	12691	13941	30931
1988-89 (PA)	18195	819*	37865
1989-90 (RE)	24592	3534	30791
1990-91 (BE)	21149	7360	29541

Source: Economic Survey.

PA: Provisional Actual

RE: Revised Estimates

* Banking system does not include (i) repayment of US Treasury Bills Rs. 1241 million
(ii) USAID disbursed to private sector Rs. 1111 million.

NA: Data could not be calculated so far.

Table 9

Scheduled Banks Advances to various Government Agencies from 1982 to 1990

Year (End of June)	Rs. in Millions				Percentage of Total Advances			% of	
	Federal Govt.	Provincial Govt.	PSE	Total	Federal Govt.	Provincial Govt.	PSE	GDP at current Factor Cost*	Total Bank Advances
1982	7045	7094	11154	25293	28	28	45	8.72	38
1983	7352	8590	15394	31336	23	27	49	9.56	39
1984	7052	6449	16088	29589	24	22	54	7.87	30
1985	7968	5983	18059	32010	25	19	56	7.36	29
1986	3928	2713	22189	28830	9	9	77	5.89	22
1987	3176	3229	18308	24713	13	13	74	3.83	17
1988	6672	4784	18200	29656	23	16	61	4.8	18
1989	7183	5427	17601	30211	24	18	58	5.32	17
1990 (P)	14859	9130	16364	40353	37	23	40	6.75	20

Sources: Estimates based on data from Pakistan Economic Survey,

1984-85

1990-91,

PP-116

PP-123

* For 1988-89 and 1989-90 the figures were calculated using estimated figures for GDP for the respective years.

Table 10

Details of Gross Receipts on Public Debt in Pakistan**Selected Years**

Receipts on	1986-87	1987-88	1988-89	1989-90	1990-91
(a) PERMANENT DEBT	28137	33745	38388	64567	67335
Wapda, OGDC Bonds		2692.3**	3467	3967	2587.6
Federal Investment Bond	23*	0.1*	-	-	19076.8
Prize Bonds	18400	18577	12870	12415	13209.3
Land Reforms Act, 1977	37.8	-	-	-	-
Special Govt. Bonds for SLIC	500	800	1200	750	393.6
National Fund Bearer Bonds	5761.9	5698	11918.5	33666.4	14990.6
Foreign Exchange Bearer Certificate	3035	5683.7	8782.5	13498	15377.2
Treasury Bills (Auction)		-	-	-	1700
Disinvestment of Shares of Public Corp.	400	294	150	270	-
(b) FLOATING DEBT	359309	413157	535828	560488.7	580956.7
Bill for former East Pak	559.6	587.9	617.7	649	681.8
Govt. Treasury Deposit Receipts	15587.8	21303.9	25276.3	41171.3	28102.5
Other Treasury Bills	622	475	2573.7	2437.7	2339.8
Ways and means advances	1077.5	1000	2523	1500	500
Treasury Bills on Tap	129991.4	190282.8	217240.5	242807.7	228187
Adhoc Treasury Bills for Ways and Means	206945.6	198538.8	283078.9	263212.3	306450
Cash Credit Accommodation	4525.4	968.6	4518.3	8714.7	14695.6
Public Debt (Gross)		446902.2	574216	625055	648291.8
Public debt Expenditure		433291.7	552780.9	585541	615115.9
Net Public debt		13610.5	21435.6	39514	33175.9

* Government Bonds.

** Market Loans

Source: Annual Budget Statements of Several Years

Table 11

Details of Expenditure on Public Debt in Pakistan

Selected Years

(Rs in Million)

Expenditure on	1986-87	1987-88	1988-89	1989-90	1990-91
(a) PERMANENT DEBT	17303	19579	18452.5	21313.3	23500
Market Loan	-	-	-	-	-
Prize Bonds	14500	15215	10870	10000	10000
Government Bonds	-	-	-	-	-
Foreign Exchange Bearer Certificates	2235	3783.7	7582.5	11313.3	13500
B.N.F.B.	567.9	580.3	-	-	-
Special National Fund Bond	-	-	-	-	-
(b) FLOATING DEBT		413712.7	534328.4	564227.7	591615.8
Bill for former East Pak		573.6	602.6	633.2	665.2
Govt. Treasury Deposit Receipts		21803.9	23721.3	44856.1	38708.2
Other Treasury Bills		545	2643.7	2503.7	2409.8
Ways and Means advances		1000	2523	1500	500
Treasury Bills on Tap		190282.8	217240.5	242807.7	228187
Adhoc Treasury Bills for Ways and Means		198538.8	283078.9	263212.3	306450
Cash Credit Accommodation		968.6	4518.4	8714.7	14695.6

Source: Annual budget statements of several years

Table 12

Details of Unfunded Debt For Pakistan

Expenditure on	1986-87	1987-88	1988-89	1989-90	1990-91
UNFUNDED DEBT:					
GROSS	44067.4				
(NET)	-17080				
Saving Bank Account	4700	5375	5912	8000	8500
Khas Deposit Accounts	12100	13470	14597	15000	-
Mahana Amdani Accounts	75	115	132	200	190
Defence Saving Certificates	4950	6200	7100	11000	9422
National Deposit Certificates	900	1398	2150	1270	-
Khas Deposit Certificates	20500	27485	25904	19000	-
State Provident Fund	502	502	502	502	502
Postal Life Insurance	340	375	415	630	500
Special Saving Certificates(Bearer)	-	-	-	1150	1406
Special Saving Certificate (Regd)	-	-	-	5528	21091
Special Saving Account	-	-	-	-	6225

Source: Annual budget statements of several years

*Table 13***Overall Deficit of Pakistan by Provinces
1947-48 to 1990-91***Selected Years*

Year	Overall Deficit	Federal (Rs in million)	Provincial	Percent of GDP at Market Prices
1947-48	13	NA	NA	NA
1960-61	-262	NA	NA	-1.4
1969-70	-1013	NA	NA	-2.3
1971-72	-450	NA	NA	-0.9
1976-77	12830	NA	NA	9.4
1978-79	17318	NA	NA	8.9
1979-80	14663	-	-	6.3
1980-81	14618	-	-	5.3
1981-82	20992	17521	3471	6.5
1982-83	25654	14046	11608	7.1
1983-84	25147	10022	15125	6
1984-85	36777	14330	22447	7.8
1985-86	41644	12222	29422	8.1
1986-87	46710	12000	34710	8.2
1987-88	57563	NA	NA	8.5
1988-89	56879	NA	NA	7.4
1989-90	58917	NA	NA	6.7
1990-91	58050	NA	NA	5.9

Source: Estimates based on data from Pakistan Economic Survey (various issues).

NA: Relevant data not available.

Financing Government Transactions in An Interest-Free Economy

DR ZIAUDDIN AHMAD

Doubtless, the expansion of money supply does have something to do with the phenomenon of inflation and deflation. Everybody criticises the government for running budgetary deficits. Is the criticism really fair? There is a concept of a safe level of monetary expansion. If the expansion of credit in the private and the government sectors can be accommodated within the safe level, there is no objection to deficit financing. In our country, the safe level is determined with reference to the likely growth rate in the economy and likely changes in the income velocity of money. In determining the safe level of monetary expansion three variables are taken into consideration. You try to project as to what is the likely demand for credit in the private sector and then the residual amount usually is reserved as deficit financing in the government sector. Within the concept of safe level, there might always be some scope for deficit financing.

I have some unorthodox views regarding relative merits, or demerits, of credit creation in the private sector versus deficit financing in the government sector by way of helping and stimulating the growth of the economy. Most writers severely criticise deficit financing by the government because they feel that it is always inflationary as opposed to the credit creation in the private sector. This view has an implicit assumption that since the created credit is for production progress, it

is non-inflationary. I have a somewhat different view on this.

Credit expansion in the private sector, if excessive, can be as harmful to the economy as deficit financing by the government. Particularly in Pakistan, we see that over the years, though the commercial banks are the larger depository of the savings of the community, a good deal of bank resources has always been used for inventory financing. Inventory financing in a situation of shortage can always create highly inflationary situation. There is no special virtue in credit creation in the private sector *per se*, it has to be seen whether it is really within the limit and absolutely necessary to meet the productive requirements of the economy, or misuse is being made of the credit creation in the private sector.

I want to emphasise this point because we are faced with the Federal Shari'ah Court judgement which asks that the dependence of the government on interest-based money has to be eliminated. We have to find some scope for deficit financing within the safe limits of monetary expansion. This is because if one cannot borrow on the basis of interest, one should be able to borrow on interest-free basis from the central bank. So I want to reserve some scope for deficit financing in the new context when the interest-based modes of financing will not be available to the government. I would, therefore, strongly urge that consideration be given in the State Bank of Pakistan to see whether all the expansion by way of credit creation in the private sector is really warranted by the productive requirements of the economy, or some of that can be skimmed off so that the scope for deficit financing by the government within the safe limits of monetary expansion can be increased.

Scope of Deficit Financing

Given the growth rate of our economy and other variables behaving as they are and particularly in inflationary situation, the income velocity of money will go up reducing the scope for deficit financing. The real purpose is to see how the government's needs can actually be met. There is a big deficit in the government budget. Over the years, the government has not been able to finance even its current requirements

through taxation. Even some part of the current requirements is met through domestic and foreign borrowing. Almost all the developmental expenditure is financed by borrowing. In this situation if all of a sudden the government wants to balance its budget and completely give up its dependence on interest-based financing, many problems are likely to come up. Therefore, we shall have to have a multi-pronged approach offering practical solutions in order to cope with the situation.

Concerning the subject of elimination of interest from the government transactions in the context of the FSC judgement, we have two broad divisions. One, what will happen to future transactions after July 1, 1992, which is the deadline fixed by the court? Two, what will happen to the outstanding debt obligations of the government?

Four Categories of Transactions

The government transactions can be categorised into four broad groups. One is the intergovernment transactions between the federal government and the provincial governments and between the provincial governments and the local authorities. The second is the government and the banking system; in our system, it is the commercial banks and the State Bank of Pakistan. Third is the government and the general public. The fourth is the government and the foreign lenders. As for the government and the foreign lenders, it has been discussed separately.

Let us see what should be done after July 1 to the other three categories of borrowings by the government. The intergovernment transactions are just paper adjustments because one government is beneficiary and the other government is giving out that money. It is a kind of adjustment which has to take place between various government agencies of the federal and provincial governments and local authorities. Some problems will arise. Resources might fall short in certain cases. The problem has to be solved on some ad hoc grounds. The whole situation will depend on a complete, pragmatic approach to the situation but there is no difficulty in eliminating interest from intergovernment transactions.

For the government and the banking system, my proposal is that as from July 1, all loans to the government by the banking system should be provided on interest-free basis. Both the State Bank and the commercial banks should provide the loans needed, within the safe limits of monetary expansion on interest-free basis. The rationale for this suggestion is that as between the State Bank and the government, this too is an intra-house kind of adjustment. The State Bank's profits are made over to the federal government. At the same time, the federal government is paying interest on debt obligations which are purchased by the State Bank. This is a two-way traffic. Interest is being paid by the government on the government securities held by the State Bank and the State Bank is paying out its residual profits after expenditure to the government.

The benefit should go to the community at large rather than to a group of shareholders of the bank. These are two basic arguments while the banks in the new situation could be asked to provide interest-free funds to the government, they are required to keep certain part of their deposit resources as part of reserve requirement. As a legal requirement, banks are supposed to keep some amount in government securities and these should be interest-free securities.

The Government and the General Public

What about the relationship between the government and the general public? The government should be completely dissuaded from issuing any interest-bearing bonds or saving certificates. In that case the only option remaining for the government would be to mobilise funds from the general public through *muqarza* bonds as is being done in Jordan. The principal amount of this can be guaranteed. *Muqarza* and *mudarba* are the same. Some projects of the government may be high-yield profit while others may be low-yield and some may even be running in losses. The government can, therefore, make some mutual fund type of arrangement in which it can ask the people to contribute and the public can share the profits.

Some other proposals have also been mooted in various circles. If the government cannot issue any money by way of interest-based securities, is there any scope for the government issuing some index bonds? With a specific reference to the indexation of government bonds, the same questions of Shari'ah will arise and so far the majority of the experts seem to be of the opinion that indexation, even of government bonds, is not approved by the Shari'ah.

Return on Government Bonds

Another suggestion was mooted especially in 1984-85 when the question of elimination of interest from government transactions was being considered. The finance minister had invited comments of the Islamic scholars on some of the specific suggestions that had been made to the government for trying to mobilise funds through non-interest-based modes of financing. The minister at that time had specifically asked whether there was a possibility of floating some government bonds on which the return will be related to the gross national product. The Institute of Islamic Economics in response to the queries made by the finance minister studied the issue at a workshop and issued this report. Excerpts:

As to the question whether in the event of a fix return on the government saving schemes being regarded as incompatible with the Shari'ah, would it be all right if the savers were paid a return related to the nominal growth registered by the economy as a whole? [The answer is] this too will be incompatible with the Shari'ah. It is true that if the return is linked to the nominal growth rate of the economy, the return will become variable. However, variability in the rate of return on capital does not make return Islamically legitimate in case the capital has been provided on loan basis, i.e. any predetermined return on loan whether fixed or variable is *riba*. Just making it variable does not bring it out of the purview of *riba*. Even if the principal is not guaranteed, it will not be Islamically legitimate to give a return on government saving schemes relating to the nominal growth registered by the economy.

The idea of linking the return on saving schemes to the nominal growth rate of the economy seems to be based on the premise that the proceeds of the saving schemes are used by the government for investment in development projects which help increase national income. Without denying that savings from whatever source help in raising the investment level of the economy, there is little ground to believe that contributors to the saving schemes can on this basis justifiably be given a return related to nominal growth rate of the economy. This is so for the following reasons:

1. Savings mobilised through government saving schemes form part of the whole pool of the government receipts and are not used exclusively for investment.
2. GNP growth rate is determined by a host of factors including weather conditions and international economic situation and not merely the level of investment.
3. GNP growth rate can, by no stretch of imagination, be regarded a phenomenon with profits of a *musharakah* undertaking. Profit is the difference between the total costs and the total revenues of a business undertaking whereas GNP growth rate represents just an increase in the value of goods and services produced in the economy.
4. Nominal growth is composed of two components: real growth and the rise in the price level. If prices rise through, say, excessive deficit financing by the government, savers contributing to government schemes will get a high return in monetary terms while large sections of the community who have also contributed to the real growth of the economy would actually suffer from inflation. Hence, this arrangement would be highly iniquitous.

These are the various reasons which the workshop's participants gave against linking the return on the government securities to the nominal GNP growth rate.

The question whether some income tax concessions can be provided on interest-free government securities was also discussed. The Islamic scholars said it was compatible with the Shari'ah and could perhaps be adopted by the government. The tax concessions should be provided to the people who are giving their savings on interest-free basis to the government.

Handling Outstanding Debt

But how to handle the outstanding debt? The Federal Shari'ah Court itself has not touched the question of outstanding obligations. My views, however, are:

We have different categories of debt. As for the outstanding debt held by the banking system, it should cease to earn any interest from July 1, 1992. For the State Bank, it is only a book adjustment. For commercial banks, this will of course set some implications for the return that they will give on the profit-loss deposits. It might mean some depression in the level of profits that the people will be getting on their profit-loss deposits, but we have to bear some cost of the Islamisation process. Since the government would be trying to stabilise the inflationary situation, some reduction in the profit-loss return should be acceptable because the people are interested indeed in the real return rather than the nominal return.

If you want to Islamise the economy, you have to proceed on a broad front. Islam attaches a great deal of importance to monetary stability. If simultaneously with the elimination of interest, the other components of Islamic economy are also kept in view and we try to create a situation in which the rate of inflation is nominal, say about 4 to 5 percent, then even some reduction in the profit-loss deposit rates will be acceptable and will not lead to much diversion of the sources away from the banking system. But even if some diversion takes place, I am not unduly worried about that. The important thing is the whole pool of

savings in the economy and the relationship of savings to GNP rather than the relationship of the bank deposits to GNP. All types of savings and investment modes contribute to the growth of the economy. At a particular point, people are investing through diverse modes such as banks, investment trusts, mutual funds, leasing and mudarba companies.

The direction of the flows of various institutions will depend on the efficiency of the relative institutions, the trust that the people have in various institutions and the returns being offered by them. So even if there is some diversion from the banks to the investment trust or to the mudarbas, it should not cause worry, because the savings in the economy are not determined so much by the rate of return available on savings as the rate of growth. Savings are a function of the growth rate of the economy rather than the rate of return. You can keep up the momentum of the economy.

What about the outstanding debt? As to the general public, it is for the Shari'ah experts to judge. The unfunded debt at present stands at a staggering figure of Rs 13,255 million on June 30, 1991. Over the last 10 years, the dependence on the debt has been increasing. Consequently, the problem has become more and more complex.

Is there a scope for contractual obligations on outstanding debt? The instruments, the saving certificates and various kinds of bonds issued with a specific promise to pay a certain amount by way of what is called a profit (but which is really interest) can be honoured and allowed to run to maturity. Otherwise, it is very difficult to cash all these things because the principal amount alone is a very staggering sum. No new saving instruments with interest features, however, should be issued after July 1, 1992. The outstanding debt instruments should not be renewed in any case.

Self-Reliance and Elimination of Riba

PROF KHURSHID AHMAD

In December 1990, Prime Minister Mian Muhammad Nawaz Sharif appointed under my chairmanship a committee on national self-reliance. The committee produced its report within a period of three months. Formal presentation of the report took place in April 1991. After that, as usual, everything was put into cold storage. Repeated requests from my side and other quarters to at least publish the report remained without response. Non-publication of this report is a serious loss to the academic community, as in this report a serious and systematic effort has been made to spell out an alternate framework for economic development and policy-making. It makes a seasoned plea for the elimination of interest as a key factor in evolving an equity-based growth strategy.

I am seriously thinking of releasing this report in wider public interest. As a first step in this direction, I am taking this opportunity to share with you at least the basic approach and some of the suggestions of the self-reliance committee. What prompted me to do so was the frequent raising of the self-reliance issue in the seminar. The committee came to the conclusion that suspension of US aid could be a blessing in disguise. We realised that the aid-based developmental effort during the last four decades has not been able to produce the results that were expected of it, and there is an urgent need to scientifically and rigorously evaluate the net contribution

of what the Third World countries in general and Pakistan in particular had been receiving in the name of aid.

Aid is a misnomer. There is only a small part which comes in the nature of a grant which can justifiably be called aid. The rest is either concessional loans or loans which are received more or less on market terms. The share of the latter is increasing in view of market-performance policies of the World Bank and other aid-giving agencies. As such not only the loan component of this alleged aid has been constantly increasing during the last two decades, the rates of interest on which these loans are advanced are approximately market rates of interest.

We realise that a large part of the aid is tied. It cannot be utilised according to one's own preferences, nor can it be used for purchasing the cheapest available supplies from the world. Instead, the donor country has a very substantial part of the commodities (or services) which it wants to sell at the price differential so large that in certain cases even up to 30 percent more than the other available commodities (or services) has to be paid.

Then there are other costs including transport, insurance, technical know-how. Once everything is taken into view, we discover that the net contribution is minimal. Currently around 70 percent of the "aid" received is directed towards loan-interest payment. The remaining 30 percent is the gross contribution; its net contribution is marginal. So it is only a trickle of contribution.

We also realise that the geopolitical situation has changed. It will be imprudent on our part to expect that whatever support and aid we were expecting or getting in the past could continue in the future. As such, we find that as a nation we have no option but to go self-reliant.

Doubtless we should have friendly relations with all countries, yet we must not remain dependent on aid. Ideologically also, we realise that one of the issues on which Islam is very sensitive is the independence, sovereignty and honour and self-respect of the Muslim Ummah. The Ummah is *shuhadaa alannaas*, and you cannot be a witness of Islam to the world

if you are dependent on them economically, intellectually, technologically, scientifically and financially. Self-reliance seems the only way.

The Concept

What is self-reliance? We define it as a condition in which a nation makes free and voluntary choices in the disposition of its resources and output and in setting its economic and political priorities. This state of affairs is totally distinct from a situation where decision-making is constrained by a political or economic situation dictated by external compulsions. We made it very clear that self-reliance signifies the capacity and capability of the country to face any crisis on the basis of internal strength. This is only possible if the economy can maintain equilibrium on the basis of commercial transactions including trade and capital movement. In short, it implies self-confidence and the capacity for autonomous goal-setting and decision-making, rejecting all forms of dependence, invited or imposed.

We, in the committee, developed this view and suggested that self-reliance does not mean self-sufficiency; no country can be totally self-sufficient. The committee does not equate self-reliance with self-sufficiency.

We also made it very clear that self-reliance does not mean isolationism or autarky; we are part of the world. We would maintain a network of relationships at all levels, including trade and capital movement.

We also emphasised that self-reliance is not a static concept; it is growth-oriented and dynamic. Yet it is very important that self-reliance must be our national objective. We also added that self-reliance is not exclusively an economic concept; it represents an approach to life and its problems.

Gradualism

The committee suggested a review of and revolution in the past approach of gradualism in achieving self-reliance. While

self-reliance is not achievable overnight, there is a certain type of gradualism to which we have been addicted to and that has taken us nowhere. Look at the five-year plans, even the first plan says that within 25 years Pakistan would be self-financing; self-sustained growth was the term used. But where are we after 40 years of planning? More dependent than from where we started. This type of gradualism is not going to work. For that reason the committee suggested that a radical departure from the past was needed. It entails some risk — a calculated risk. Time has come that the nation should take this calculated risk. Make a decision; come up with a national commitment and harness all its economic, political, educational and information policies to achieve this objective.

What is the extent of our dependence on others? We probed this area quite thoroughly. It is not possible to go into all the details, yet we found alarming dependence on foreign aid and lack of self-reliance even in certain items of food, in oil, technology and defence production. That is why the key recommendation was that the nation should adopt self-reliance as a national covenant, the fundamental principle of the socioeconomic policy and the basis for individual life in the national context. That there should also be legislation on the subject, which we have described as a national self-reliance act. In fact, the committee has given a tentative draft of the self-reliance act as well.

Multi-Dimensional Approach

The programme we have suggested is multi-dimensional. One of the dimensions is that the government would have to launch a programme of curtailing conspicuous consumption and check non-developmental expenditure. A law should be enacted putting a ceiling on both budgetary deficit and deficit financing, because rhetoric apart, even blunt criticism from experts, economists and parliamentarians has not been able to deter the government from incurring reckless expenditure, deficits and deficit financing.

The present gigantic size of the government, as well as all-pervasive presence of the government in the country's eco-

conomic life, has immensely contributed towards the dependence of the country on the outside world. An important element of committee's proposed strategy of self-reliance is a significant reduction in the size of the government. It needs to confine itself to:

- protecting ideology, sovereignty and security of the nation;
- protecting the rights of the weak and the underprivileged in the society; and
- creating a congenial social and administrative environment for economic activities in the country.

The annual development plan would have to be totally restructured and many of its economic chapters would need to go to the private sector. Education, health and the social sector should be the primary concern of the annual plan.

We stressed that a privatisation act would be required not only to give it a proper legal basis to provide for a more sustained and long-term policy but also to build into it the essential safeguards. We are not suggesting a total abdication of the government in the economic field; there should also be some corporatisation away from the public sector — proper corporations, accountable to the government and the parliament with built-in incentives, can ensure efficiency. (Out of over 154 units being examined by the Privatisation Commission, only 10 have been running profitably, another 12 have been breaking even and the rest are running in losses over the years.)

A kind of a decentralisation was also suggested to transfer a number of functions from the centre to the provinces and from provinces to the local administration.

We carefully noted the recently-introduced reforms in the system of exchange and payments. Yet we felt that a foreign exchange regulation act was needed; we called it foreign exchange liberalisation act. A draft of that was provided.

We also suggested a new, more powerful tariff commission

and a new long-period tariff policy. This we thought was important because with industrialisation in the private sector, the role of tariff commission would be very vital. So far the performance of the tariff commission has been disappointing.

We stressed the need of a thorough revamping of the taxation system because resource mobilisation is not possible without a fundamental change in the taxation system.

The committee also suggested establishment of a public utilities commission under an act of the parliament to ensure that the consumer interests are safeguarded from the monopolistic price manipulations and other such influences.

The question of black-market economy was also addressed and it was concluded that tax system should be changed. The idea of a final whitening act was also examined.

Detailed proposals were given for critical sectors of the economy. On the issue of riba, the committee said a deadline must be fixed for total elimination of riba from the government sector.

Elimination of Riba

We concluded that movement towards self-reliance in our context was impossible without elimination of riba. As such our most revolutionary proposal was that a cutoff date be fixed for the elimination of riba, first from the domestic economy and then from external government dealings. This is the only point where we had some difference of opinion amongst the committee members. One group said that both dates should coincide while the other thought that the domestic economy could be cleansed of riba much more quickly and thus from the next budget, the domestic economy should be freed from riba. For external dealings, two years' time should be given. The 8th Five-Year Plan should not provide for any government or private sector loans based on riba.

As for the present debt burden, the committee was of the view, again I am not taking the Shari'ah sensitivity fully here, that because of the contractual responsibility of the gov-

ernment, let us take the loans plus whatever interest or other obligations have accrued but at the cutoff point we would take a new figure and that figure would make the total debt liability. Then we will try to analyse it and see what its components are and how they can be discharged.

Individuals and governments are to be treated differently. Since the intergovernmental transactions are mere book transfers the interest should be written off altogether. For the rest, we have suggested that a mutual fund for debt liquidation should be created. We worked out that the total investment in public sector was presently about Rs 125-130 billion. The total assets are estimated to be about Rs 900 billion. Our total international and domestic debt comes to about Rs 850-900 billion. We suggested that we start with domestic funds and whatever we get from the disinvestment of the public sector should go into the national debt-liquidation fund and then through a phased programme we would liquidate these debts.

Now the immediate impact would be that about Rs 70 billion worth of debt-servicing, a drain on the budgetary resources, would become available for other heads of expenditure. And if we can impose the discipline we are suggesting the future budgetary deficit can be restricted to the required limits. Meanwhile, we will be in a position to liquidate the entire debt burden over a period through the resources which have been made available in this form, without default and without revoking any of our commitments.

As far as the grants or nominal service-charge-based transfers are concerned, they do not fall within the ambit of interest; that door will remain open. But all other capital transfers should be either in the form of interest-free grants and loans or equity investments and venture-capital.

We found out that of the present debt, about 86 percent is owed to consortium countries (USA 23 percent, Japan 14 percent, West Germany 10 percent and multinational agencies 42 percent). We suggested, of course, that we examine the possibility of default also — and there are many countries which have done that — but we did not recommend it; instead, we suggested the idea of renegotiation and restructur-

ing of the loans and that is what we have done in the past. In 1971-72, and then in late '70s, Pakistan has done that twice. And dozens of other countries have done that, too.

We suggested that there are many possibilities available for the international transactions. First, we realise that even in the western world there is an increasing realisation that interest-based loans are becoming an unbearable burden for the Third World countries. Canada has already waived off all the interest. Australia has made a similar move. President Mitterrand of France has officially suggested in the Group-7 meeting that at least 30-50 percent of the present interest element of the debt should be waived off. So, debt remission is one possibility. It should be worked out both bilaterally and multilaterally. Other Third World countries should also be mobilised for this purpose.

We also suggested that debt-equity swap is one of the techniques that has been adopted successfully in a number of countries. It could be debt auctioning or negotiated conversion. It could also be negotiations with creditors permitting them certain part of investment in national corporations and domestic investment, turning their debt into equity.

National Self-Reliance Fund

Creation of a national self-reliance fund in which contributions could be received from the people within the country and particularly from Pakistani expatriates was another major suggestion. We suggested that export of manpower as well as the resources of Pakistani expatriates should be utilised both for bringing venture capital in Pakistan and asking them to buy this debt by converting it into equity in national enterprises.

All these dimensions were examined and a workable package given within the framework of international law and understanding.

There is a need for a clear vision and the resolve that we are not going to go back, whatever the consequences, and preparing the nation for that through a comprehensive educa-

tional programme. We suggested a new educational corps directed towards preparing the nation for self-reliance. We also suggested specific projects and strategies in the fields of agriculture, energy, engineering, industry, exports, imports and defence industries.

Apprehensions — How True?

We came to the painful conclusion that we are victims of our own obsessions and apprehensions. We assume that if we adopt this path then everyone would turn his back on us; this by all means is an assumption. We do not realise that debt-based development and interest-based loans are not the only ways of economic cooperation between individuals, enterprises, corporations and governments.

I have a couple of things to assure you that once we are firm on self-reliance and have a clear programme, others would be prepared to negotiate and even cooperate with us. Let me quote from the IMF staff papers:

“Indeed it is readily apparent that the Islamic model of banking based on the principle of equity participation bears a striking resemblance to proposals made in the literature on the reform of the banking system in many countries. The Islamic system may well prove to be better suited to adjusting to shocks that result in banking crises and disruption on the payment mechanism of the country. In an equity-based system that excludes predetermined interest rate and does not guarantee the nominal value of deposits, shocks to asset positions are immediately absorbed by changes in the values of the share deposits held by the public in the banks. Therefore, the real value of assets and liabilities of banks in such a system will be equal at all points in time. In the more traditional banking system since the nominal value of deposits is fixed, such shocks can cause a diversion between real assets and liabilities. It is not clear if this would be correct and how long the process would take.”

[Mohsin Khan, *Islamic Interest-Free Banking*; Staff Paper, vol 33, No 1, March 1986, p. 19.]

Another quote from Prof Haus Alba'ch, a leading German economist, who says that Islamic banks belong to the class of equity-participation banks.

"They supply equity in the form of venture capital to investors whose share is their ingenuity and their labour. Secondly, they supply equity in the form of equity capital as participants in the type of project which in general has a majority shareholder. They may be ideally suited to meet the need for equity capital in developing countries where the business risk is particularly high as well as in the industrialised countries where the development of new processes and new projects involves high risk and requires large amount of venture capital."

[*Islamic Banking*, proceedings of the Baden-Baden seminar, London.]

Also, your attention is drawn to the OECD study entitled *Arab and Islamic Banks* in which Prof Traute Wohlers-Scharf accepts that Islamic banks are not merely trying to give interest another name. Legal instruments, within the framework of Shari'ah, exist which permit profitability on a different, albeit Quranically acceptable basis. He concludes:

"Islamic banking is trying to develop the relationship between finance on one hand and industry and commerce on the other. This new relationship is the basis of the Islamic economic system being set up. Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic asset creation. Islamic banks could make a useful contribution to economic growth and development particularly in a situation of recession, stagflation and low-growth level because the core of their operation is oriented towards productive investment. All countries, both in the North and in the South, need more venture capital. Loan capital is available, particularly from industrialised countries but at high interest rates. However, even medium-scale entrepreneurs find it difficult to raise sufficient risk cap-

ital for expansion and innovation. This has acted as a brake on productivity and economic growth in the North. Thus practical and immediate cooperation possibility exists between Islamic banks and enterprises all over the world. The intermediation process remains to be fully developed."

[Traute Wohlers-Scharf, *Arab and Islamic Banks*, OECD, Paris, 1983.]

And finally to put ourselves to shame let me also quote from an International Finance Corporation (IFC) report. On a proposed investment in the Hala Spinning Mills, the President of IFC and the World Bank observed:

"A change to Islamic modes of financing has been considered by IFC. This would be contrary to the Government of Pakistan's intentions on foreign loans. Adoption by a foreign lender of Islamic instruments could be construed as undermining the government's policy to exempt foreign lenders from this requirement."

[Report No. IFC/P-887, dated Dec 22, 1987, to the board of directors, IFC.]

What a shame! Others are prepared to examine the possibilities of switchover to Islamic modes of financing and we are put off because we are not prepared to move in that direction. That is the real hurdle. The authority lacks the will and determination to move in this direction. That is why we need a leadership that is motivated enough to pursue this new path. There is no danger that they would flounder in wilderness. If a reasonable and economically viable arrangement is suggested to others, even to the West, we are sure, the response would be positive.

DISCUSSION

DR ARSHAD ZAMAN: I would like to seek guidance on four questions in the light of these presentations. First, should the interest already agreed upon be honoured? Second, is there a safe level of budget deficit? Third, would it be feasible to eliminate interest in one stroke? Dr Ziauddin said a complete ban will pose problems for the government and we need a multiple approach; by contrast, Dr Faiz Muhammad said radical steps are needed to get out of the domestic debt trap and Prof Khurshid Ahmad said gradualism needs to be reevaluated and that a deadline must be fixed for the elimination of riba. The forum should address to this aspect of the problem. My fourth question relates to the importance of future transactions. Dr Ziauddin Ahmad suggested that the government dealings with the general public should only be through *muqaraza* bonds, ruling out the proposal of linking bonds to nominal GNP.

DR ZIAUDDIN AHMAD: The domestic interest-bearing bonds are invalid and should not be allowed to run to the maturity. But if people come to encash the money, about Rs 130 billion, the government would face a liquidation problem. Is there any flexibility in Shari'ah? Second, what is the Shari'ah position on foreign borrowings?

MUFTI SHUJAAT ALI QADRI: It is my personal view that you cannot abruptly end the interest-based dealings and these can continue for a short period as exception.

PROF KHURSHID AHMAD: Bankers complain that if they waive interest on loans given to individuals, enterprises or industries, the bank assets decrease to one-fourth and banks cannot fulfil their liabilities. While the parties, which borrowed these amounts from banks and have made huge profits, now want that the interest on loans should be waived. What is the Shari'ah guidance?

MUFTI SHUJAAT ALI QADRI: I am not sure how to deal with this issue. But if you want to overhaul the financial system

The discussion was made on the presentations by Dr Faiz Muhammad, Dr Ziauddin Ahmad and Prof Khurshid Ahmad. The session was presided over by Dr Arshad Zaman.

on Islamic teachings, you should take the revolutionary step even if some individual or institution suffers losses.

DR ZIAUDDIN AHMAD: Is there any progress on self-reliance committee report recommendations? Second, Dr Faiz Muhammad said the federal government pays State Bank Rs 5,000 million as interest and State Bank transfers to federal government whatever it earns. What is that figure?

DR GHULAM RASOOL: There was a mention of *mugarza* bonds. One can take lesson from Wapda bonds. Unless they are linked with some very profitable enterprise, they will not invite the amount of funds the government requires to compensate for the dismantling of the so-called saving schemes.

Second, how far is that legitimate in the context of Shari'ah to compensate for the erosion of value of money over time?

PROF KHURSHID AHMAD: Does Shari'ah allow putting money in a federal consolidated fund, which collects taxes?

MUFTI SHUJAAT ALI QADRI: Yes, the government can impose as much income tax as and when required.

PROF KHURSHID AHMAD: To a question about expatriate investment, the idea is to offer shares to expatriates in corporations which run under the normal rules.

To Dr Ziauddin's question about the implementation of self-reliance committee report, I would say that the prime minister was briefed for about four hours in the presence of finance minister and officials of the ministry. Despite my reminders and letters, he kept mum. Then I asked him to allow me to make this report public. There was no response, either.

DR ARSHAD ZAMAN: Prof Khurshid's presentation on self-reliance was very relevant. He suggested that if we decrease expenditures, we may not at all need to pay interest on borrowings.

Since 1971, when the country broke up, the expenditure on account of loan went up, the reason being the larger and larg-

er component of expenditure as luxury: for the sake of political patronage and building up political constituency and not for the sake of political and social uplift.

Now take the expenditure on defence, which is a sacred cow; nobody can discuss it in the parliament. Look, what's going on. A lieutenant-general is being provided with a car and a stenographer all his life; there's no precedence in the world. Similarly, there is a division of batmen. Now, after we get F-16s and sophisticated weapons, there should have been economy in the manpower, because as the weapons system becomes more advanced a greater economy should be exercised in the manpower. The parliament has failed to discharge its duty and the government is free to spend money on anything it likes.

As far as the developmental expenditure is concerned, it is going on building the constituencies and not on any projects or the purpose of increasing the overall development. The *israf* is at the root of building up of all our expenditures. If we allow any *rukhsat*, we will be encouraging public representatives to go on increasing their expenditures. They don't need *rukhsat*. Instead, they should be made accountable before the parliament and the general public.

JALEES AHMED FAROOQUI: Most of the international loans to Pakistan are on very low rates of interest. Is it possible to commercialise at least some of the social projects in which these loans are invested and earn a profit of 3 to 10 percent and then invite the foreign loan-giving agencies to share the profit? Can the government subsidise the poor users by paying the price of services and help the project to earn profit? This approach may solve some of the problems of international loans.

DR HUSSEIN MULLICK: People have been saying that we spend too much on defence. Compare it with South Korea. In 1965, per capita income in South Korea was about \$90, ours was a little higher. Now, we are stuck up at \$350 and they are passing beyond \$5,000. South Koreans are spending \$240 of per capita on defence. It is a small country with hardly any adversary like India. What we are spending is almost nothing, not compatible with genuine requirements of

the country. If we reduce this expenditure there might arise more insecurity. The defence expenditure appears more because the revenue has not been growing; it has almost been frozen.

REPLY: You have completely missed me. I have not challenged the level of expenditure. When a lieutenant-general is being provided with a stenographer after retirement, how is it going to strengthen your defence? What I have said is that the non-essential expenditure in defence should be cut down.

COMMENT: Prof Khurshid has said that expatriates should be encouraged for equity participation in the government projects. I doubt people will ever be inclined to equity participation in the government projects.

QUESTION: Dr Ziauddin has talked of revamping the tax structure. As a member of the tax reform commission, I would like to know whether there are any specific areas where the problems are identified. Second, is there any concept of central consolidated fund under the Shari'ah?

COMMENT: Unless they are really linked with some very profit-backed enterprises or ventures, *muqaraza* or *mudarba* bonds will not invite the amount of funds which the government requires to compensate for the dismantling of the so-called saving schemes. Second, in the present circumstances when the currency is not linked to any gold standard, is it legitimate to find an indicator or an index to compensate for the erosion of money over time in the context of the Shari'ah?

QUESTION: What are the limits to interest-free recourse by the government in the banking system?

DR ZIAUDDIN AHMAD: There is a concept of limits, already being used in Pakistan, of safe limits of monetary expansion within the budget. But this limit has not been observed, actually breached, and you have seen the result as inflation. We may suggest something like a budgetary limitation on government borrowing from the banking system, as in Australia. If the government wants to overstep the limits, it has to go to the parliament for approval and should not do on its own.

Practical Options for Central and Commercial Banking

S M HASANUZ ZAMAN

The Federal Shari'ah Court judgement does not directly impugn the functioning of the State Bank of Pakistan except for section 22 (1) of the State Bank of Pakistan Act, 1956. But this apparently minor repugnancy to Shari'ah involves the most important role of the central bank that governs interest rates chargeable by all the financial institutions in the country. In addition, because State Bank regulates, directs and monitors the financial institutions in the country, it cannot remain unconcerned with the judgement relating to:

- Negotiable Instrument Act XXVI of 1981.
- Agricultural Development Bank Rules, 1961.
- Banking Companies Ordinance (LVII of 1962).
- Banking Companies Rules, 1963.
- Banks (Nationalisation) Payment of Compensation Rules, 1974.
- Banking Company (Recovery of Loans) Ordinance (XIX of 1979).

The sections that have been declared by the court in the above laws or rules involve charging of interest or mark-up which, according to the court, resembles interest. Interest rate is governed by the bank rate. Mark-up is one of the modes of finance which the State Bank recommended to the banks. Thus, it is the State Bank that will have to find out a solution to the problems arising out of this judgement. Charging of in-

terest or mark-up is not confined to the few cases that the court has assailed. The judgement has to be viewed in broader perspective. Hence arises the question of practical options for central banking in order to meet the challenge.

The Prerequisites

Islamisation of banking in Pakistan was initiated in 1980 with introducing some changes in ICP, NIT and HBFC. This was a simple task because the first two institutions required minor portfolio changes while HBFC which used central bank funds also did not find it difficult to adopt a new mode of operation for its only long-term portfolio. This change, in principle, could decrease the returning but it was the headache of the central bank or of the institution itself. The problem arose when commercial banking was required to eliminate interest from its transactions. This process was to be pioneered by the central bank which had to choose one of the two alternatives. The substitute that was recommended by the Council of Islamic Ideology (CII) and which comprised six modes of financing with emphasis on *musharakah* and *mudarba* or another substitute comprising 12 modes of financing including the council's six modes without any special emphasis. The financial institutions were allowed to choose any of them that suited their interest. The council's modes required the fulfilment of certain basic conditions to make the new experiment a success. These were as follows:

- a) Interest-free banking system can only, function successfully and prove to be fruitful subject to the condition that simultaneously with its introduction strenuous efforts are made on a wide front to inculcate in the society such basic virtues as fear of God, honesty, trustworthiness, sense of duty and patriotism. (p.3)
- b) With a view to ensuring the success of the new system of banking it is of paramount importance that the government should carry out a thorough reappraisal of the tax system, focusing in particular on the need for greatly simplifying the system of income tax. A thoroughgoing reform of the income tax system is a *sine qua non* for the success of interest-free banking. This is because that under the new system, the in-

come of the bank would crucially depend upon the profits of the business firms which receive financial assistance from them. If the existing system of income tax remains as it is, the business firms would continue the malpractices of concealing their profits and maintaining multiple sets of accounts which would deprive the banks of their rightful share in the profits of these concerns and would thus adversely affect the earnings of the banks. (p.4)

- c) At present, two factors militate against a wide-ranging application of the principle of profit-and-loss sharing, widespread prevalence of unethical practices in the society and illiteracy... We have to, therefore, channelise all our energies and resources towards promoting honesty among the people and banishing illiteracy. (p.5)

The prerequisites laid down above assign the most basic role to the government. The success of the experiment depended upon successful campaign of moral reform. Changes in the mode of financing without fulfilling the basic conditions of success should have meant frustration in the new experiment leading to financial crisis. This also reflected the degree of sincerity with which the government was proceeding in this direction. The government's lack of interest should have been sensed by the State Bank as also by the financial institutions. As a result the sensitive financial institutions, since the very beginning, took the programme of change in a similar mood.

Thus, on the one hand, the government claimed that lending by banks at interest has been eliminated since July 1, 1985, but on the other, some ministers claimed after the FSC judgement that interest was inevitable and that its elimination was a disastrous step. This self-contradiction has caught the central bank between the devil and the deep blue sea. Thanks to the appeal against the judgement which has granted some time to reformulate the strategy to meet the challenge. The strategy should be based on the assumption that the government, due to its own constraints, would not be able to fulfil the prerequisites as emphasised by the CII. This calls for a fresh thinking on the realities about the special position and importance of financial institutions, the constraints that

keep them from adopting modes of finance warranting for risk exposure and a solution that satisfies the Shari'ah requirements and is also acceptable to the financial institutions. An attempt to examine the anomalies in the existing theory and practice and propose new *modus operandi* for the financial institutions has been made below.

The proposals made in the annexure recognise the constraints and guarantee risk-free income for the banks and an active participation of the subsidiaries in modes like *musharakah*, *mudarba*, operating lease, hire-purchase, etc.

Bank-Rate Substitutes

After the modes of financing as set out in the annexure are adopted, the bank rate would become redundant. The central bank, in order to discharge the functions of bank rate, namely, rediscounting bills and commercial papers and lending to banks against eligible collaterals will have to rely upon the data regarding average return (AR) and overall return (OR). AR would be the average earning made by different units of the same industry or in the same trade during a given period. OR would represent average earning of all the industries or trades taken together by assigning weights according to their financial involvement during a given period.

Rediscounting bills and other commercial papers would be done by the central bank on the basis of a portion of AR. The same basis would be adopted in case of central bank financing of specialised financial institutions which finance a single sector of economy. OR would be adopted in case of financing commercial banks and those NBFIs that cater to financing requirements of various industries or trades. The same rates may be made the basis of prescribing profit-sharing ratio between the financial institution and the trader and between the financial institution and the depositor. It should be noted that AR and OR would be *ex post facto* rates and may be different from the actual in the future. A provision for adjustment between the two may be made only if the difference between actual and *ex post facto* rates is substantial. This need for change would be determined by the central bank.

In order to ensure that reliable AR and OR are available the

central bank will have to set up a commercial intelligence unit enlisting informers who are skilled in all the trade techniques.

The rates thus obtained would replace the bank rate in the same way profit-sharing ratio is proposed in the CII report on the elimination of interest from the economy.

Monetary Policy Instruments

The monetary policy instruments that the central bank in Pakistan has been adopting would largely be unchanged. The penal interest which it charges from the banks on non-observance of minimum cash reserve or liquidity ratio requirement would also continue with replacement of the word *interest* because the penalty that it imposes on banks does not come within the purview of prohibited interest. The same would be the case with default by bank in respect of observing overall ceilings on the lending and investment operations or of observing mandatory targets for providing finance to priority sectors.

Elimination of interest on borrowings by federal and provincial governments involves two elements outside the control of the central bank: sacrosanctity of the concept of interest for the federal government and federation-province politics. Thus State Bank does not have any option to choose.

Interest payable through State Bank in dealings with international financial institutions and foreign aid agencies involves international economic and political constraints for which no convincing and viable solution has so far been found out.

Anomalies in Interest-Free Banking and Proposals for Reform

The most important point that Muslim critics of interest bring forward is a fixed return on lent out funds irrespective of the actual productivity of these funds in possession of the borrower. Another point relates to risk distribution which, in the case of lending at interest, is solely borne by the borrower

who is generally the entrepreneur. Thus the owner or depositor of idle funds makes a sure earning while the producer is exposed to risk of loss. These characteristics of interest are treated to be unjust. As compared with it, profit-and-loss sharing in the form of *musharakah* and *mudarba* is proposed to be the most effective technique of doing away with these unjust aspects of interest. It was, however, realised that a bank could not contract *musharakah* or *mudarba* on behalf of its depositors in cases where financial return would not be calculable during the period of financing contract; where trade was not involved or where long gestation period of the project was involved after investment of huge funds.

As a result, in order to cover all the economic sectors many more modes of financing have been introduced to replace financing at interest. They are *murabaha*, mark-up (a variant of *murabaha*), credit sale (*bai' mu'ajjal*), leasing, hire-purchase, rent-sharing, development charge, buy-back (*bai' wafa*), deferred delivery against prompt payment (*bai' salam*), in addition to induction of financial instruments like participation term certificate, term finance certificates, *mudarba* certificates, etc.

This paper aims at making an inquiry into the extent to which the present Islamic banks in different countries are investing their funds on the basis of PLS. The next point to examine is whether the modes other than PLS are capable of doing away with the criticised aspects of interest. This will be followed by a discussion whether PLS *musharakah* and *mudarba* are really practicable solutions from Islamic point of view. If it is not so what practicable alternative can be devised to conform to the Shari'ah on the one hand, and to avoid interest in letter and spirit, on the other.

More than 50 interest-free banks have been set up in different parts of the world which claim to be operating on the basis of modes like *musharakah*, *mudarba*, *murabaha*, leasing, hire-purchase, etc. This is in addition to the complete change over of the entire banking system in Pakistan and in Iran which have adopted all the modes for financing different sectors of the economy as enumerated earlier. But for a few exceptions the most popular mode of finance adopted not only by individual interest-free banks but also by Pakistani banks is *murabaha* which is also termed as mark-up or *bai'*

mu'ajjal.¹ The way in which *murabaha* is practised by banks is different in different banks. There are also differences in operational techniques of *musharakah* and leasing.

In spite of differences in operational modes of different banks there appears to be a remarkable affinity in their outlook and approach towards bank functions. It seems that first, there is an implicit consensus among them that a banking institution is competent to contract as a trader, manufacturer, lessor, hirer or owner of merchandise and retain a share of profit accrued in such transactions so as to satisfy the Shari'ah requirements. Second, the profit assumed to be accruing to the sellers, entrepreneur, lessee or factory owner can validly be made an object of distribution between them and the bank. This has not only created a number of practical difficulties for the banks but has also introduced anomalies in the scheme they have adopted. It seems that in large number of cases the ghost of interest is haunting them to calculate a fixed rate percent per annum even in *musharakah*, *mudarba*, leasing, hire-purchase, rent sharing, *murabaha (bai' mu'ajjal*, mark-up), PTC, TFC, etc. The spirit behind all these contracts seems to make a sure earning comparable with prevalent rate of interest and, as far as possible, avoid losses which otherwise could occur.²

¹ In Pakistan, investment by way of *musharakah* and *mudarba* in the case of trade-related modes of financing is extremely negligible. The 1407 H Annual Report of Bahrain Islamic Bank reveals about 94 percent financing through *murabaha* as compared with 6 percent on the basis of *musharakah*. The Islamic Development Bank financing on the basis of mark-up amounted to 70 percent of its total financing till 1407 H. Short-term investment by 20 banks connected with IDB amounted to about 70 percent of their short-, medium- and long-term investments and real estate transactions in 1406 H. The basis on which short-term investment is made by these banks is not specified in the aggregate balance-sheet of member banks but it is learnt that in most cases such financing is made by banks on the basis of *murabaha*. Some of these banks like the Kuwait Finance House take care to ensure that the deal is made in conformity with the Shari'ah rules but many other banks practise this technique in Pakistani style in which a fixed percentage per annum is added to the advanced funds, by way of increase in assumed price. In recent years, however, Pakistani banks are changing over to buy-back technique which, in its spirit, is a variant of the early *bai' wafa*. In *bai' wafa*, price of resale should not be different from purchase price; in buy-back, there is always a difference in both prices.

² PTC (participation term certificates) and TFC (term finance certificates) are the two Pakistani instruments to provide long-, medium- and short-term finance. TFC is now a Popular Mode in Pakistan. This might be treated by the bank representatives to be a temporary phase because of competing interest system to which the customers have become accustomed to. But this leads to the conclusion that while suppliers of fund are interest averse by risk-willing; users of fund are interest-willing but not risk distributing. In case of Pakistan, however, the argument of competing institution loses its weight because the interest-free banks have no rivals practising on the basis of interest.

It is observed that the designers of interest-free banks with all their good faith and intentions will be facing this dilemma unless and until they are ready to assign the bank a position which it really deserves. The question of a bank's right to claim a share in profit or a remuneration for its services involves a number of practical issues. And it is here that the role of a bank needs to be carefully examined.

It is due to historical reason that banks have been evolved purely as a financial institution. They are suited to attract money, keep it in safe custody, lend it under safety, invest it profitably and enjoy the capacity to create the means of payment. A bank has to maintain a balance between income, liquidity and flexibility. While allocating its funds it has to be meticulously sensitive about the factors like capital position and rate of profitability of various types of loan, stability of deposit, economic conditions, influence of monetary and fiscal policy, ability and experience of bank's personnel and credit needs of the area. So far these banks thrive on a fixed rate of return a portion of which is passed on by them to the depositor. Thus the entire effort of a bank is directed towards money management and it is not geared to act as an entrepreneur, trader, industrialist, contractor, hirer, lessor or caterer.

The question arises: with all these limitations can a bank claim any competence in trading or in entrepreneurship which is necessary for *musharakah* or *mudarba* contract, or can it act as an owner of a large variety of heavy machinery, transport vehicles or real estate to take the position of a lessor or, can it act as a stockist to buy and resell the entire stock of imports and exports that are actually needed by genuine traders? In case the bank is historically and practically not competent to do all these jobs its claim to share a portion of profits as a working partner, trader or lessor becomes questionable.

Bank as Business Partner

There seems to be an agreement among jurists and Islamic bankers on the issue that a bank can act as a business partner even though it has no prequalification to run a business. In

case any of the partners is supervising this business the bank can act as a sleeping partner. Theoretically, the Shari'ah does not object to this position because, in an Islamic *shirka*, all partners have a right to work but are not bound to work. But this cannot be claimed in the case of *mudarba*. Practising *mudarba* would raise a number of issues, purely from Shari'ah point of view, before the bank involves itself into this contract. First, can the bank be treated a working partner in a contract of *mudarba*? If yes, will the bank be expected to work itself or allowed to pass on the *mudarba* funds to a third party for doing business or allow the third party to pass on the funds to a fourth party and so on? Then, can it legally undertake *mudarba* in any sector of the economy it likes?

In essence the rules of the Shari'ah do not normally permit the contract of *mudarba*. The reason why the Prophet (pbuh) expressly did it in supersession of rules was that saving in the hand of inexperienced owner of funds and skill of a resourceless entrepreneur do not remain idle. This means that the spirit behind legalising the institution of *mudarba* was transferring idle capital to an entrepreneur but not to a financier. In other words, *mudarba* is a combination of capital and entrepreneurship but not capital and financing intermediary by declaring the depositor as the owner of fund and the financial institution as a trader (*mudarab*). There is no doubt that the bank is the user of the fund but this use is simply a reallocation of this money among those parties who use these funds for their business. Thus a bank, although legally competent to contract a *mudarba* as an agent or a middle-man is incompetent to practically do so as a working party. The reason why the bank insists on taking this position is that it will thus shirk of the liability to bear any probable loss¹ which it cannot do as a financier.

The second point is that in case it can prove its competence to contract as a working partner to evade the risk of business it has to prove that it really performs the work or manages the work reassigned by it to a third party by way of sub-*mudarba*. But practically it is not always necessary. The bank may advance the funds to another financial institution which itself may not be the last intermediary. Take an example.

¹ In *mudarba*, the financing partner alone, but not the working partner, is liable to loss.

Suppose a group of depositors, A, offers its funds to bank B on the basis of mudarba. But B advances it by way of sub-mudarba to a finance house, C. C enters into a sub-sub-mudarba with a leasing company, D. D, in turn, purchases taxi cabs to lease out to the transporters E on the condition of sub-sub-sub-mudarba. The transporters distribute these taxis to drivers F who are the actual workers, on the condition of sub-sub-sub-sub-mudarba. It is the drivers who would ply these taxis and pass on a portion of their earnings to transporters. The transporters, retaining a portion of profits for themselves, would pass on the agreed portion to the leasing company; the leasing company would share it with the finance house; the finance house with the bank and the bank with the depositors or the owners of fund. The situation is not only ridiculous but is also bound to reduce the share of profit for the owner of fund to a ridiculous portion. The

TABLE 1

Sub-Mudarba Contracts

A	advances	Rs 1,000	to B	at 50-50	share of accrued profit		
B	readvances	"	"	C	"	"	"
C	"	"	"	D	"	"	"
D	"	"	"	E	"	"	"
E	"	"	"	F	"	"	"

TABLE 2

Distribution of Profit with a Hypothetical Earning at 24 percent (Rs 240) by F

F	passes on 50%	of Rs 240	to E (Rs 120)	retaining	Rs 120
E	"	"	of Rs 120	to D (Rs 60)	Rs 60
D	"	"	of Rs 60	to C (Rs 30)	Rs 30
C	"	"	of Rs 30	to B (Rs 15)	Rs 15
B	"	"	of Rs 15	to A (Rs 7.50)	Rs 7.5

above situation can be tabulated in the following way:

A earns a total profit of Rs 7.5 over Rs 1,000 or 0.75%.

It may perhaps be due to this ridiculous situation that the discussions in books of fiqh do not go beyond the tier of sub-mudarba.

Another question arises as to the scope of mudarba. The fiqh literature insists that mudarba is applicable in trade operations only but not in manufacturing, transport, agriculture, construction, etc. Thus, while a bank may qualify itself to become a business partner, it may not be practicable for it to venture the contract of mudarba.

As regards a bank's competence to contract *murabaha* or mark-up etc, the legality of existing practice of a number of banks is also not very convincing. All these techniques involve the Islamic law of the sales of goods. A necessary condition of sales of goods is that the goods should be in possession of the seller. Possession also involves that the seller should transfer it from the premises of the first supplier. Another condition of sale of goods is that goods should be precisely defined. As long as small individual banks with insignificant share of funds and limited number of fund seekers requiring selected items are operating, these techniques would be found practicable conforming to Shari'ah requirements. But, the large banks with huge funds required to cater to the countless requirements of a hundred thousand customers can hardly manage to fulfil all the Shari'ah requirements concerning *murabaha*, buy-back, *hai' salam*, or mark-up.

The problem would be found all the more serious if the switchover encompasses the entire banking system. Take the example of Pakistan where five major Pakistani banks have a network of over 7,000 branches which meet most of the requirements of all the economic sectors. These banks have over 1.5 million loan accounts, and commodities and services which come under these economic sectors and should be precisely defined for transacting under the Shari'ah-approved *murabaha* or mark-up must be in five figures. The general category of furniture or chemical cannot be the object of

transaction unless the unit of the commodity is precisely determined. Thus, if a bank is required to resell furniture to a trader on the condition of *murabaha* or buy-back it has to define the unit of furniture, viz. table, chair, bed, etc. and its quality. Resale of toothpaste cannot be valid unless the brand name is specified. These examples would have to transact under *murabaha* or mark-up.

It emerges that practically it is impossible for large banks or the banking system to practise the modes like mark-up, *bai' salam*, buy-back, *murabaha*, etc. in a way that fulfils the Shari'ah conditions. But in order to make themselves eligible to a return on their operations, the banks are compelled to play tricks with the letters of the law. They actually do not buy; do not possess; nor actually sell and deliver the goods; but the transaction is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfil a legal requirement but it is by violating the spirit of prohibition.

An interesting point is that all these techniques are not adopted in their normal course which involves prompt payment. Rather, all these techniques involve bank funds without which nobody would be tempted to transact with the bank. Even the banks are not found anxious to attract customers who can make prompt payment. This also shows that the real performance of the bank is advancing funds but not purchasing or selling of goods for trading, or receiving regular rent as a risk-bearing owner and earning by possession of a large number of real estates for speculation, renting or for developing. A large bank is and will never be anxious to really offer any goods for sale or offer its services for transport, development or construction to any other party than the one who actually needs funds for this purpose. A buyer, a seller, a developer, a land owner, a manufacturer comes to the bank not because the bank is a stockist, a seller, an importer or exporter but because it can advance funds to cater to these requirements.

To sum up, we come to the following conclusions:

1. What the banks are really doing is pooling up idle monetary resources to reallocate them to useful na-

tional purposes.

2. The reason why the banks have adopted a variety of financing techniques with least emphasis on profit-and-loss sharing is partly the fact that PLS does not seem to them practicable in all the economic activities and partly that it does not guarantee a return which is necessary for maintaining the institution and distributing it among the depositors which is one of the barometers of its solvency.
3. All the techniques involve bank funds to finance the procurement of goods and services but not the other way.
4. The techniques, claimed to have been adopted by these banks, do not often follow the procedure which is necessary in the Shari'ah; it is rather assumed that the procedure has been acted upon.
5. In all the techniques, without any exception, the profitability of the bank depends on the element of postponement of payment. In other words, earning depends on converting the transaction into a debt.

These conclusions prove that banks are rendering a service and should be paid for it. But, this fact does not entitle the banks to claim a share by way of profit as is validly claimed by a seller of goods, a manufacturer or a transporter.

The above points take away the credibility of these techniques being an ideal system. This situation will persist unless the whole system is redesigned by recognising the purely financial role of the bank. A new approach to the role of bank in an interest-free economy is proposed in the following:

To ensure that Islamic modes of financing do not give way to the evils that interest is claimed to generate, it is necessary to shun mark-up, *murabaha*, buy-back, *bai' salam*, etc. all such techniques ensure a return for the bank without any consideration to the productivity of bank funds in the hands of the en-

trepreneur.

The banks first of all should specify those sectors where profit-and-loss sharing can be practicable.

Practice on *mudarba* would raise a number of issues before the bank involves itself in this contract. While contracting *mudarba* it would not be permissible for the bank to take the place of an entrepreneur or a working partner. It will be equally inadvisable for it to take the position of a co-financier and thus bear the risk of loss. Thus in all the sectors or transactions where *musharakah* is not practicable or advisable a bank can at best take one of the following positions:

- It may act as a *amin* (trustee) of deposits.
- It may be treated as an intermediary between the savers and the users of bank funds.

As regards above, it is not possible to treat the bank as *amin* because under the rules of the Shari'ah, an *amin* has no right to make use of the funds of the owner without his permission. Presently, this permission may be treated to be implicit and customary. But the main problem will arise when the bank incurs a loss on this amount in which case, as the Islamic law prescribes, the entire loss will have to be borne by the trustee — the bank. Similarly, in the case of earning profit the bank will be entitled to take away the entire profit. This position will not be acceptable to the bank nor to the depositor.

Bank as Intermediary

The second position makes it an intermediary to attract deposits from the saver and advance them to the user of funds. Thus, it establishes a link between supply of and demand for funds.

As an intermediary, the bank would neither be liable to any loss nor entitled to a share in profit. It may, however, claim a remuneration for its act of intermediation. This remunera-

tion may be a prefixed lump sum or proportionate with the amount it handles. This remuneration may not, however, be contingent upon earning a profit because in this case the return of the bank becomes uncertain which, according to the Shari'ah, would make it a voidable contract. As an intermediary the bank is committed to serving both the parties — the saver and the user of funds. In this case, it has a right to claim remuneration of its service from either or both the parties irrespective of whether the entrepreneur uses them profitably and whether the owner of funds gets any return on his capital. But in this case also, the bank will relate its charges to the service it renders but not to the period of its retaining the funds with it or with the user of funds. Moreover, the entire share of earning it receives from the user of funds will be passed onto the owner of funds. Similarly, the entire burden of loss to be shared with the user of funds will be borne by the owner of funds after debiting his account for the amount receivable by the bank by way of its remuneration and of any other charges that the bank has to incur on behalf of the owner.

The terms of providing finance would depend on the option of the depositor. He may choose to finance on the basis of *mudarba* with a trader, an importer or exporter, *musharakah* with the bank or through the bank with a construction company, manufacturer or hotelier, share-cropping with a cultivator and so on. But this will not involve the modes like *murabaha*, *bai' mu'ajjal*, *bai' salam* or *bai' wafa*. The function of the bank will be to ensure through the services of its specialised staff that the interest of the depositor is protected. Expenses incurred on this staff will be deducted from gross profit payable to the depositor. The rate of remuneration chargeable from the depositor and/or entrepreneurs will be fixed by the central bank.

This proposal involves the bank as an intermediary between the depositor and the entrepreneur or trader. This seems to be a practicable alternative in the case of small or moderate size interest-free banks. In the case of very large banks and the countrywide banking system this is not as establishment of investment companies and financing institutions to finance the different sectors and specialised in different modes of financing would seem to be a more manageable alternative.

The investment companies would be subsidiaries of the bank to relieve the latter of the function of direct supervision and monitoring. It would be possible for these companies to have closer contacts with the businessman and gain much accurate information about market conditions. These would in fact be the effective operational wings of the banks.

To sum up, many techniques that the interest-free banks are practising are not either in full conformity with the spirit of Shari'ah or practicable in the case of large banks or the entire banking system. Moreover, they have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate. PLS has a limited scope and should be retained but the fields where it can be applicable should be specified. The banks cannot act as trader nor as a working partner under the contract of *mudarba*. In this mode and in other techniques of financing it would serve as an intermediary and would charge remuneration for its services irrespective of whether the business earns or loses. Large banks and countrywide banking would require structural change by setting up investment companies as specialised operational subsidiaries. It is not necessary that all the banks set up similar investment companies to cater to all the sectors of economy; it would be preferable to have specialisation in only a few spheres. The subsidiaries of a bank A, for example, may specialise in housing and transport while those of bank B may concentrate on services and small-scale industries, and so on.

The last question that needs to be tackled is the economic implication of charging a remuneration from the depositor in case he incurs a loss on his funds. A loss will happen only when funds are separately operated for each individual. Banks, on the other hand, would pool up funds for different portfolios and diversify their investment to become profitable on the whole. If even then, some portfolio fails to earn, a number of solutions may be devised to compensate the bank without putting an additional burden on the fund owner who has already lost a portion of his capital.

Financial institutions should be categorised on the basis of period of finance. Commercial banks should finance for short and medium term; NBFIs and specialised banks should

concentrate mainly on long-term financing. Short-term financing of agriculture, small trade and handicrafts should be the exclusive concern of cooperatives. Commercial banks may perform all the conventional banking functions on the basis of commission, service charges or remunerations and act as intermediaries in *musharakah* or *mudarba* contracts between the financier and the entrepreneur or trader. The subsidiaries of these commercial banks may come up where overseeing its financial assistance becomes necessary. That the financed firm retains its entrepreneurial freedom, protects its trade secrets and remains at liberty to take policy decisions in the larger interest of business, the role of financing institutions should not be that of an active partner but that of a sleeping partner. It should be allowed to intervene only when the firm adopts a policy that risks its finance. One of the reasons why the traders are not willing to accept partnership with banks is the fear of unnecessary intervention in policy matters by these banks. The government, in cooperation with the financial institutions and traders, should draft a law to define the rights and duties of such special sleeping partners.

DISCUSSION

DR GHULAM QADIR: Dr Zaman's presentation gives me the impression as if the commercial banks are just like a trust. Let me submit that the banks also have the shareholders equity on which they have to earn a small profit. In fact, the minimum ratio, i.e. 8 percent of the total liability, must be in capital form to hold this equity participation. When Dr Zaman talks about the average and the overall rate as a legal depositor, he is right; the commercial bank is a trust. But when you are talking about the central bank lending the commercial bank, it's a different matter. Suppose the overall rate of return is 10 percent and the central bank's deposit forms part of that and its own financing for the commercial banks is say 7 percent, this means that 3 percent will be there as administrative cost, service charge and operational cost because they are not supposed to make any profit. The whole idea of a bank's operation without any equity and as trust is a novel one and might not prove very practicable.

DR MUHAMMAD HUSSAIN: My question relates to placing bank rate with the overall rate or average rate as suggested by Dr Zaman. Could it be acceptable in the Shari'ah because as he has said discounting bills and other commercial papers would be taken care of by the central bank on the basis of a certain portion of profits made?

KHWAJA MEHBOOB ELAHI: Some bankers fear that when on June 30, 1992, the interest on internal loans will be eliminated, the banking system will collapse. This fear has nothing to do with reality. Bankers say Rs 5,000 million have been advanced as loans. According to this amount, if interest is eliminated, it will be only Rs 800 million yearly at the rate of 16 percent or Rs 400 million for first six months, which is not a large amount.

The real issue is of sick units which are neither returning the capital nor paying the interest. It might be possible that if interest is waived, they may repay actual loans. But of course, there are dishonest people who do not want to repay loans.

The session was presided over by Dr Arshad Zaman.

Now after the FSC judgement, people say: don't submit your instalments; after the interest is completely eliminated, you would need to pay only the actual loan amount. This is dishonesty.

MUFTI SHUJAAT ALI QADRI: There's no question of dishonesty in not paying interest. Allah has forbidden interest clearly. So any interest-based dealings are forbidden in Islam.

ZAIGHAM RIZVI: We criticise gradualism off and on. But I feel that gradualism has improved things. We may say that we should avoid this or that at once but we have to see things in overall perspective taking into account practical problems of bankers. We should be flexible while striking down procedures.

COMMENT: The Shari'ah experts say that the persons who are able to pay but do not pay, the penalty should be covered from them. They also agree that the ability to pay will be determined not by the statement of that very person but he will be considered to be unable to pay only if he is officially declared bankrupt. The apportionment of total mark-up, which has been disallowed, is a separate matter. As far as the pressure is concerned, ulema agree that the pressure has to be built on the willful barterers and that too is the priority.

COMMENT: If the government is reluctant to give return on outstanding debt, it will undermine public confidence in the state. Besides, it will have repercussions on borrowers, making them free from any liability although they have borrowed millions. It will be unjust from the Shari'ah viewpoint and not rational either. I suggest that the creation of money or borrowing from the central bank should be linked with quantum of goods and services in the country or to the growth rate of economy.

Second, in case of outstanding debt, *musharakah* should be used where possible. But where debt-money raised has not been used for the progressive purposes, the issue should be referred to the Council of Islamic Ideology or the Federal Shari'ah Court. Whether outstanding debt can be linked to GDP indicator, growth rate or other such NDCs must be reflected upon. I think this is both ways: if the government has

to remit, it should also have a right to bar interest on government security.

S M HASANUZ ZAMAN: Dr Ghulam Qadir fears loss of income to shareholders. I think it is the shareholder who earns from all the banking services other than lending or direct trading. In addition, because the bank will be an intermediary, it will also earn its agency charges and this will be a major source of its income. The bank balance will be entirely on all these funds — I mean no depositor will be excluded and only the shareholder will get it.

About the average and ordinary rates, it is a variant of the concept of normal rate of return that has been accommodated by the CII in its report without details of the instruments. The State Bank may be allowed to accommodate bills, though it will not advance return on loan; it will be a return on accommodation of these requirements with the condition that there should be an adjustment of this *ipso facto* rate. If the difference is not substantial, it could not be supported then.

DR ARSHAD ZAMAN: The choice for us now is between ways to justify existing practice and to change the practice altogether. Now, one way is to preserve our wish that the existing practice continue and change the Shari'ah. The other is that we take the Shari'ah and change the practice. The consensus emerged from today's discussion is that we have to change the practice — the system.

Role of Mudarba Floatations in Pakistan's Capital Markets

DR GHULAM RASOOL

The phenomenon of socioeconomic changes during the last two centuries has been characterised overwhelmingly by economic relationships based primarily on debt. Islam abhors debt-based life and prohibits interest in all its forms. According to the tenets of Islam, capital formation results essentially from the participation of labour and capital in the growth process and reward for factor services must be paid for their respective contribution to productivity. Saving which is the result of sacrifice of consumption foregone warrants a reward only when it gets translated into investment. No return on saving would be legitimate if it goes into hoarding instead of being directed towards investment. Islam is by no means averse to equity-based investment. Risk-sharing by labour in capital and entrepreneurship is in fact considered to be the vehicle of growth and development. Being an Islamic state, Pakistan is committed to establishing a socioeconomic order based on the Islamic principles of equity and justice. To achieve this goal, elimination of interest from the system occupies a central position in the policy-making process of the government.

In 1980, Pakistan government formally launched a programme of gradual transformation of its economy from a secular basis to the one free from all such elements as are repugnant to Shari'ah. The process was initiated by

introducing certain Islamic modes of financing such as profit-and-loss sharing, equity participation, leasing, hire-purchase, mark-up, *mudarba*, *musharakah* and *murabaha*. All these modes were more or less approved by the religious scholars with of course some exception. Interestingly, while Islamic banks including the one based in Jeddah, are all using these various modes throughout the world, controversy exists in Pakistan with respect to some, especially the mark-up system. *Mudarba* technique under review is, nevertheless, accepted on all hands beyond controversy as purely an Islamic instrument.

Currently, a principal concern of government policy-making is the extraordinarily excessive expansion of credit pushing inflationary pressures to alarming proportions in the system. Role of *mudarba* floatations in Pakistan's capital markets, besides Islamising the economy, is highly significant particularly in combating inflationary tendencies by relieving at least part of the pressures of excessive credit expansion through resource mobilisation from the stock markets and providing these to finance equity in trade and industry. Purpose of this paper is primarily to highlight the role of *mudarbas* in this regard. But before dealing with the actual operation of the *mudarba* technique in Pakistan an outline of the background to its induction into Pakistan and a word about the concept may not be out of place.

Concept

Mudarba refers basically to a partnership between two parties: a *mudarab*, meaning a professional or and expert; and saver or owner of money. The saver invests money while the expert contributes his entrepreneurial skills. Profit-accruing from the undertaking is shared equally between the two partners, but the loss, if any, must be borne by the saver alone who has the capacity to absorb it.

Authorisation

In Pakistan, *mudarba* technique was inducted into its financial system through the *Mudarba Companies Ordinance*,

XXXI, 1980, providing for matters relating to registration, floatation and regulation of mudarbas. From the date of application of the mudarba company till the authorisation for floatation on the stock exchange, the entire process can be covered in three broad steps, which on average take about 6-12 months as under:

CERTIFICATION OF REGISTRATION

No mudarba company is allowed to operate without registration with the Registrar of Mudarbas, appointed by the federal government for the purpose, subject to the following:

- The proposed mudarba company must have a minimum of Rs 2.5 million as its paid-up capital if it is to engage solely in floatation and management of a mudarba. If it is to engage in other business, the limit of paid-up capital is to be no less than Rs 7.5 million.
- Character of directors or employees of the proposed company must be above-board.
- Solvency of each one of the directors must be ensured. It generally takes about 2-4 months for the Registrar's office to scrutinise the eligibility of the company in terms of integrity of character and financial soundness of each one of the sponsors of the company.

ENLISTING MUDARBA ON STOCK EXCHANGE

Application for floatation must be accompanied by a prospectus containing relevant information regarding such matters as the nature of business scheme to be undertaken, the mode of distribution of profits and others as prescribed in the proforma.

CLEARANCE BY RELIGIOUS BOARD

No mudarba is allowed to operate without the clearance of its prospectus by the religious board appointed by the federal government. The board consists of three members. Besides chairman, qualified to be a judge of a high court, two members are religious scholars. After careful scrutiny of the draft prospectus by the registrar's office as referred to above, the same is placed before the religious board for certification in

writing that the proposed mudarba is not a business opposed to the injunctions of Islam. It takes about 4-5 months for the registrar to obtain the relevant certification of the religious board and then grant authorisation depending on the completeness of information or documentation given in the initial application and the points of clarification or modifications, additions or omissions that might be required by the board to be incorporated in the final prospectus. Sometimes, the board meets after several months which obviously prolongs the period necessary to fulfil such formalities. Once the prospectus is approved, it is required to be published in the press.

Role of Regulatory Bodies

Mudarba operations are subjected to regulatory controls right from the start. Four different agencies act as watchdogs of the mudarba operations. Corporate Law Authority grants registration after careful scrutiny and allows flotation only after approval of the prospectus for proposed mudarba businesses by the religious board. The State Bank monitors the operations by requiring each mudarba management to submit reports on its activities on a regular basis.

Besides the above government regulatory bodies which oversee the operations, accounts of the companies are checked and certified by chartered accountants of national repute in accordance with the provisions of the 1980 Mudarba Ordinance. Under the overall supervision of CLA, the Registrar of Mudarbas, on his own or on an application made by the mudarba certificate holders, the value of which is not less than ten percent of the total subscribed amount, is empowered to open an inquiry into the affairs of a mudarba company and can take necessary action in case of any contravention of rules provided in the ordinance.

Economic Impact

Although mudarba mode of financing was introduced over a decade ago as part of the government's policy to Islamise Pakistan's economy, it is only during the last couple of years

that mudarba has emerged as one of the principal Islamic financing instruments. Mudarba floatations make immense contribution towards development financing in the country which is presently starved of financial resources and where the saving rates are shamefully low. In fact, the principal constraint of development at present is inadequacy of local financial resources.

A major reason for substantial shortfalls in implementation of foreign-aided projects is the lack of matching rupee resources. The need for resource mobilisation from the stock market to finance industrial investment can, therefore, hardly be over-emphasised.

Debt-Based Capital Structure and Credit

The capital structure of companies in Pakistan has been characterised by a very high ratio of debt in relation to equity finance. Loan facility from development finance institutions (DFIs) and the nationalised commercial banks (NCBs) has been the dominant source of industrial investment in the past. A switchover from debt to equity-financing through mobilisation of resources from the stock exchanges through mudarbas, however modest at the start, is thus a most welcome step. This is particularly creditable at present in view of the sharp acceleration in demand for credit both from public and private sectors leading to its excessive expansion which is far beyond the safe limits envisaged in the current annual credit plan (ACP) targets.

It would be observed that the 1991-92 credit plan envisioned a total increase of Rs 45.4 billion (12.2 percent) in the monetary assets as the safe limits for monetary expansion within the overall framework of macroeconomic policy. This included a target of Rs 26.7 billion for private sector. Reports on credit expansion during the first eight months reveal that whereas the utilisation of credit by the private sector is within the ceiling allocated to it (Rs 20 billion against Rs 27 billion), the government sector utilisation, on the other hand, is far in excess of its ceiling at Rs 56 billion. Obviously, the end result of such expansion is to aggravate the liquidity position and the inflationary pressures. Any

move aimed at reversing such a trend is indeed a healthy pursuit.

Growth of Floatation

At the end of 1991, there were some 497 companies listed on Karachi Stock Exchange (KSE). Of the total of Rs 44 billion as the amount of capital issued by all the 497 listed companies, a fairly good proportion (Rs 3.5 billion or about 13 percent) pertained to the relatively small number of 38 mudarba companies. Market capitalisation of the latter is more than double at about Rs 7.3 billion.

Performance of mudarbas in terms of turnover is even more impressive as the volume of transactions of mudarba certificates constituted more than 40 percent of the combined turnover of all the remaining 459 companies put together. An exceedingly important feature of mudarba companies is their support to equity as 70 percent of the funds of these companies is utilised for financing industrial investment while the remaining 30 percent supports such businesses as leasing and other allied activities.

Recent upsurge in mudarba activity can be directly linked to the major fiscal incentive enjoyed by these companies, namely total tax exemption of company's profits if 90 percent of these are distributed among certificate holders. This factor, supported by government policies of strengthening the stock market through massive privatisation programme and the liberalisation of foreign exchange controls, has indeed been largely responsible for the successful induction of this Islamic mode into our financial system.

As an added advantage to Islamisation, the process has helped achieve one of the most desired objectives of credit policy, namely mobilising household savings from the stock market in order to meet the rapidly increasing credit demand. The pivotal role being played by mudarbas in this context becomes evident if the mechanism of credit allocation is studied within the framework of the ACP, formulated and monitored by the National Credit Consultant Council. Within the parameters of the ACP, overall credit ceilings are fixed for each

lending institution in order to ensure consistency with macroeconomic policies. Minimum levels of credit are earmarked for priority borrowing sectors and maximum levels for the non-priority sectors. Tremendous increase in demand for credit, experienced during 1991-92, both from the government as well as from the private sector, burst the credit ceilings, upsetting all intersectoral priorities when the country's saving rates continue to be shamefully low. Under these conditions mudarba floatations have helped relieve at least some of the pressures of excessive credit expansion, since mudarba funds mobilised from the stock exchange form an important alternative source in place of commercial borrowings by trade and industry.

Throughout the history of industrial development in Pakistan, there had been a ready availability of institutional term financing at concessional rates of interest from both the DFIs and NCBs. This made commercial borrowing as a much more attractive source of industrial finance than equity. This is evident from a comparison of dividend yields which on the average were 13 percent compared to the cost of long-term local currency debt-financing estimated at less than 11 percent. In fact, relative cost of debt-financing was further reduced because interest paid by a company on its loans is deductible from profits considering it as part of production cost and the tax is imposed on net profits of the company. On the other hand, profits distributed to shareholders of a company are first subjected to company taxation and then to individual income tax, though public limited companies listed on the stock exchange are subjected to slightly better treatment in terms of rebate of a small percentage which is not available to private companies. Sluggishness of activity on the stock exchanges in the past has, therefore, been rightly attributed to the relative attractiveness of concessionary loans.

Test of Efficiency of Operations

Calculation of current ratios based on typical current assets such as cash and short-term investments and current liabilities hardly make much sense in testing efficiency of mudarbas. Very often the standard of indicator in assessing their operations is the so-called price-earning (P/E) ratio based on the

stock market price of the mudarba certificate to profits earned.

P/E ratios worked out on the basis of quotations of selected mudarbas on KSE at the end of 1991 showed considerable variation between seven and 31, which were definitely on the high side. However, that point of time was indicative of an extraordinary buoyancy of the market and exceptionally high P/E ratios might have included a certain degree of unrealism in the market. Although no calculation of P/E ratios for a more recent period reflecting the depression in the market has been made, the thinking is that the market is nearer to a more realistic situation now than earlier. However, it is premature to know about the exact position of the efficiency of mudarba due to too short a span of time and the complexity of market. But it is definite that most of the parties involved are genuinely interested in the success of the new concept.

Coop Scam vs Mudarbas

In the wake of the cooperative scandal involving billions of rupees and some 250,000 small depositors, rumours of an imminent crash of mudarba companies became commonplace. Despite assurances given by CLA chairman regarding the legitimacy of mudarba operations refuting such rumours as baseless and without substance, apprehensions still persist regarding the danger of mudarbas' crisis. The fact is that any parallelism drawn between mudarba floatations and the defunct finance corporations and cooperative societies is absolutely uncalled-for and has no validity for the following reasons:

First and the foremost point is that the cooperatives or finance companies were established quite illegally and were never subjected to such close scrutiny at the initial stage of launching as is the case with the mudarbas, nor were their operations monitored with any effectiveness. The cooperatives act lacked provisions for an effective monitoring control by the government. It is only recently after the occurrence of the coop scam that the Punjab government has promulgated an amendment in the act providing for some

control of their operations. In fact, the finance companies had sprung up without any legal authority from the government.

Second, unlike mudarbas, the cooperatives acted as banks involving normal commercial activities by accepting deposits without authority outside the normal banking operational discipline which is imposed by the State Bank of Pakistan over the rest of the commercial banking activity. Mudarbas, on the other hand, are not permitted to accept deposits and are subjected to close scrutiny prior to registration and grant of authorisation for floatation, and their operations remain under vigilance of such regulatory agencies as (a) the Corporate Law Authority whose primary function is to ensure legitimacy of their affairs; (b) State Bank which is the monitoring authority for overseeing the affairs of mudarbas; and (c) on top of that, the religious board to certify the legitimacy of their operations to be strictly in accordance with the injunctions of Islam and disallow anything considered as repugnant to the tenets of Islam.

Third, an important feature of mudarbas which distinguishes them from coops is the nature of their sponsors. Finance companies sprang up almost overnight and their management got involved in speculative or even fraudulent practices in real estate without practically any legal check. The sponsors of mudarbas, on the other hand, are either masters of highly successful industrial enterprises or renowned professional bankers. Big industrial groups sponsoring a number of mudarbas include such well-known names as the Dawood Group, the Habibs, Crescent Group, Tawakkal Group of Companies and Manshas. The other category comprises mudarbas which are sponsored or administered by such well-known professional bankers as Mr N.M. Uqaili, a former finance minister, Mr M.R. Khan, a former chairman of Pakistan Banking Council, Mr Tajammal Hussain, former chairman of PBC and present president of the Punjab Bank, and Mr Naik Muhammad Qureshi, former chairman of Central Board of Revenue, who repre-

sented Pakistan as executive director, Asian Development Bank, for over eight years until recently.

Fourth, unlike coops, mudarbas are not permitted to accept deposits. Their assets are based exclusively on the sponsors' own contribution (including that of their relatives and friends) in cash to the tune of 50 percent of the total paid-up capital. Moreover, in most cases, DFIs like NIT, PICIC, BEL and NDFC are subscribers to their funds. These institutions not only lend credibility and strength to mudarbas, but also act as watchdog of their operations. The remainder of the paid-up capital is received as contribution of a large number of individuals through offerings to general public before floatation. As described earlier, once a mudarba is floated on the stock exchange, its operations fall under strict vigilance of the three regulatory agencies, i.e. CLA, SBP and religious board. Besides, the accounts of these companies are checked and certified by established chartered accountants before submission to CLA and State Bank.

Finally, apart from the overall supervision exercised by the government agencies, a self-regulatory system has been established under the Companies Ordinance 1984, in the form of the Mudarba Association of Pakistan. The principal objective is to promote, safeguard and protect the interests of mudarbas and liaise between the management of mudarbas and the government. An important function of the association is to promote honourable practices by its members in the conduct of their businesses in accordance with the injunctions of Shari'ah within the framework of rules and guidelines issued by the competent authority.

Conclusions

Mudarba has emerged as the single most important Islamic financial instrument in the process of Islamisation. It performs a dual function of eliminating interest from industrial

relations and providing support to essential equity financing by mobilising resources from the stock market.

Mudarbas can be of immense usefulness in employment generation. It must be appreciated that mudarbas are in the unique position of funding medium or small industries which under the present conditions fail to have access to the financial institutions which mostly cater to large industries in the organised manufacturing sector. Mudarbas can act as catalysts in stimulating productive employment in the unorganised manufacturing sector if properly guided with adequate capital at their disposal.

It must, however, be recognised that fiscal incentives presently enjoyed by mudarbas are the motivating force behind their remarkable success. Any reduction in these incentives would jeopardise their performance. To maintain momentum and expect further growth, continuation of these is the minimum.

For further acceleration of mudarbas, the following suggestions are made:

At present, mudarbas operate with limited funds from whatever they are able to mobilise, from sponsors' own contribution supplemented by the amount subscribed by the general public. The only option for enhancement of funds available to a mudarba is the issuance of rights issues, which again has an extremely limited scope. It would indeed be worthwhile to allow mudarbas to mobilise through term certificates as has been done in favour of other institutions.

A feeling exists that availability of fiscal incentives which are not allowed under other modes is a great attraction leading to mushrooming effect in the case of mudarbas. The competence of professionals and their size who provide the supervisory role in the government must be commensurate with the requirements of an effective performance from the viewpoint of overseeing the conduct of affairs of these institutions. It is, therefore, argued that in such a situation of an unwieldy number of mudarbas in the

field, misconduct of a few may result in a disastrous effect for all. Capacity and competence of the regulatory bodies must be enhanced before allowing rapid increase in numbers to cope with the diversity of the task of supervision and guidance.

The religious board performed a remarkable function of legitimising the operation of the new Islamic mode. However, its role should be confined to guidance and interpretation and application in establishing norms in such a way as has been the practice so far with respect to scrutiny of the prospectus of mudarbas by CLA and its authentication by the board. Beyond this, assumption of administrative role by the board in respect of specifics is most likely to hinder rather than promote the cause. That would, in any case, duplicate the functions of other regulatory bodies.

The function of scrutiny of proposals during the pre-investment phase and that of monitoring of operations should be performed by the same institution. At present, while the former is handled by the CLA, the State Bank is entrusted with the latter. Obviously the pre-investment evaluation and monitoring done by a single agency would be more effective and appropriate. Lack of relevant information and its analysis is a major shortcoming of monitoring the actual implementation of credit and monetary policy. It is, therefore, imperative to strengthen the regulatory and monitoring bodies in a manner that the modern methods are applied through use of computer facility to the best advantage. Need for recruitment and training of professional staff by the CLA and the State Bank can hardly be over-emphasised.

Finally, it goes without saying that induction of mudarba concept into Pakistan's financial market is undoubtedly an important milestone in achieving the goal of interest-free banking and Islamisation of the economy.

DISCUSSION

EBRAHIM SIDAT: Here is a summary of Dr Abdul Malik Irfani's paper:

Ten years ago, a legal framework named the Mudarba Ordinance was issued to Islamise Pakistan's economy. It provides a vehicle for venture capital run by a management company which provides finances raised from the open market. The job of the management company is to manage the funds and run the day-to-day affairs of business; the profits belong to the providers of capital — something synonymous with share certificates. Mudarba is a legal entity, an artificial juridical person, who can sue and be sued, own property in its own name. Thus, the mudarba is a company under the normal regulations.

Dr Irfani gave an overview of the working of the mudarba, the legislative framework within which the registration of the mudarba company takes place along with other legal details. But more importantly, he holds that the mudarba company is accountable for any loss of citizens' money. He derives his rationale from the Shari'ah.

Whereas the paper by Dr Ghulam Rasool has dealt with the mudarba and the role it has played in mobilisation of resources and credit and corporate expansion, as well as the role it can play after necessary reforms, Dr Irfani's paper has a fiqhi perspective — to bring mudarba more in conformity with the Shari'ah. He stresses that we should have a close scrutiny based on a sounder thesis. He emphasised the concept of '*urf*'. This concept of '*urf*' as elaborated by him is no doubt very significant, but needs a cautious approach when applied.

PROF KHURSHID AHMAD: The concept of '*urf*' comes only after we fail to find interpretations in Qur'an, Sunnah and *ijma*. The '*urf*', in vogue during early centuries after Islam, cannot be applied in today's business practices. A new sys-

Dr Abdul Malik Irfani also gave a paper on mudarba. The paper was in Urdu and as such could not be included in the proceedings. As discussion on Dr Ghulam Rasool's paper and that of Dr Irfani was undertaken jointly, a summary of Dr Irfani's paper is included. Mr Ebrahim Sidat chaired this session.

tem violating Allah's *ahkam* during the last five centuries has taken over the world where *'urf* can hardly find a place.

NAWAZISH ALI ZAIDI: A view has been expressed by Dr Irfani that certain provisions of the Mudarba Ordinance are un-Islamic. If it is so, the matter can be referred to the Federal Shari'ah Court.

Dr Ghulam Rasool has suggested that mudarba company be authorised to raise additional capital by accepting term deposits. Apparently, he feels that the mudarba company should be allowed to make its deposits daily while I feel resources can be enhanced by raising capital, through increasing the authorised capital and raising the trade.

There is a board which scrutinises the applications to see if the objectives of a mudarba company are in line with the Shari'ah, though I am not aware of an arrangement in force that would have monitored the operations actually taking place from the Shari'ah viewpoint. There should be a monitoring body which should watch the actual operation from the Shari'ah viewpoint.

Mudarba laws are now quite old. It is because of the fiscal incentives that market forces took notice of the mudarba opportunities. In my view, these fiscal incentives should also be provided to other corporate sectors. As regards the banks if they want to diversify themselves into non-banking businesses, here was an opportunity waiting for them. Unfortunately, they have failed to capitalise on it.

COMMENT: Some points need explanation. What is the justification for mudarba? What are the Islamic injunctions under which mudarba is allowed? If your financing is through loans where there is no interest, you can create many interest-free modes of financing. You only need to take care of two things. One is the Islamic norm that it should be free of riba. Second, under the mudarba umbrella both parties should be willing to face risk, but here return is not guaranteed. Third, it is part of the profits where you cannot exclude others — the profit has to be shared. That means you cannot conceive of a mudarba unless you have separate accounts, projects and yearly profit-and-loss budget.

Concerning *'urf*, we need to know its role and jurisdiction? There is no role for *'urf* as a source of the Shari'ah; it is a mode of interpretation like *qias* and tells us what is the injunction of Allah; it is invoked only after a contract is concluded. Also, it falls short on specifics. Needless to say, it is accepted by all jurists as a valid mode of interpretation.

COMMENT: Dr Ghulam Rasool has said that the mudarba contribution in Pakistan has been very significant. To my knowledge, there are 32 and not 40 mudarbas doing underwriting and entering into a buy-back arrangement. The religious board is going to vet every agreement which a mudarba negotiates in order to reconcile it with the Islamic injunctions. I do not feel any justification of vetting a specific-purpose mudarba by the religious board when they have allowed multi-purpose mudarbas.

QUESTION: About generation of funds through term certificates, Dr Ghulam Rasool says that the only option of mudarba is the issuance of right issues which again has an extremely limited scope. It would indeed be worthwhile to allow mudarba to mobilise through term certificates, though there are reservations about them. Is issuance of PTCs officially permissible or will it be a back door operation? Who will be held responsible for the losses and what will be the consequences if the companies started issuing PTCs officially?

COMMENT: We have a dual kind of banking: the Islamic mudarba and non-Islamic modes. If in the facility package the concessions granted to the non-Islamic sector are more than what the Islamic sector gets, the possibility is that the Islamic sector will never make it. Until the interest is eliminated, concessions should be withdrawn. Second, it is highly politicised. The rate of mark-up is again not determined by the market; it is determined by bureaucrats.

I do not know if the mudarba is a limited company. If it is limited only to the *rabbul maal* capital, then bankruptcy law will be applied. There may be unpaid bills to the tune of millions of rupees. Who is going to pay bills in excess of the original capital?

COMMENT: I thought that there was a withholding tax of 10

percent on the profit given on the *mudarba* certificates. If that is true, it is not tax-free. In my view, people prefer equity to *mudarba* because only equity-holders control the project. Through the *mudarba* mechanism if you have one rupee, you can easily generate hundred rupees, with the obvious advantage that the remaining 99 shareholders would not interfere in what you like to do with the capital. As to the persons who took finance from the banks or from others either in the shape of buy-back or *musharakah*, the treatment is the same as given to any interest-based activity.

DR ZIAUDDIN AHMAD: What is happening on the assets side of the *mudarba* companies is very encouraging. As a mode, it has a great potential for achieving Islamic socioeconomic objectives. And that can only be done if we have a two-tier *mudarba* system. The *mudarba* companies, after having received enthusiastic public response, are adopting the same kind of operating procedure from the asset side as that of commercial banks and other institutions. This way they will not be helping significantly in achieving Islamic socioeconomic objectives of eradicating poverty and reducing income disparity. The very fact that the government recently has come out with a new scheme to promote employment by using the technique of *qard* with mark-up loans indicates that the government itself is not satisfied with the so-called Islamic banking and *mudarba* performance. I am not sure whether the religious board has got a new instruction for the *mudarba* companies.

QUESTION: There are reports that some *mudarba* companies have also been investing in stock exchange market purely in the speculative businesses. What is the opinion of the Islamic financial experts on the speculative nature of the stock market, specially in our country where many companies are indulging in malpractices of buying and selling shares without even delivering the stock?

DR FAIZ MUHAMMAD: The purpose of Islamic modes of finances should not be just to settle the problem of highly organised formal sector but to focus on how we can make this mode of financing practicable at the grassroots level. Unfortunately, the present practice is restricted to the need of a highly organised formal sector. If you look at the actual

rules implemented by the Corporate Law Authority, they are sometimes beyond the rules on the paper. Somehow, it should have been left to those who are experienced in this field.

My other submission to the Islamic financial scholars is that mudarba is an alternative to riba and should be understood not necessarily as a religious reference but as a business. Whenever certain things are done in daily life, the people act invariably with all their energy. Therefore, let there be some scope for the experts' opinion with the actual business that they are doing. The observation that *qard* is abhorrent is a very far-reaching statement. In the Qur'an, Allah invites who is there who will advance *qard-e-hasan* to Allah. Can Allah encourage the concept of *qard* if it were abhorrent? The Prophet (pbuh) himself incurred debt. The credit need is still there as short-term working capital, which is often met by commercial banks. For sure, that can't be met out of whatever you raise in the capital market.

Second, the credit need is there to the extent the government exempts you from the capital. That is why I say the credit will continue to be an important element in the economic growth. *Qard-e-hasan* is the best way of financing. The next best is profit-and-loss sharing which we call as *musharakah* or partnership. The banks have a lot of resources and I wonder why they can't give *qard-e-hasan*. May be it is because our depositors want the safety and a return of their money plus something as profit. The ulema have not addressed the *musharakah* mode of financing. We should discuss the present *musharakah* terms and conditions and to know what are those conditions which are against the interest of business community so that besides the Shari'ah interest, these agreements could be amended and made suitable to them.

DR GHULAM RASOOL: It is with the approval of the religious board that the mudarba certificates, to which Dr Irfani objected strongly, are floated. I agree with Mr Nawazish Ali Zaidi that there is a need for monitoring, although the CLA in principle is not only supposed to scrutinising the floatation but also monitor them. Lately, the State Bank has established a section for monitoring mudarba business. But instead of

being helpful, it is creating many problems from the Shari'ah viewpoint.

The religious board is all the time there to pinpoint any deviation from the commitments made in a mudarba prospectus that comes or is brought to its notice by the CLA. There is a strong need for strengthening both the CLA and the State Bank and also a need for coordinating and streamlining the working of the two organisations in these matters.

As to fiscal incentives for mudarbas, the Mudarba Ordinance was passed in 1980. The first mudarba proved a total failure. Obviously, nobody paid any attention to mudarbas' development. But as soon as fiscal incentives were announced, the mudarba business flourished. There is a tremendous scope for using this Islamic mode in servicing the unorganised sector provided it is properly monitored and adequate incentives are given, especially towards the enlargement of the funds. Authorisation is always very cumbersome. PTCs could be issued only where it is permissible under the Shari'ah. If the leasing corporations are allowed, so could be these mudarbas.

QUESTION: In violation of the investment ratio?

DR GHULAM RASOOL: This is a real problem area. The mudarbas are restricted by the amount of funds at their disposal. Unlike other organisations, there is a private association of mudarba companies, though their number is small. A question was raised about 90 percent dividends. I don't think it is the dividend, it is the profit. If the 90 percent profits are distributed, it becomes exempt from taxation barring withholding tax. I did not make up the 11 percent figure; this is from World Bank's paper. As to the speculative nature, all markets have an element of speculation and we cannot do away with them. I would like to quote the CLA report of 1991, which says that 70 percent of the mudarba funds are not loan but financing equity. Mudarbas are not based on loans. If credit and equity financing that mudarbas are doing were not available to the industries, whether as financing capital expenditure or working capital requirement, they would have resorted to obtaining credit from the banks.

EBRAHIM SIDAT: The mudarba law was passed in 1980 but there had been no mudarba activity for about four years. Why did it not pick up as a mode of financing? My view is that most of the things in Pakistan revolve around tax concession. You needed that concession for the mudarba as well. There would have been very little charity or donation coming in if section 47 of the Income Tax Ordinance were deleted. Why? Because that section provides tax exemption on charity and donation.

On the other hand, there is a credibility question on bureaucrats dealing with taxes. Entrepreneurs were not sure whether this fiscal concession, which was quite a departure from the normal pattern of fiscal legislation and which came as part of the Mudarba Ordinance and not as part of the Income Tax Ordinance, would even continue or not. This, I think, provides one reason why people were waiting. On a few occasions, a reference had been made to do away with mudarba calling it a failure. Probably because of that, mudarbas did not grow fast in the beginning.

Nevertheless, from the point of generating funds and considering the project of the first mudarba, it was a big success. For a total capital of about Rs 30 million, a 5-6 time money was raised. Where people went wrong was in estimating and projecting the profits of the mudarba.

I felt a bit of confusion regarding the intermingling of the term mudarba company and mudarba. During discussion, there are a few places where things related to mudarba have been linked with the mudarba company. Mudarba company and mudarba are two distinct legal entities. All the mudarba companies in Pakistan are private limited companies under the Companies Ordinance, 1913, and not Companies Ordinance, 1984. Mudarba is a legal entity and it can sue and be sued. It is an artificial juridical person. Whether Shari'ah allows for an artificial juridical person or not is an altogether different debate.

Dr Ziauddin Ahmad has raised a point on the aspect of assets. He did not want to discourage people in the mudarba business. But let me say all is not well on the mudarba front. First, not everything done under the umbrella of mu-

darba is sanctioned by the Shari'ah. Some of the corporate practices with regard to the mudarba business are questionable. Most of the mudarbas are corporate groups of large dimension using funds for in-house financing. Thus besides religious board, there is need for constant corporate mechanics. The idea was that we need a tax concession to motivate people to declare corporate profits. We have a very bleak record in terms of most of our quoted companies with regard to the dividend distribution. The idea was that somehow the self-interest of the corporate entrepreneurs is linked with the benefit through the medium of tax concession. Now with this tax exemption an anomalous situation has been created. The economics of a leasing mudarba's operation and leasing company are totally different because one has to pay through his nose corporate tax as high as 40 percent if it is a quoted company and as high as 55 percent if it is an unquoted company. There is an unfair element of competition; a mudarba is tax-free whereas in the same business, a company has to pay taxes. Whether this kind of unfair competition between one vehicle of corporate financing should be allowed to continue is debatable.

A period of 10 years is long enough for us to establish that even without tax concession, mudarbas would continue to flourish. Even if tax exemption is removed today, we should positively respond to mudarba only because it is an Islamic mode of financing.

Legal Framework for An Islamic Financial System with Reference to Company & Mercantile Laws

EBRAHIM SIDAT, FCA

Islam is a universal religion and its fundamentals are and will be applicable for all times to come. But no wonder that even today we have quite a few people among us in the 20th century who do not take any religious fundamentals or ideology seriously unless it expresses itself in its practical manifestation. For a few, unfortunately, the religious injunctions are a legacy of the past which cannot be made applicable to the present times because Islam, in their opinion, is medieval and not applicable to the present times. This attitude persists, although the world has had enough of gigantic problems handed down by various economic orders and systems so much so that the interest-based economic system is almost on the brink of disaster. It is in times like these that the phenomenon of Islamic resurgence has started making its impact and is affecting many fields of human activity, but, in my view, it is in the sphere of socioeconomic order where the effect is likely to be most significant and pronounced.

As a sequel to the judgement of the Federal Shari'ah Court on *riba* we are confronted with a host of practical problems in our efforts in transformation to interest-free economic system in accordance with the fundamental tenets of the Shari'ah. But I believe that since Islam is not merely a spiritual formula but a complete code of life in itself envisaging economic well-being of an individual as well as society upon sound foundations and Divine instructions, we would,

inshaallah, in course of time surmount our transitional problems. So universal and effective is the message of Islam that the depth, scope and comprehensiveness of change, which the transition from materialism has been brought about with the dawn of the Islamic era, is incomparable in dimension and substance to any cultural change in history we are aware or can conceive of.

Contemporary Confusion and the Challenge

Time and again it is not uncommon to hear either someone whisper or have the tenacity to challenge aloud, is *riba per se* necessarily obnoxious? A section of intellectuals and the press also seems to labour under illusion, manifest in their views, insisting that simple interest is not *riba* and go on to advocate why money (in which banks deal) not be treated like the commodity it can buy. Following this line of thinking it is viewed with skepticism and astonishment why the increase earned on loan money is *riba* while the increase earned in the trade of a commodity that money buys is not. We also find questions whether interest charged in modern time in its present form is all that interest which, to use the Qur'anic terminology, is *riba*. It is also mooted in certain quarters that the present-day confusion has been artificially created by labelling agreed profits or interest as *riba*. How strange it is and how unfortunate still it is today that in the matter of our attempts towards the Islamisation of the society and economy even after 1400 years since the Revelation, the same kind of doubts and aspersions are expressed as in the days of the Prophet (pbuh) that profit in trade or *bai* and *riba* are accretions of the same kind and are on the same footing, so why legitimise the former and condemn the latter? It is to people with these views the Holy Qur'an has directed its admonition in the following words:

“Those who swallow usury cannot rise up save as he ariseth whom devil hath prostrated by (his) touch. That is because they say: the trade is just like usury; whereas Allah permitteth trade and forbideth usury.”
(al-Qur'an, 2:275)

The Holy Qur'an is replete with candid injunctions pro-

hibiting and forbidding riba in all its forms and, therefore, instead of debating and juggling with semantics, it is in the fitness of things as Muslims that we take the Qur'anic warning given to those who continue to deal in riba with the seriousness it deserves. By saying this, is not to demonstrate an escapist attitude or to water down the need to understand fully why after all is riba forbidden and prohibited by the Shari'ah but any attempt in that direction would be beyond the scope of my paper. There is ample room for disagreement with my viewpoint that once we are in the fold of Islam, it is indignant and insolent to question why is this permitted and that forbidden. Accordingly, therefore, it would not be in keeping with the theme of my paper if I would at this forum have reacted to certain views which hold that interest on consumers' credit is essentially reprehensible but interest on business loans does not come within the ambit of the scope of riba. For, to me an approach of that kind is tantamount to condemning theft and legalising robbery.

At this stage, it is apt to ask: what should be the legal framework of an Islamic financial system and what fundamental changes does the interest-free system of financing envisage as compared to the existing interest-bearing arrangements? In general terms, the answer is easier to seek, for, under the existing system, regardless of the fate of the project or the operational results of an enterprise using borrowed funds, interest has to be borne and paid in all events at the cost of making an entity, to use the present-day terminology, totally sick. Such is the interest-based system that even in times of financial stringency, the financier wishes to have his pound of flesh in the form of interest, no matter the capability for repayment is totally impaired. As against this, under the system contemplated by profit-sharing arrangements, the provider of funds as a partner in the project has a share not only in the profits but shall also be liable to bear the losses. Since he is a partner in the enterprise, he should be willing to forego any claim in times of economic and financial crisis until the situation reverts back to the normal. The financial arrangements invoked under participation term certificates (PTCs), term finance certificates (TFCs) as also under *musharakah* arrangements raise many questions of propriety and reasonableness in the light of the principles enunciated by the Shari'ah particularly for the sharing of profits and

losses which I may discuss later. However, any system in its preliminary stages is anything but totally perfect and, therefore, attempts to free our interest-bearing system from the curse of riba would be no exception. I am hopeful that with an eye on Divine instructions and blessings of Allah on the one hand and sincerity of purpose and clarity of direction on the other, we would in due course be able to evolve a truly interest-free system which shall serve as a model and guide for other Muslim countries to follow, who, for want of a prototype system to adopt may not have yet ventured even to make a beginning. To me, what matters is that a beginning should be made and, therefore, efforts directed towards a virtuous goal are, *inshaallah*, bound to succeed.

In transforming the entire economic system in accordance with the fundamental tenets of Shari'ah, the elimination of interest alone will not be sufficient unless our entire economic behavior is so moulded as is conducive to the creation of socioeconomic order, satisfying the demands of equality and justice and principles of morality as enshrined in the Qur'an and Sunnah. Nevertheless, the fact remains that elimination of interest occupies the key position in the establishment of Islamic economic order which the people of Pakistan have set out to achieve as one of the fundamental goals. In our attempts to find a workable, viable and legitimate solution in the form of interest-free economy, it is indeed imperative to undertake the exercise with a frame of mind totally reconciled to the philosophy as a Muslim that interest in all its manifestations is forbidden and prohibited by Islam. Unless we approach the problem with this attitude, we would not see urgency of the need to contemplate and seek organised form of interest-free financing in accordance with norms laid down by the Shari'ah. There is something inherently wrong in the present-day financial system of fixed return without a probability of suffering any loss implicit in any interest-ridden financial system.

Current Approach to Interest-Free Financing

In judging the propriety of any participatory arrangement on the basis of sharing profit and loss, it should be borne in mind that according to the injunctions of Shari'ah, distribu-

tion of profits between the parties concerned, is a matter of mutual agreement based on which any ratio may be agreed upon by the parties while it is one of the principal obligatory conditions of such arrangements that loss, if any, shall be shared in direct proportion to investments of the respective parties. In our context, it is important to understand that eventually, it would be imperative for our entire system of banking and financing to be integrated with the deposits generated by banks and financial institutions on PLS accounts on the basis of profit-and-loss sharing in its true sense. In other words, it is the profit generated by banks and financial institutions from their efficient portfolio management, perhaps principally through equity financing and investment in *mudabas*, that they are able to give an acceptable rate of return to PLS deposit holders.

The needs of present-day finances particularly in the corporate sector are both long term and short term. It is the financial needs of the industrial sector in particular which are being focused here because not only by the enormity of the funds needed by them but also by the complexity of corporate structure, management and operations, the mechanics of interest-free financing in that sector becomes if not impossible a formidable exercise.

One feature inherent in most of the existing interest-free financial arrangements conspicuously brings out the fact that banks and financial institutions participating in the arrangement appear to be apprehensive in outlook and approach and over-cautious in their conduct and dealings, as a consequence of which the existing legal arrangements do contain provisions, which in many instances, smack of terms and conditions identical to an interest-ridden arrangement. This kind of response to the process of Islamisation of economy apparently seems to stem from the hard facts of our commercial life in which the moral fibre of the society leaves much to be desired. But to wait for that time when all elements having economic interaction between them prove themselves to be totally honest and above-board would be a futile hope and, therefore, some form of beginning with necessary checks and balances has to be initiated. However, great caution and care is needed against overdoing it which may vitiate the entire spirit and objectives of the exercise.

My presentation would be confined to the corporate legal structure envisaged by the companies ordinance, 1984, within which a few principal interest-free modes of corporate financing, namely PTCs, TFCs and *musharakah* have been experimented. My exposition may be viewed more in the nature of an attempt to identify major issues rather than a blueprint of how to remedy those aspects of financial arrangement which are questionable or of doubtful interpretation.

Participation Term Certificate

Since June 1980, the issue of fresh debentures has generally been discouraged and instead, the Controller of Capital Issues has permitted the issuance of PTCs. This instrument of financing has been in operation since then in substitution to debenture financing and it is, therefore, often heard that perhaps it is a debenture called by a different name. Conceptually, if not practically, the difference between the two lies in the fact that unlike debentures, PTCs should not carry a fixed rate of return and, therefore, should have participated in losses as well. However, they are similar, considering the fact that they do not comprise part of permanent capital of an enterprise but are for a stipulated term. In fact, PTC is one of the forms of redeemable capital as defined by the Companies Ordinance, 1984.

The mode was originally intended for medium- and long-term fixed capital needs of business entities until these have been largely replaced by term finance certificates (TFCs) which are fundamentally based on mark-up. TFCs, therefore, do not and have not participated in losses of the investee companies. It should, however, be appropriate to emphasise that since the financial and economic relationship envisaged under PTCs is not that of a debtor and a creditor but as partners in business venture providing capital resources which are usually scarce, a great deal of business judgement on the part of the financier is imperative in the matter of portfolio selection. I would view this aspect of interest-free financing not as its weakness but as the fundamental premises on which the hope of the very success of interest-free participatory financing shall be dependent. The inclination of the financiers to divert the scarce capital resources only to such projects and entities where these can be used profitably and efficiently

should have served as a built-in guarantee or at least a safeguard against financial catastrophes but in practice, we observed otherwise. This factor should have assumed greater significance in the context of public-sector undertakings as well, some of which are now being privatised, who according to the then policy of financial reorientation, should have been denied budgetary support for their balancing and modernisation or for new investment. This aspect of economic policy, if practised objectively both in public and private sectors, shall augur well in promoting competition for the scarce capital finances and resources available on the market. This by itself should infuse competition between the nationalised public sector and a healthy private sector purely on considerations of commercial profits. I mention this because it is not uncommon to hear from public-sector undertakings which are in red that profit is not their business or consideration and that they are involved in the high-sounding game of achieving social objectives. While there is no denying the fact that the attainment of social objectives by any enterprise, let alone a public-sector enterprise, is a commendable pursuit but that should not be a garb to camouflage their inefficiencies and losses. Another inherent advantage in a profit-sharing arrangement is that it would provide the much-needed incentive for the mobilisation of savings which would be made possible through efficient use of capital.

Before undertaking discussion on those aspects of PTC arrangements which are questionable, I would like to present principal elements of a typical PTC arrangement.

- a) PTC financing was fundamentally intended for medium- and long-term financial needs of business entities.
- b) Funds under the PTC arrangements were obtained either from a single financial institution or from a financing consortia or syndicate.
- c) Investment under PTC is evidenced by PTC certificates issued by the fund-using entities and included in the definition of "securities" under the Capital Issues Act, 1947 and "redeemable capital" under the Companies Ordinance, 1984.

- d) Project financing and underwriting of public floatation of shares were also financed through PTC.
- e) Business entity is expected to pay to the financial institution or bank provisionally on half-yearly basis an agreed percentage of anticipated profits with a provision for final adjustment at the end of the financial year against profits ultimately accruing to the PTC holders.
- f) In the event of loss, the financier, i.e. the financial institution, is legally expected to refund the share of profit received by it half-yearly on a provisional basis. It is, however, generally provided that loss sustained by an entity in any accounting year will first be adjusted against the reserves of the company and the balance, if any, in the subsequent year shall be available for appropriation between the parties in agreed proportion.
- g) The share of profit accruing to the PTC holder shall be deemed to be an expense not only in determining the distributable profits between the parties to the arrangement but also for the purposes of taxation.
- h) If the fund-using entity distributes profit to the PTC holders within 30 days of the close of annual accounts, a rebate of 2 percent shall be allowed whereby PTC holders shall be entitled to a maximum profit of 15 percent per annum on the face value of PTC.
- j) The financial institution shall have a right to cover 20 percent of the principal amount of the PTC into ordinary shares at par value so long funds against PTCs are outstanding. This right of option shall be exercised in the event the average rate of profit, to which the PTC holders are entitled, falls below the agreed minimum.

One of the most conspicuous features of PTC arrangement is that pending commercial production and generation of operational profits, financial institutions desire to be compensated and the compensation takes the form of a discount, usual-

ly 12 percent per annum, computed from the date of release of fund by the financial institution or the syndicate until the entity goes into commercial operation. The agreements further provide that the borrowing entity will issue further PTCs to the extent of the amount of discount and such PTCs are to rank *pari passu* with original PTCs in terms of future entitlement to profits and losses. Agreements have also come to notice where the entity is obliged to pay in cash the amount of discount stated above. This aspect is very close to an interest-bearing arrangement which thus mars the very objective for which the new scheme was conceived. I have no doubt that having initiated the new arrangement with an integrity of purpose, the fund-providing agencies would deal with this aspect with sagacity and due regard to the fundamental tenets on which the whole system of interest-free economy is based. During the preproduction stage, there should be no question of any compensation to the financier in any form and there should be no entitlement to any profits as none accrues until commercial operation starts. Also, the provision to claim commitment charge on undisbursed funds, just as in a loan agreement, seems out of place under an interest-free arrangement.

Another aspect of PTC arrangement is the provision to entitle PTC holders to an amount of profit as would yield a certain minimum return, say, 17 percent of the PTC investment whereby the purported objective would be to provide incentive to the fund-using entity to maximise its profits and retain the same, by enabling PTC holders to be entitled only to a maximum agreed proportion of profit. Although, in practice, a minimum return commensurate with the erstwhile interest seems to be the more pronounced objective. While the apparent spirit of motivation inherent in the contemplated arrangement which it sought to provide to finance may apparently not be suspect, our banks and financial institutions could not divorce themselves from the thinking which is germane to and associated with an interest-bearing arrangement. It would thus be seen that the provisions of the agreement such as above tend to indicate that our financial institutions do not find themselves satisfied unless they are entitled to and ensure firmly a rate of return which they were getting hitherto in the form of interest on their lendings. Undoubtedly, the injunctions of Shari'ah do permit sharing of profits in any

agreed ratio but in the present phase of transformation, every effort needs to be made to ensure that investors and investees are able to free themselves from the mental subjugation. This could be achieved by discreetly eliminating provisions in the financial arrangements which may be akin to or even tend to seem like one based on interest.

Of all the provisions in the PTC agreement, the one relating to treatment of losses or profit falling below the norms is most debatable. It is being argued that such measures serve not only to act as deterrent against malpractices but are also in the nature of a compromise formula in substitution of an intensive monitoring or interference which would otherwise be inevitable in the day-to-day affairs and management of the investee company.

There appears to be reluctance on the part of banks and financial institutions to share losses of the business venture in which they pretend to be partners, but in real sense they are not. Agreements provide that:

- a) Any shortfall in share of profit in any year against the agreed norm shall be compensated for out of the profits of the subsequent years until fully rewarded, meaning that in no case should the bank or financial institution receive an amount less than the agreed minimum. This feature of guarantee in a perverted form, though not so termed, is in utter disregard of the Shari'ah injunctions for distribution of profit.
- b) In the event of loss, it would first be adjusted against the existing reserves. Since reserves belong exclusively to owners or shareholders as part of equity, under all concepts of corporate jurisprudence, why should the entire loss in any year be absorbed by the reserves? In fact, the losses should be pro rata between the "partners" in business and be charged off accordingly.
- c) In the event of loss, the total amount of PTCs outstanding shall be transformed to the extent of share of PTC holders in the loss in convertible shares which, for all practical purposes, be deemed similar

to preference shares in terms of rights and privileges. In the year following loss, should there be profit, such convertible shares shall be reconverted back to PTCs and entitled to its shares of profit. In no event, the investor, i.e. bank or financial institution, is willing to be exposed to share loss which runs contrary to the spirit and objectives of an interest-free arrangement.

Musharakah

This mode of corporate financing, like PTC, has come into being without any legal framework and as such no statutory definition can be offered except that it is one of the forms of "redeemable capital" defined by the Companies Ordinance, 1984. Generally speaking, the arrangements that have been concluded until now between banks and the borrowing entities bring to the fore an important feature that under this mode of financing, working capital needs of business entities, which are short term are intended to be catered. In the light of this, the *musharakah* arrangement may be said to encompass agreement on the concept of profit-loss sharing in which the parties agree to contribute capital and managerial effort or a combination of both on an agreed basis. Here again, the contractual arrangement may envisage profit-sharing in any agreed proportion but the losses, if any, have to be borne alone by the party contributing the capital and in the case of both investing in the venture, it shall be in proportion to the respective investment of the parties.

It would not be out of place to mention that as a consequence of having launched PLS account scheme vigorously, commercial banks seem to find themselves laden with disposable funds, which they should endeavour to put in interest-free pursuits. In this context, it is imperative to realise that there is a close link between the operation of PLS account scheme and the investment by banks under *musharakah*.

The salient features of the *musharakah* agreement may be summed up as under:

- a) The profit-sharing arrangement is contemplated on

the basis of future projections of profits which in turn is based on past averages duly adjusted according to the future plans and projections and overall state of the economy, the duty and tax structure to which the business is subject to and the industry in which the firm operates. How far such projections and, in turn, share of profits or losses are realistically determined has more to do with the integrity of the entities, the general state of accounting, the degree of credibility and a realistic assessment of other surrounding factors.

- b) A provision usually contained in various *musharakah* agreements is that a certain weightage is assigned to the total amount invested by the bank while the equity of business entity is based on actual levels. This feature which enables banks to claim higher percentage of profits compared with the actual investment seems to be questionable because if at all any weightage appears desirable it is in respect of the undertaking's own investment because besides capital, it is contributing business management and expertise.
- c) The funds being basically provided for working capital needs of the business are in the form of a chequing account somewhat akin to cash credit or overdraft account in which operation could be carried out by depositing funds and withdrawing the same.
- d) The investment of the bank is construed to be the totals of daily products of the account participating in profit arrangement. Correspondingly, the investment of business entity for the limited purpose of profit-sharing arrangement under *musharakah* agreement is also to be determined on the basis of the totals of the daily products of paid-up share capital, revenue reserves and undistributed profits. Funds within the use of business entity obtained from any other source which is not liable to any interest shall also be part of the company's investment. Likewise, in order to determine "net equity" of the company, accumulated losses shall be deducted.

- e) While in theory, it is envisaged that the directors of the company and management shall have absolute independence in managing and conducting the affairs of the company, in practice, however, it seems that certain major decisions such as disposition of profits, change in the existing line of business, etc. may be subject to bank's consent. In any event, however, it seems imperative that banks shall employ some mechanics for monitoring the affairs of the company.

Although it is conceded that in the initial phase of the existence, additional safeguards to secure the interest of the investing bank may have been a practical necessity, two fundamental features of *musharakah* agreement, which closely resemble the dominant features of an interest-bearing arrangement must be mentioned. All *musharakah* agreements contain a provision which declares the legal relationship between the parties to the contract as that of debtor and creditor. While this may seem to be in consonance with the existing statutory requirement of the Banking Companies Ordinance, 1962, which has expanded the definition of "debtors" and "creditors" to include parties to a profit-sharing arrangement as well, this provision cuts at the very root of the arrangement. Consequently, while no partner in any partnership would seek to obtain physically any security, the kind of partnership envisaged under the *musharakah* agreement requires that the same type of security shall be made available by the business entity as were hitherto furnished in respect of the usual interest-bearing bank borrowings.

On the positive side of the whole arrangement is the fact that due cognisance is being given to acknowledge superiority and managerial excellence, the reward for which is termed as "good management bonus" in such agreements. The mechanics of this aspect is to set aside first a certain proportion of profit for management bonus and the balance is to be pro rata in agreed proportions based on projected profits before taxation.

Major Impediments During Transition

The foregoing survey of the principal features of the profit-

sharing arrangements envisaged under PTC and *musharakah* would make it quite clear that every effort has been made to ensure that the existing banking system is not subjected to perilous upheavals and to prevent existing commitments, both national and international, from being disturbed. One can also discern keenness on the part of banks and financial institutions participating in the so-called profit-sharing arrangements to ensure that they do get a return on their investment at least equal to what they were earlier entitled to as interest.

In the present state of things, lack of mental orientation and preparation on the part of banks and financial institutions to bear and sustain loss is perceptible. The basic motivation for over-cautious safeguards against losses or miserably low rate of return is indicative of a principal aspect of our national life to which in varying degrees most of us are prone. My reference is to the widespread inclination to conceal real profits or in certain cases, the tendency to persistently declare a loss position. Let us hope that measures taken in various agreements to ward off consequences of such tendencies only prove to be transitory until adequate experience is gained. But the question is: when we have once again set out to chart for ourselves a course towards a system free from riba, does it not befit us to ensure that the deficiencies are removed not by superficial but by positive and objective measures which are imperative to make the system free from even an iota of interest? Should it be dubbed as a puritanical attitude?

We are aware of the underlying cause and although we may not have a sound and workable solution to get over such problems straight away, but there is an urgent need to take a fresh look at our taxation system which is predominantly revenue-oriented and is in total disregard of all other material considerations which are necessary to the success of an interest-free system.

While no patriotic citizen would commend tax evasion, is it not time to see what are the fundamental causes for the present state of affairs? The present rate of corporate taxes and the manner of tax administration only seeks to deter the honest, efficient and industrious while placing a premium on dishonesty. Sometimes, it is claimed that the rate of taxes in Pakistan is lower than many other countries. While this could

be a separate debate. I would say that one of the imperatives for a successful operation of interest-free economic system makes it incumbent for a bold, honest, pragmatic and aggressive attitude towards tax reformation. It is futile to think that the society would be totally honest overnight after introduction of the Islamic economic system.

A quote from an article on limit of taxation by Parkinson, who in lighter vein states:

“It may not seem easy to fix on certain level of taxation as representing the maximum. So far it would seem that there are successive points at which evil results successively appear. With peacetime taxation amounting to over 10 percent of the national income, capital will begin to migrate. If its flight is prevented, whether by circumstances or by legislation, taxes could rise to 20 percent but against a stiffening opposition which takes the form of tax avoidance and evasion carried to the utmost lengths of determination and skill. Above 20 percent, each tax increase will produce proportionately less. Above 25 percent, there is serious inflation reducing the value of revenue collected. Above 30 percent, the decline in national influence, observable long before to the expert, becomes obvious to the world at large. At 35 percent, there is a visible decline in freedom and stability. At 36 percent, there is disaster, complete and final, although not always immediate. Taxation beyond that point, feasible and perhaps necessary in time of war, is lethal in time of peace. Of the taxation precipice, 36 percent (for most countries) represents the brink.”

The above would remind us that we too have reached in our corporate taxation what the Indian luminary, Mr Palkiwala, observed in the context of Indian situation that the corporate taxes have reached kelvin zero beyond which, just as in physics nothing can be colder than “kelvin zero”, so also in the matter of taxation, having reached extreme, nothing can go beyond. Let us pause to ponder: is our situation any different than that?

Whereas there would inevitably be some degree of tax eva-

sion whatever be the rate of tax, it can hardly be disputed that a reasonable rate of tax shall certainly mitigate the incidence. We have experimented with quite a few matters in our national life, and may not always be with profitable results, it is essential that the tax structure be conceived on a pattern which should motivate our entrepreneurs to not only greater productivity and profits but also to a greater willingness to declare and share higher profits. Now that the interest-free system exposes banks and financial institutions to high stakes it is more pressing to undertake revamping and restructuring of the whole tax system. Time and again, we have resorted to extraordinary measures of general immunity for declaration of undisclosed income at a concessional rate of tax. But did such patchwork bring about desired results beyond generating a few thousand millions in the state exchequer? A suggestion is being mooted in certain quarters for establishing a normal rate of profit margin or determining a norm as return on capital to enable various agencies including banks, financial institutions making investments on profit-sharing basis to judge the reasonableness of the declared rate of profit. But, besides being difficult to implement due to practical and technical complexities it would fail to achieve the desired results unless we infuse sanity in our taxation system.

Auditors

I would be taking cognizance of another important segment involved in the game which would have an exceedingly difficult and significantly greater role to play with the advent of interest-free economic system. My reference is to public accountants, who act as auditors in the corporate sector. A great deal of rethinking needs to be done so as to fill in the gaps which are obvious in our present approach and outlook towards the attest functions on financial statements which the auditors perform. While the objective of corporate audit has and shall remain focused on the expression of an independent, informed and considered opinion on the truth and fairness with which reporting corporate entity presents its financial statement, a lot would need to be done to retain or restore public confidence in the institution of audit.

I agree that the right of appointment of auditors which the

law vests in shareholders should not be subordinated to any other agency or institution but the fact remains that the shareholders would have to shrug off some of their present-day indifference towards the selection and the appointment of auditors. As a member, Institute of Chartered Accountants of Pakistan, I am conscious of the responsibility which the changing economic system should seek to place on the institution of audit and I have no doubt that the challenge shall adequately be responded to. Every group of people has its own share of delinquents and the derelicts and we must certainly be having some amongst us, but given the awareness on the part of those who are responsible for appointing and using the services of auditors, the audited financial statements, which shall form the basis of appropriation of profit between the concerned parties, should after necessary reforms be given due credence.

The banks and financial institutions participating in interest-free arrangement shall have to gear up their own machinery for a thorough appraisal of the project feasibilities and other aspects in the preliminary stages as well as for subsequent monitoring of project implementation. Neither should we repeat the unfortunate episodes of the finance companies and the cooperative societies at whose hands colossal amount of savings of men of meagre means were manipulated nor should we have corporate failures resulting in sick segment of the economy. This is indeed possible if our banks and financial institutions involved in the game steer and monitor the course of corporate events with total awareness towards corporate objectives and formulate means for achieving it.

Conclusion

We have embarked on a pursuit of great consequence which is one of the paramount objectives of state policy as enshrined in the constitution. While undoubtedly, as the phase of events suggests, there are enormous technical and practical problems with which we are, and shall be, confronted with in our attempts towards transformation to the interest-free economic system but such impediments and controversies shall be resolved eventually provided there is a keenness on our part to transform the interest-ridden economy to an interest-

free system.

While it should be appreciated that a handful of people, both in the official quarters and otherwise, have undertaken the herculean task and are seriously deliberating with all sincerity of purpose to evolve legitimate, viable and acceptable means of financial intermediation within the norms of Islamic economic system, there are elements who would in the name of *ijtehad* seem to be contended with cosmetic manoeuvre aiming to apply veneer surface in the form of service charges or mark-up, etc. without any fundamental changes in the existing system. Coupled with this attitude, such elements would wish to retaliate to the so-called puristic attitude towards application of fundamental religious injunctions and insist that in the process of finding alternatives to the interest-ridden system, rigid attitude be given up and the problem be approached with an open mind in true Islamic spirit. These quarters reiterate that what is meant by *riba* is not simple interest or profit but earning interest on interest or profit on profit that is compounding.

I would like to share the views of those who wish us to approach the problem with an open mind in the true Islamic spirit but these quarters need not forget that the only true spirit with which the problem needs to be tackled is the complete awareness of the true Islamic injunctions. In our quest for finding alternative solutions, all our experiments need to be exercised with utmost understanding and caution to prevent circumventing injunctions in the name of *ijtehad*. There does not arise any question of reformulating any of the Shari'ah injunctions by a process of *ijtehad* in respect of matters which have been candidly laid down in the Shari'ah, however difficult it might be in practical formulation and implementation.

I am reminded of having read about a dialogue that reportedly took place in 1952 between Mr Zahid Hussain, former Governor of State Bank of Pakistan, and eminent Muslim scholar, late Maulana Shabbir Ahmed Usmani, who, on the subject of freeing the economy from the clutches of interest, reportedly said that whereas difficulties inherent in eradicating interest from the present economic order are to be appreciated, it is incumbent upon those who are responsible for

managing economy and financial affairs to recognise the fact that interest-ridden economy is an unhealthy economy. He, therefore, stressed to seek ways and means to cure illhealth of economy. Quoting the analogy of bodily diseases, he emphasised that man is still searching for cures of many ailments but it would be inexcusable on his part to forget them and behave as if they do not exist. What the Maulana emphasised is that while we work in the present system, we must make ceaseless efforts for finding the new order based on interest-free concepts.

It is ironical that the constitution embodying the famous Objectives Resolution declared that no law shall be made which is repugnant to the injunctions of the Qur'an and Sunnah, yet we had on our statute book for several years at stretch the Banking Companies Ordinance, 1962, which, until recently amended, prohibited trading by banks and permitted interest in blatant violation of the injunction that "Allah permitteth trading and forbideth riba" (al-Qur'an, 2:275). Fortunately, in December 1980, the government amended the ordinance allowing the banks to undertake specified finance-cum-trading operations on a restricted scale on the basis of profit-and-loss sharing, mark-up, leasing, etc.

The process of Islamisation of the monetary system initiated since 1981 has, contrary to general expectations, reportedly generated substantial PLS deposits with banks. In fact, it is understood that whereas there is no dearth of PLS deposits, it is the banks and financial institutions who are confronted with the problem of investing disposable funds in sound and viable interest-free ventures.

Man-made laws and human conceptions are undoubtedly susceptible to criticism and so are the forms of corporate financing. It is however, incumbent upon us, who may be skeptical about the success of the system, to offer constructive suggestions for improvement. I am hopeful that keen professional interest in such schemes shall lend a helping hand to the process of Islamisation of economic system. The all-important criteria of a just socioeconomic order on which so much emphasis has been laid in the message of Islam should demonstrate itself in business ethics in all its comprehensive nature.

The problem is basically ethical and the success of the system, therefore, principally rests on integrity on the part of all concerned. It has to be realised that for any system to work properly, it is indeed essential that men involved at all levels should be of integrity and committed to the avowed objectives of the system. No system will work if the mental orientation of those involved is hostile to the discipline of accountability and no law can restrain them from their deeds.

Whatever we are in our pursuits in life, it is incumbent upon all of us to have a thorough understanding of the basic principles of the Shari'ah in a dynamic manner so as to make Islam a living force in our attempts to find solutions to the practical economic problems of the present-day world. We are on the threshold of a new economic order where the solutions of our economic problems will have to be sought, conceived, rationalised and implemented while the forces opposed to change would compete and even retaliate vigorously and every solution in the initial stages would be viewed with suspicion. With Allah's guidance and blessings, we should not allow ourselves to fall prey to such manipulations.

DISCUSSION

Haji Abdul Jabbar: PTCs and *musharakah* agreements that Mr Sidat has referred to are no more alive.

COMMENT: That TFCs have replaced the PTCs is unfortunate. Commercial banks are being charged for not following the *musharakah* mode of financing, while there are other factors which are being ignored. In the case of PTCs, I can quote a party which was making huge profits before entering *musharakah* with the bank. But after *musharakah* with the bank, they showed loss. The banks participated in certain cases for new ventures, which was perhaps not proper. Obviously, if one invests, one has to wait for profits. In certain cases, the official commercial production was delayed as much as five years and after the date of commercial production, they gave their projections. I think projections should not go so long.

Khwaja Mahboob Elahi: While Mr Sidat has covered almost all the laws on lending of loans, he has not touched on the laws relating to the recovery of loans by banks. For instance, loans of some of our institutions are recoverable as arrears of land revenue. Other institutions are also demanding that their dues should be recovered as arrears of land revenue. According to this procedure, there are some eight or nine steps prescribed for the revenue authority to recover loans. This should also have been discussed by Mr Sidat.

Zaigham Rizvi: When we look at the role of banks and DFIs, we find problem areas in modes like direct-decree investment. In fact, the banks and DFIs are not really equipped to monitor these kinds of investments. We have been talking of the financial audit but when we really go for profit-sharing, we are more dependent upon what we really get below the borderline. The problem is that everybody can manoeuvre his own balance-sheet and the financial audit cannot help us in that case. What we really need is to make an effective role of cost audit, to encourage cost audit firms of really professional repute whom we could trust, where figures for differ-

ent sectors of economy are available to help cost auditors carry out their assignments.

Besides, we in the banks and DFIs do not have any support for the management audit because when you really take equity support, you rely on the loan agreements and not on the mode of management, its efficiency, its integrity and honesty. The banks and DFIs cannot spare their own staff to really be with all these firms, nor do we have any management corporations or institutions where we can do this kind of work.

The problem is tax system and its structure. It is said that people do make profits but probably are not willing to pay to the banks. No, they know that if they want to remain in business, they would like to make DFIs happy to the extent that they pay them and bring their future profits. The problem, however, is that when they want to satisfy the banks and DFIs on what is really below the borderline, they have to give a major part of the profits as taxes to the government. This is where they feel that above the borderline they cannot take anything in the name of interest which is fake, while others take all their shares under the table. The banks and DFIs have to contend themselves with the accounting profit. On the legal system and tax sides something got to be done to make this system work. The banks and DFIs have to see what they can do to enhance the role of cost audit as well as the management audit.

JALEES AHMED FAROOQUI: I have two questions. First, can the accounting firms assure and undertake a profit audit? It is a key issue as the company is now a profitable venture and next year, it starts *musharakah* and goes into loss. Second, can the shareholders in Pakistan sue a chartered accountant firm for not having carried out a proper proprietary audit and discover true profits?

COMMENT: On implementing Islamisation, we may find that in the *mudarba* field, some banks make mistakes. This is natural because we have started such mode only recently. Second, we should be very clear about what real and pure Islamic injunctions are but it should not be forgotten that we are only one screw in a machine (the whole system). Unless the whole system is improved, the difficulties will remain there.

COMMENT: Mr Sidat has mentioned various clauses of participation term certificates. I don't know who drafted the agreements of PTCs and brought in such un-Islamic and oppressive clauses. But we have seen the result: by putting in so much precautions and safeguarding bank's interests we have not achieved anything except bad name. We have seen that larger amounts and advances given on interest have been written off, but no concessions were given on the *musharakah*. The next draft that we prepare for *musharakah* or for any other instrument should be fair. Under the mark-up system, we go from 14 percent interest to 16 percent mark-up overnight. We make credit nearer by 2 percent in the name of Islam and then add 210 days cushion period. It has not helped; they have also struck off in the same way and we maligned the system.

DR SAYYID TAHIR: We have to convince people that the bank interest is really *riba*. If the people understand that this is *riba* against the Islamic injunctions, they would be ready to deposit their money in the interest-free banks. For instance, in Malaysia they are having Islamic bank as well as the non-Islamic banks based on interest. The profit rate on returns in interest-bearing banks is 7 to 12 percent and in non-interest-bearing bank it is only 3 to 5 percent. Yet deposits in the interest-free bank are going up much faster than the interest-bearing banks because people know what is *halal* and what is *haram*.

COMMENT: We were expecting some good suggestions from Mr Sidat. But I don't find any concrete proposals in his paper. Second, while reflecting on corporate financing, Mr Sidat has confined himself to *musharaka* and PTCs which, as Haji Abdul Jabbar has said, are already dead.

EBRAHIM SIDAT: First, about what they called dead instruments, they are not dead as yet; they are in a state of coma. The PTC and the *musharakah* agreements are still running the tenure, though no fresh agreements have been made. Some may have substituted PTC for TFC, which is worse. PTCs are symbolical of interest-free system while TFC is a totally interest-based system. It has been very undesirable.

I do agree about the laws of loan recovery, but the paucity

of time would not permit me to take up all the laws for discussion. Banking tribunals ordinance helps us towards that end, but it was not the way it was contemplated.

I also agree with Mr Zaigham Rizvi's remarks that DFIs are not equipped to monitor their portfolio in terms of interest-free arrangements where there is a probability or where vulnerability of capital is eroded because of actual or fictitious losses and that there is room for reform in that area. Because of lack of total commitment banks would not gear up their own organisations in order to foster growth of the interest-free system in Pakistan. We say something else in public and quite differently on one-to-one basis.

As for financial and cost audits, the financial audit is comprehensive enough. When we say that the financial statement reflects true and fair view of a company's state of affairs and the results of its operations, we mean it is a sum and substance of the entire financial dynamics in which the profit or loss and the statement of financial position are presented. This is not to say that we need a separate audit for profit or for assets and liability; it is a concept in totality and it also takes into account the cost audit, or the performance audit, or the management audit, or the operational audit.

I do agree that there is a need for tax reform. The IPS has done some work on network taxation. I have the good fortune of working with Dr Fahim Khan and Dr Hafecz Pasha as a working group under the leadership of Dr Ziauddin Ahmad four years ago. The group made out a model where network taxation could prove perhaps a better alternative than income-based taxation because the concept of income is illusive. You will be surprised to know that the Income Tax Ordinance, 1979 and its predecessor 1922 Act do not define income.

Can there be any accounting firm which can give assurance about profit? The word "assurance" is a rather sensitive and dangerous concept. Audit report is not a certificate, we call it auditor's opinion and there is a certain difference between the two. Auditors can be sued if it could be established that they have been grossly negligent in the performance of duty. There are two regulatory agencies which regulate the ac-

counting profession in Pakistan: the Corporate Law Authority and the Institute of Chartered Accountants of Pakistan. The institute itself has a disciplinary body comprising elected members from the profession and two other members, of whom one has to be a person qualified enough to be a judge of the high court. All cases of professional negligence or misconduct have to be submitted before this authority. The institute body after due disciplinary proceedings refer the matter to the high court.

Unfortunately in Pakistan, indifference is exercised in the annual general accounts. After all, what is a corporate framework? A corporate framework is that there is a board of directors, there are to be annual accounts, annual general meetings and an institution of audit. All these four elements put together should provide you the necessary credibility for a good corporate system to work. Unfortunately, no importance is attached to annual general meeting.

COMMENT: In early 1950s we found in our inspections that one of the auditors audited the balance-sheet of bank wrongly and deliberately ignored certain things. We reported this to the commerce ministry and held that the firm of chartered accountants be disqualified for three years. Accounting system in our country is very unharmonised and through this way our industrialists can manoeuvre accounts to a large extent.

EBRAHIM SIDAT: There is no such disharmony. According to the president of International Accountancy Standard Committee, to which Pakistan is also a signatory, Pakistan is one of three countries who by section 234 of the Companies Ordinance, 1984 has given legal sanction to the international accounting standards. These standards are for universal application.

Prospects for International Transactions Without Riba

DR SAYYID TAHIR

Riba is a delicate matter. In the final decree on this subject in Ayah 278 of Surah al-Baqarah, Allah has set abstention from riba as a condition for *iman*. The very next Ayah contains a declaration of total war from Allah and His Prophet (pbuh) on those Muslims who do not stay away from riba. The result of confrontation with the Almighty is a foregone conclusion. These factors put elimination of riba on the top of economic agenda for Muslims. It should be clear at the outset that primarily the matter has to be settled on the basis of *iman* rather than economic considerations. However, there is definitely an economic case, too, for elimination of riba.

When Allah prohibited riba, He did not ask Muslims to shy away from economically gainful pursuits. Indeed He prescribed many forms of transactions beneficial for mankind. History is witness that Prophet's companions and other Muslims traded and interacted with the rest of the world for centuries without riba becoming an issue. The same can be true even today provided that there is a will on our part. The challenge before us is to identify the functions being performed by riba at present and Islamic ways of performing the

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Islamically legitimate functions. Basically a riba-free system demands a different kind of thinking. At present, all costs — those attributed to time lag in deferred payment, default risk and foreign exchange risk — are all covered under the interest rate and premiums added to it. Such costs are not likely to disappear in an Islamic riba-free framework; the *via media* to address these will, however, be different.

The general approach in this paper is to identify the avenues through which riba creeps into existing international transactions. In most of the cases, the functions served by the transactions are Islamically legitimate. In some cases — exports, imports and direct foreign investment — the primary transactions too are okay without any further ado. Thus, our task essentially becomes one of singling out the role played by *ribawi* elements in existing international transactions and identifying their Islamic alternatives. A general message of this paper is that the emphasis should be on Islamically permissible forms of transactions. The task of singling out economically feasible Islamic alternatives should be left to economic forces freely working in a Shari'ah-consistent system.

In Section I, the stage for discussion is set by stating the criteria for evaluation of any transaction from the riba angle. In Section II, we take cognizance of the Islamic position on buying and selling of foreign exchange with special reference to the *Ahkam* (orders) of *sarrf*. In Section III, a close scrutiny of the existing practices reveals that riba is dispensable in the case of exports and imports. After explaining how riba creeps into these activities, steps to avoid it and to develop an efficient riba-free system are explained. In Section IV, a note is taken of existing international capital movements and riba-free possibilities. In Section V, the critical subject of international dealings at governmental level is addressed followed by conclusion. Most of the discussion is with Pakistan in mind. But the analysis and conclusions apply to other Muslim countries, too.

SECTION I

Criteria for Appraisal from the Riba Angle

Let us recall that since pre-Islamic times Arabs were trading with the Roman, Persian and `Himyarite territories. The Prophet (pbuh) himself went on a trading trip to Syria with his uncle before Nabuwwah. Many companions too had trading links beyond the Arabian peninsula. Thus foreign trade was a familiar activity during the time of the Prophet (pbuh). Roman, Persian and other sovereign states had their own coins. Usually these were full-bodied metallic coins, either silver- or gold-based. The silver-based coins were generally known as dirhams and the gold-based ones dinars. De facto, there existed foreign exchange markets in order to serve practical needs of the people.

These facts prove that all existing international transactions — except perhaps international lending, borrowing and direct foreign investment — have their analogues traceable to the first Islamic era. Indeed, human experience has added to sophistication. But the basic purpose and nature of most transactions are still the same. In this background, one approach for our purpose can be to compare existing international transactions with their earlier Islamic equivalents and draw necessary conclusions. But a practically more efficient approach is to do the needful in the light of some general principles for appraising existing transactions from the riba angle as well as identifying the Islamic options. We follow the second approach. Four principles in this regard are as follows:

RIBA AND A RIBAWI TRANSACTION

Riba is mentioned in four places in the Qur'an: Ayah 39 of Surah al-Rum, Ayah 161 of Surah al-Nisaa', Ayah 130 of Surah Aale `Imran and Ayat 275-281 of Surah al-Baqarah, in the order of revelation. A close look of these Ayat reveals three points:

- Whenever riba is condemned in the Qur'an, *infaq* (spending for the sake of Allah) is commended.
- While riba is castigated in Ayah 275 of Surah al-Baqarah, Allah approves trading and, hence, profits.

- The final command on the prohibition of riba is given undoubtedly in the context of loans. These loans may be in monetary terms or commodity forms. Furthermore, these loans can arise in the ordinary borrowing and lending process or in credit transactions — sales on deferred payment or vice versa.

Another related point is as follows:

- Both the Qur'an and Sunnah support business partnership.

It is notable that *infaq* is a one-way transaction. Trading involves a two-way exchange in which items of different types change hands — money versus good or one good versus another good. Loans are also two-way transactions, but the same item — money or some good — is exchanged by both parties in the course of the transaction. A business partnership is essentially exchange of one's money (financial capital) or other resources with the partner in return for the latter's services. It is pure coincidence that in the end the partner's services too assume the same form as the financier's capital.

Keeping in view these differences in the nature of all these transactions, one may define riba as follows:

Riba is the discrepancy in a direct exchange of items of the same general kind, which arises as a result of contractual obligations of the concerned parties.

By analogy, a direct exchange of items of the same general kind with a discrepancy will render it a *ribawi* transaction. As to the meanings of "items of the same general kind," several Ahadith conclusively establish that qualitative and other minor differences between items on the two ends of an exchange are to be ignored in assessing riba. For example, dates are to be viewed as dates even if those given and taken are of two different varieties. Similarly, gold is to be treated as gold, whether in the form of full-bodied coins, pieces or jewellery.

A word of caution is warranted here. The relevant Ahadith on riba pointedly mention direct exchanges involving six

items: gold, silver, wheat, barley, dates and salt. These Ahadith emphasise that in a like-for-like trade of these items, the principles of hand-to-hand exchange and equality in exchange are to be observed. Fuqahaa' mostly looked at the nature of these six items and brought all other items with similar attributes under the scope of this proviso. However, let us note that trading of, for example, dates for dates represents a special case of a loan of dates with zero time lag in the give-and-take (back) process. This being so, the *ahkam* in Ahadith are to be viewed as rationalising the trading practices with the *ahkam* on *riba* in the Qur'an. Note that the Qur'anic Ayat on *riba* are absolute and they cover loans in terms of all commodities. The only exception traceable to Sunnah relates to camel-for-camel loan transactions. Thus, in our view, comparable loan transactions — not credit sales — should not give rise to *riba*.¹ In all other cases, one has to guard against any discrepancy in the exchange of items of the same general kind.

DIAGNOSIS IN TRANSACTIONS WITH SUB-TRANSACTIONS

Let us take the case of an export transaction between a Pakistani exporter and a US importer. The principal deal between the two parties may involve a string of contracts between the exporter and a shipping company, the exporter and his bank, the exporter's bank and the importer's bank and, finally, the importer's bank and the importer. Each of these sub-transactions involves an exchange between two parties. All these sub-exchanges have to be *riba*-free for the master transaction between the Pakistani exporter and the US importer to be free from *riba*. This principle of tracing *riba* in a transaction is generally applicable.

STRUCTURE OF TRANSACTIONS WITH NO QUALMS

If a transaction does not involve direct exchange of items of the same general kind, the issue of *riba* does not arise. On the contrary, if a transaction involves the exchange of items of the same general kind, such as a loan, it has to be on a one-to-one and equal basis to be *riba*-free. When exchange of items of the same category becomes essential, *riba* can also

¹ Whereas direct borrowing and lending of camels is confirmed in Ahadith, the Prophet (pbuh) forbade animals-for-animals credit sales. This is consistent with the general approach in various *ahkam* whereby Shari'ah does not want people to confuse one order with another.

be avoided by replacing the direct exchange by an indirect one. For example, according to Ahadith of Abu Saeed Khudri, the Prophet (pbuh) ordered the substitution of a direct exchange of poor quality dates for good ones on unequal terms by an indirect exchange involving the use of sale proceeds of inferior dates to buy the preferred dates. This is akin to a transaction with the exchange of similar items based on valuation of both of them at their respective market prices.

SCOPE AND COVERAGE OF THE AHKAM ON RIBA

The rules of Shari'ah for individuals also apply to institutions and the state. Furthermore, the agreement signed by the Prophet (pbuh) with the people of Najran implies that Muslims cannot enter into Shari'ah-proscribed contracts with non-Muslims.

These are the basic points for diagnosing riba in existing international transactions and sorting out its viable Islamic alternatives. For the latter purpose, two other relevant points are as follows:

First, costs can be claimed in lieu of Shari'ah-permitted services. For example, one can make a trip to bank to cash his cheque. Alternatively, he can ask someone else to help in doing the same. The latter can claim charges for his services. A corollary of this point is that risks which can be reduced through Islamically legitimate actions can be insured. For example, the goal of safely carrying a thing to one's customer can be achieved by asking another party to guarantee safe delivery of the same at its destination in return for some fees.

Second, all contracts should be free from *ghararr* — any ambiguity leading to unfair advantage for one party at the expense of the other. This may happen, for example, when there is imperfect information and one of the parties is obliged to deal with the other on terms not consistent with the prevailing market conditions. This principle is important to foreclose the possibility of riba coming through the back door.

The aforementioned four principles plus these two points

form the yardstick for this study. These provide the basis for conceiving Islamic alternatives anew, where necessary. Before we get down to our main task, it is important to have a clear idea about the operation of foreign exchange markets during the early Islamic period and the lessons that can be drawn for today.

SECTION II

Islamic Position of Foreign Exchange Transactions

The existence of several different kinds of dinars (gold coins) and dirhams (silver coins) — by implication, foreign exchange markets — in pre-Islamic Arabia is a historical fact. Foreign exchange dealings involved dinar-dinar, dirham-dirham and dinar-dirham transactions. These dinars and dirhams were full-bodied coins in their base metals. However, there was no universal weight-face value standard for dinars or dirhams issued by different sovereign states. Moreover, lack of precision in minting meant that two dinars (or dirhams) of the same dominion could also have minor differences in their weights. The Prophet (pbuh) ordered trading of gold for gold (dinars for dinars) and silver for silver (dirhams for dirhams) in terms of weight — not by counting.

One obvious implication of this injunction was rationalisation of the trading practices with the Qur'anic *ahkam* on *riba*. A less recognised but equally important result related to the own value of a coin vis-a-vis its relative value (in terms of command over other goods). The own value of a full-bodied gold or silver coin was declared to be equal to the weight of its base metal, regardless of the coin's denomination. In gold-for-silver (dinars for dirhams) type transactions, the Prophet (pbuh) allowed the trading partners to follow either the weight or the counting principle in hand-to-hand exchanges.

It is very important to note that the Prophet (pbuh) pointedly forbade forward buying and selling in all of the aforementioned cases. Details of these principles may be found under the *ahkam* of *sarrf* in Fiqh (Islamic jurisprudence). What conclusions can be drawn for trading of, say, Pakistani rupees

for the US dollars?

In modern times, dollars and rupees perform the same basic function as dirhams and dinars did in the early Islamic era, namely, medium for exchange. Rupees are used as measures of exchange for values of goods and services in Pakistan. Dollars play the same role in the USA. Both are generally acceptable in their own countries. This acceptance, however, stems from the legal force behind them rather than any intrinsic value of the papers on which they are printed. By default, rupees and dollars are stores of value, too. Both embody command over resources in their respective economies.

So in a subtle sense, the technical position of a dollar versus a rupee is the same as that of one good vs another or dirhams vs dinars. In other words, both rupees and dollars can be traded for each other like dinars and dirhams. But the parallels end here. Unlike the dinar-dinar, dirham-dirham or dinar-dirham exchanges of the early Islamic days, a dollar-rupee exchange is conducted by counting, at a rate determined in the foreign exchange market. The position of these exchanges vis-a-vis the *ahkam* of *sarrf* needs a careful rethinking in view of the nature of the dinars and dirhams and the purpose(s) served by the ban on their forward transactions.

Let us consider an example of a dirham-for-dinar exchange 1400 years ago. Imagine a person X with 100 dinars seeking dirhams. Suppose there was a bunch of dirhams in ready possession of another person Y in the market. Imprecision in minting meant that any two dirhams with Y could be slightly different. The same was true about the dinars with X. When X approached Y, each person had a chance to appraise the other's "merchandise," and make a personal evaluation of the same. Suppose both X and Y agreed to exchange 100 dinars with the former for 500 dirhams with the latter — at a 5:1 rate — on the spot. Islamically this was all right. But what did actually happen in "value" terms in this spot transaction?

When X committed to 500 dirhams on spot in exchange for his 100 dinars, from the Shari'ah point of view he was committing to the value (in terms of weight) embodied in those 500 dirhams. Thus the weight of 500 dirhams effectively be-

came the Shari'ah-recognised claim of X in silver terms. But if the payment was deferred, the value of the "500" dirhams (in terms of weight of silver) that X was to receive at a later date could be different from that of the 500 dirhams "agreed upon." In other words, X could end up getting either more or less than "his" due. In a technical sense, such a discrepancy would tantamount to riba!

Let us now assume that dirhams were not present in the first instance and a forward sale by Y — forward purchase from X's angle — was proposed at the same 5:1 rate. In this case, the claim of X would be ambiguous in own value terms and the contract inadmissible on *ghararr* grounds. Riba will not be an issue. But do the riba and *ghararr* arguments apply to rupee-dollar transactions?

Unlike the dinars and dirhams during the time of the Prophet (pbuh) and Khulafa-e-Rashedin, at present both rupees and dollars are currency notes. They simply represent means of exchanging property rights for goods and services in their respective economies. No more, no less. The "value" of a bunch of notes is determined by the associated count number. The question of a discrepancy between two rupees at a point in time as well as across time does not arise. From the point of view of their respective features, the following are true:

Any two one-rupee notes with different serial numbers but issued on the same date are identical. Similarly, a one-rupee note issued on, say, July 3, 1961, is identically the same as a one-rupee note issued on, say, June 29, 1992. This is also true for dollars. So if X agreed to sell his \$100 to Y for, say, Rs 500 and the payment was deferred at Y's end, X will still receive — and Y give — the same Rs 500 (by count). The picture should be clear now.

The present-day rupees and dollars do not come under the purview of the *ahkam* of *sarrf* for the following two reasons:

- The *ahkam* of *sarrf* basically apply to those monies which have "own" values defined in cardinal units — weight in the case of gold dinars and silver dirhams.

Today, rupees and dollars belong to an entirely different lot. They have no "own" values defined in cardinal units: rupees (dollars) may be exchanged for rupees (dollars) only by count — an ordinal measure.¹

- Unlike the original dinars and dirhams, there is no chance of a change in the "own" value of a due amount whether the deferred payment is denominated in rupees or dollars. So, forward trading of rupees and dollars (at pre-fixed rates) will comply with the Shari'ah *ahkam* on *riba* and *ghararr* — the main aims of the *ahkam* of *sarrf*.

In order to reconfirm the above-mentioned conclusion, one may also take note of the following possibility: loaning of dinars and dirhams by count was not prohibited; but in such a case the lender and borrower were required to close the transaction by count. Thus, one can imagine Y securing a loan of 500 dirhams from Z and X receiving 500 dirhams for his 100 dinars in a 5:1 spot exchange from Y. This arrangement serves the same purpose as the forward transaction between X and Y discussed above. However, now Y will be indebted to Z, instead of X. Moreover, at the time of clearing the debt with Z, Y will have to have 500 dirhams — not the 100 dinars acquired from X. There may be economic implications of the deal for Y. But there is nothing wrong *per se* with this possibility from the point of view of either the *ahkam* of *riba* or those of *sarrf*.

In the light of all these points we are inclined to conclude that there is no problem in the basic concepts of spot and forward foreign exchange markets for today's rupees, dollars and other currencies. Of course, the forward transactions have to be strictly according to the *ahkam* on credit transactions in Ayah 282 of Surah al-Baqarah and Ahadith on *bai' mu'ajjal* (sale on deferred payment) and *bai' salam* (sale with cash payment for future delivery). These include, among others, exchange of one currency for another at a rate mutually agreed at the time of closing the deal. These conclusions do not unconditionally sanctify all forward foreign exchange

¹ In the case of coins with a mixed gold and silver base or any other metallic coins, the "own" value can be defined as a weighted aggregate of the weights of various base metals. Therefore, they too are subject to the *ahkam* of *sarrf*.

transactions. A final word will also depend on a given forward transaction also being free from other caveats supporting *riba* and/or *qumar* (speculation). Some of these cases are noted in connection with international capital movements in Section IV.

Let us now consider the existing international economic exchanges one by one from the *riba* angle and look at new Islamic options, wherever necessary. We start with international trade.

SECTION III

International Trade: Exports and Imports

The most critical feature of international trade is lack of geographical proximity between trading partners.¹ This gives rise to a time lag between the confirmation of an order and the delivery of goods. Thus there is the problem of either the seller accepting a delay in payment or the buyer conceding advance payment for future delivery. In other words, for all practical purposes, the basic transaction in international trade is not an ordinary hand-to-hand trading deal but a forward transaction: either *bai' mu'ajjal* or *bai' salam*. Another label for the latter is *bai' istisna'*. These may be viewed as the primary transactions between exporters and importers. In principle, both have Shari'ah sanction.

But three factors complicate matters in international trade. First, risks of nonpayment for exporters and nondelivery of goods for importers due to a lack of personal contact between the trading partners during all stages of a transaction. Second, separate legal systems. Third, separate currencies. These factors give rise to economically meaningful roles for other parties in the process of international trade. The role of banks lies somewhere between collection of funds on behalf of exporters and financing foreign trade operations.

¹ In this paper, technical details of the existing foreign trade mechanism closely follow those in *The Fundamentals of Trade Finance* by J Kingman-Brunddage and S.A. Schulz (New York: Wiley, 1986), especially chapters 1, 4, 5 and 6. No cross-references, however, are made.

The foreign trade process is governed by sales contracts between exporters and importers. Among other things, a sales contract specifies complete description of goods, the price of merchandise, the currency of payment and the payment terms — cash, draft, letter of credit and so on. The ownership of goods is controlled through the bill of lading for merchandise, issued by a freight company to the exporter. In a straight or non-negotiable bill of lading the merchandise is shipped directly in favour of the importer. In the case of an order or negotiable bill of lading, the ownership of goods is transferable to another party through proper endorsement. Except in case of cash in advance, payment is made by way of a draft or bill of exchange.

A draft is unconditional written demand of the exporter (seller) for payment by which he charges the importer (buyer). A draft is drawn either on the buyer himself or on the bank who assumes the legal obligation to pay under a letter of credit (L/C) arrangement. The tenor (maturity date) of a draft indicates when the payment is due. A draft payable upon presentation is a sight draft with tenor simply "at sight." A draft payable on a specified or a determinable date is a time draft or usance bill. The period of time drafts usually depends on the time necessary for goods to reach their destination, be resold and the proceeds becoming available to importers to clear their obligations. The tenor of a time draft is stated as follows:

- **June 30, 1992**
— Payment is to be made on June 30, 1992 — a fixed date.
- **At 60 days sight**
— Payment is to be made after 60 days of presentation of the draft to the drawee (who may be buyer himself or his bank under an L/C).
- **30 days date**
— Payment is to be made 30 days from the date of the draft.

Release of title documents to merchandise follows only after the payment of a sight draft or acceptance of a time draft. Thus the seller and/or his bank retains the control of goods until the buyer either pays or acknowledges the obligation to pay. An acceptance is created when the drawee (the importer or his bank in the case of an L/C arrangement)

writes "accepted," the date and his signature on the face of a time draft.

Drafts are negotiable instruments if they are made payable to order or to bearer. That is, they can be sold and the collection rights transferred, without any limit on the frequency of such transfers, by endorsement to another party termed the holder in due course. Whoever owns the draft at the maturity date presents it to the drawee (importer or his banker) for payment. If the drawee defaults on his payment obligation, the holder in due course has recourse through all previous endorsers in turn back to the drawer (seller) of the draft. The drawer has unconditional obligation to honour such a draft. Draft plays the key role in allocating risks between the exporter and importer when the importer does not want to pay in advance and/or the exporter has doubts about payment. In this regard, two arrangements with draft at the centre are documentary collection and letter of credit.

A documentary collection transaction works as follows: the exporter ships his goods and submits the draft along with the title documents for the merchandise to his bank. The exporter's bank may either directly or through an intermediary bank approach the importer. If it is a D/P (documents against payment) draft, the bank gets the payment, in return for the documents, from the importer and passes it on to the exporter. In case of a D/A (documents against acceptance) transaction, the importer writes "accepted" and the date and signs across the face of the draft, thereby creating a trade acceptance. In this way, the exporter is assured about payment. The transaction closes only after the importer has discharged his obligation. However, the accepted draft becomes a negotiable bill of exchange. In a documentary collection, each intermediary bank claims fee for its services.

An L/C is a written undertaking issued by a bank at the request of an importer (buyer). According to it, the bank assumes the legal obligation to fulfil the importer's payment commitment — within a prescribed timeframe — upon presentation of documents in line with the terms of the L/C. For all practical purposes, the L/C becomes a contract between the issuing bank and the exporter (seller or beneficiary). The bank is obliged to pay to the beneficiary if the latter fulfils

all terms and conditions stated in the L/C. The bank's obligation to pay under an L/C is at the discretion of the seller or beneficiary unless a revocable L/C is issued. The tenor of draft submitted to the bank corresponds to credit terms in the sales contract between the trading parties. Thus, it can be a sight draft or a usance bill.

The role of a bank under an L/C entails some commitments as well as some risks. Normally an importer is not required to deposit 100 percent of the L/C value with application. Thus, the bank practically becomes a creditor to the importer from the time of payment until its reimbursement by the latter. This exposes the bank to commercial credit risk of the importer. Sometimes the issuing bank may have the bill of lading consigned to itself. In this case, the bank will be the owner of merchandise up to the time when the documents are transferred to the importer. If the importer (applicant) finds even a minute discrepancy, he can reject the documents and deny the bank reimbursement. The currencies in the importing and exporting countries can be different. This will lead to foreign exchange risk for the bank.

In practice, the L/C process has several roles for intermediary banks at the exporter's end. These include advising the exporter on fulfilment of L/C formality by the importer, confirming an L/C, negotiating the bill of exchange with the exporter and bankers' acceptance for exporters. Of course, the number of steps before the final settlement of a transaction increases in each case and so too the costs to parties seeking credit and/or reduction in risk.

In the case of confirmation, the confirming bank assumes the responsibility for reviewing the documents and the obligation of cashing the exporter's draft. The confirming bank claims a payment commission — usually a percentage of the face value of the L/C for the duration of the confirmation — in addition to commissions for any other services.

In the negotiation case, the intermediary bank purchases the draft and documents from the exporter, transmits them to the issuing bank and waits for reimbursement from that bank. The right to be reimbursed by the bank issuing L/C is transferred to the negotiating bank. Negotiation may be with a re-

course, i.e. if the issuing bank fails to reimburse the negotiating bank for any reason, the latter can recover the funds from the exporter. Normally the negotiating bank buys the draft at a discount from the face value; the net amount is paid to the exporter. The negotiating bank may have a right to sell the draft and documents in the open market with the exporter's agreement. As per the existing practices, the negotiating bank claims from the beneficiary negotiation fees, charges for a foreign exchange spread and interest for the period of time its funds are committed.

In the case of a bankers' acceptance (BA), the bank establishes an acceptance facility and line of credit for the exporter before it accepts the draft. The bank discounts the draft presented by the exporter, i.e. it pays the exporter a sum less than the face value of the draft and creates the BA by stamping "accepted" on the face of the draft. The significance of BA is that it may be created in lieu of a time letter of credit or independently of it. In the second case, BA is similar to an export credit. BAs have a secondary market with the accepting banks, dealers and investors (individuals, commercial banks and central banks) as the players.

This completes our review of major transactions in lieu of exports and imports. In order to appreciate the picture from the riba angle and to identify probable solutions, it is important to understand the goals of various parties, their roles and risks faced by them in the transaction process. For the sake of simplicity, we assume all contracts to be carefully drafted and implemented and no foreign exchange or other controls in international trade. The key players in international trade are importer, exporter, the importer's bank and the exporter's bank. Their goals, roles and anticipated risks are summarised as follows:

The importer wants to serve a target market on profitable terms. He may face no shortage of funds. Or, he may be short of funds but hopes to meet his payment obligations either as they become due or some time after he receives the goods and sells them. The importer also faces risks of nonshipment of goods, damage during transit and foreign-exchange rate fluctuations.

The exporter has a profitable proposition in the form of a confirmed or expected order from a foreign importer. He may have all necessary funds. Or, he may be short of funds but hopes to pay back the acquired funds according to the tenor of draft. He also faces the risks of goods not reaching their destination, the importer delaying (even refusing) payment and foreign exchange rate fluctuations.

The importer's bank provides simple funds transfer services and payment guarantees in the form of L/Cs. Its role may be direct or may involve an intermediary bank. While paying under an L/C, it effectively becomes a financier for the importer until the funds are reimbursed. It may even choose to directly finance the entire import operation. It also faces the commercial credit risk of the importer and the risk associated with foreign exchange rate fluctuations.

The exporter's bank acts as intermediary between the exporter and the importer or the L/C issuing bank. It can help in cashing the cheque in simple funds transfer as well as act as agent of the exporter in documentary collection or payment under L/C. It can confirm the L/C and assume payment obligations according to the tenor of the draft. It may negotiate the collection rights and responsibilities for the bill of exchange with the exporter at a discount. In case of either confirming L/C or negotiating bill of exchange, the bank becomes a financier until the draft matures. A similar role is performed by creating bankers' acceptance or providing loan to exporter against a confirmed (or expected) order. The risks faced by the exporter's bank depend on the degree of its involvement. There may be only commercial credit risk of the importer's bank in case of L/C confirmation. This risk will be compounded by the exporter's credit risk in the case of negotiating the draft or creating bankers' acceptance. Direct lending to the exporter also entails the latter's commercial credit risk. The risk of foreign exchange-rate fluctuations may also be relevant if the bank's fund commitment involves currency conversion.

We can now proceed to a formal analysis of the existing trade-related transactions from the riba angle. In the context of a sales contract, an export-import transaction involves many contracts among the four parties listed above as well as some others, such as shipping and insurance companies. Ultimate aims behind these contracts are mostly legitimate. Sometimes modalities for the goals may be questionable. But if one does not lose sight of the goals, riba-free alternatives in such cases too become transparent. Whereas our principal concern is with riba, in passing we also touch upon some other questionable aspects of the existing international transactions. One such example is as follows:

As noted in Section I, an exporter can safely carry his merchandise to the importer's doorstep or contract shipping and safe delivery with another party for a lump sum freight and insurance payment. In this regard, there is no *Shar'ie* problem with the exporter signing a single shipping plus insurance contract with one party and letting it subcontract the insurance part to a third party. But the exporter's entering into separate contracts with shipping and insurance companies needs some rethinking. See, when the same company provides transportation as well as safety services, safety is provided in lieu of transportation. But if the contracts for both purposes were independent, what would be the basis for the insurance company's contract with the exporter? Will it not be selling something which primarily does not exist from its standpoint? As per the well-known Ahadith of `Hakeem bin `Hizam, such sales have been forbidden by the Prophet (pbuh). Anyhow, this is not a riba issue. Riba arises mostly in financial matters. Accordingly, we focus on the financial aspects of exports and imports and, in particular, the role of banks.

The banks provide communication channels and payments avenues for exporters and importers. Both the funds transfer and funds collection are legitimate functions whose expenses are claimable. The transfer costs to importers are over and above the sum transferred. This is understandable. The collection costs to exporters represent a slightly different case. These

costs may be either paid by an exporter separately from the sum involved or treated as a discount on the face value of the bill of exchange. Moreover, the rights to payment for a bill of exchange can be transferred. Therefore, for all practical purposes usance bills can be treated as tradable instruments. What is wrong then? Nothing. The problem arises when banks' role goes beyond collection and transfer of funds to financing of export-import operations.

At present, banks can directly opt for interest-based loan contracts with trustworthy exporters and importers to facilitate their operations. Practically, payments against approved L/Cs are loans against importers until they reimburse the banks. The same applies to payments by banks confirming L/Cs until the funds are recovered from banks issuing L/Cs. When negotiating banks buy drafts from exporters, they in fact purchase titles to merchandise and collection rights. Technically speaking, no loaning is involved here. This is also true for bankers' acceptance created in lieu of an L/C. However, a bankers' acceptance created without an L/C represents a complex case. One has to concede either that the bank is creating a loan or that it is buying something on paper only but with a high probability of materialising. This latter feature makes the transaction dubious on grounds of trading something nonexistent, while the loan aspect warrants caution against riba.

The case of riba in interest-based lending is clear. But in other instances, too, there are two important factors contributing to the problem of riba. First, once banks commit their funds, the next transaction along the line becomes a direct money-to-money exchange and any discrepancy makes the deal a *ribawi* transaction. Secondly, the way in which costs are appraised and defined in existing transactions also abet riba. The interest clauses in all standard bills of exchange reflect on the timing factor in payments — opportunity cost of tied funds. The rate of interest also provides cover for creditors against delays in repayment. Moreover, interest rates also embody premiums for

commercial credit risks of debtors as well as risks of exchange-rate fluctuations. Let us now consider riba-cleansing of the existing transactions.

Need for Four-Pronged Effort

Elimination of riba requires four-pronged effort. First, the basic thinking on assessing and defining costs has to be changed. Secondly, existing practices and procedures have to be reviewed in order to strengthen the defence against riba. Thirdly, new transaction modes free from riba need to be developed. Fourthly, innovative steps to promote a riba-safe environment for exports and imports should be called for. Let us consider the four points one by one.

COSTS AND THEIR ACCOUNTING

Collection costs and income foregone on tied funds may be legitimate concerns of exporters. At present, these costs are claimed in the form of a per-period percentage of the sum involved. This approach needs some fresh thinking. *Ahkam* of riba make it amply clear that the creditors cannot claim collection charges. These charges are to be viewed as part of the entrepreneurial obligations of exporters — creditors in sales on deferred payments. The same principle should be observed for income foregone on tied funds. An exporter usually has a fair idea about the effort for recovering payment and duration of his financial commitments in an export deal. He should reflect the collection costs and opportunity cost of tied funds in his margin over other costs of the merchandise. But there is a catch here. If an exporter does so, the importer will have no chance of reducing the size of credit through an early settlement of accounts on revised terms. This should not be a cause for concern. The mutually agreed product prices will automatically take care of this factor. What is crucial for practical purposes is that the agreed prices also accommodate compensation for banks consistent with their desired roles. The banks, in turn, can claim their rewards only in terms of fees.

Commercial credit risk of an importer, or any other party, is something which cannot be reduced through Shari'ah-sanctioned activities — as in the case of safe delivery of goods. In the end, such a risk has to be treated like entrepreneurial

risk. That is, the *modus operandi* for commercial credit risks should be the desired profit margins of those concerned. No doubt, in the end market forces will result in acceptable risk-return tradeoffs for all.

Cost of loaning — as opposed to creating credit in a deferred payment sale — may be an area of concern. A popular view is that Islamic banks can claim “service charges” for loans from the borrowers. These charges represent, for example, costs of mobilisation of funds between branches, documentation of loans, salary of bank staff and other overhead expenses for maintaining records. This matter has to be seen in the light of the abrogation of interest liabilities against the debtors of Sayyidena Abbas by the Prophet (pbuh). It is usually noted, and correctly so, that the time value of money was being denied to Sayyidena Abbas. He was also refused the collection costs. But the point often overlooked is that the loaning act itself must have had some “costs” behind it — regardless of how insignificant those costs were. The case of Sayyidena Abbas and the Qur’anic *ahkam* on credit transactions in Ayah 282 of Surah al-Baqarah, therefore, yield the following principle for loan transactions: apart from pure documentation costs, all loan contracts must be cost-free to the borrowers. This rule implies that if two parties opt for a loan contract in the strict Shari’ah sense, service charges apart from documentation costs should be conceded by the lender. Of course, the lender may even waive the documentation costs. However, if loaning is not an attractive proposition for someone, he has no option (of lending) but to seek a return through another permissible mode for “profitable” transactions, to be explained under point later.

CHECKS ON EXISTING PRACTICES AND PROCEDURES

All transactions in lieu of an export-import deal are eventually governed by a sales contract. Therefore, the problem of riba can be tackled at source by ensuring that sales contracts do not have any provision for interest-based payment terms and instruments. Procedural requirements for foreign countries can be accommodated with zero-rate-of-interest clauses, if necessary.

Drafts can remain negotiable instruments but with fixed face values. In this way, the costs of negotiation or discount-

ing will be charged to exporters — the creditors.

The time lag between a draft and the obligation of the importer or local bank issuing L/C needs to be shortened. This can be done by maximum use of sight drafts or by making the tenor of usance bills according to the expected date the goods reaching their destinations. If there is any discrepancy between the tenor of a draft and the time when the importer is expected to reimburse the bank issuing L/C, the bank should rationalise its fees for L/C services accordingly.

Foreign banks can have reservations about interest-free terms when their funds are likely to be involved in a payment arrangement. Confirmed L/Cs and negotiable L/Cs encourage interest clauses in negotiable bills of exchange for this reason. This compulsion can be sidetracked by discouraging the use of negotiable L/Cs for imports altogether. As for confirmed L/Cs, expeditious transfer of funds by the L/C issuing banks with recourse in their favour is the only conceivable solution.

When a bank finances an export (import) operation in some form and provides funds collection (transfer) services to the same party, caution is warranted in the valuation of such services. For example, as a financier with no managerial role — *rabbul mal* in a *mudarba* arrangement — the bank is not obliged to participate in the running of the venture. It can, therefore, claim compensation for funds collection or transfer services at market rates. However, as a financier as well as party to management — *musharik* in a *musharakah* arrangement — the cost of collection or transfer services claimed by the bank should equal the market value of those services minus the margin for the bank's "own" endeavours. The reward for the own services should be addressed through the bank's share in profit (loss) of the enterprise; otherwise, *riba* can find a way through the back door. Notwithstanding these technicalities, if a bank chooses to act as a *rabbul mal* in a *mudarba* framework, the partner — the *mudarab* — should not be obliged to acquire funds collection or transfer services from the same bank, though he may. Because to do so will come close to having two conditions (and conflict of interests) in one contract, which is again discouraged in Shari'ah.

SELECTED RIBA-SAFE TRANSACTION MODES

When a bank chooses to extend its role from just a supplier of funds collection or transfer services to a financier as well, the likelihood of money-to-money transactions increases. This is the first step towards riba unless a bank can perform the impossible feat of providing zero-return loans. We list here some permissible modes of profitable transactions which are not direct money-to-money exchanges. Their actual use will depend on market conditions.

Pakistani banks may provide financing to exporters on a single-transaction *mudarba* or *musharakah* basis. In both cases the banks may also claim costs for their collection services in lieu of running expenses of the joint venture, in the manner explained earlier. A *mudarba* arrangement will be attractive if it is in the bank's interest to dissociate itself from managerial obligations. While the *musharakah* option may enable the bank to monitor the export operation, it will call for the provision of funds collection services at below-market rates. These differences in rights and responsibilities will affect the profit-sharing ratios and the degree of risk. Like any standard profit-loss sharing contract, the profit-sharing ratio in the bank's favour can be set independently of its share in the enterprise's capital; however, exposure to loss will be proportional to the funds committed. The bank may have a recourse to its funds if, and only if, the exporter does not fulfil his contractual obligations. This, in turn, requires that the rights and responsibilities of the exporter should be clearly spelled out in the contract. This method has a great potential in the case of confirmed export orders. Additional risk-taking will be involved if banks choose to join hands with export houses on *mudarba* or *musharakah* basis, because the final sale of merchandise and reimbursement of funds to the bank will depend on market conditions.

The *mudarba* and *musharakah* techniques can be adopted by Pakistani banks for local imports, too. Of course, the banks may claim compensation for L/C operation and payment services in the manner explained above. However, the stakes for a bank will be higher than in export financing. The conclusion of an import operation will depend upon market conditions for the imported merchandise. Thus, the period of funds commitment at the bank level will become uncertain

and risk for the bank increase. In the event of a loss, the bank may recover its funds only if the importer violates terms of the *mudarba* or *musharakah* contract.

A bank may also provide financial backup for export and import operations by acting as a trader. Let us consider the simple case of a confirmed export order. The bank can buy merchandise from the local exporter on the basis of *bai' salam* and resell it to the foreign importer. Thus, two trading contracts involving the bank will replace the original sales contract between local exporter and foreign importer. Formalities at the foreign importer's level will be completed in favour of the bank, rather than the exporter. The differential between the prices paid to the exporter and charged to the importer will cover all sorts of economic considerations from the bank's point of view. Such a transaction process will ensure that exporters get necessary funds to fulfil their export orders. The ownership of merchandise will initially transfer to the bank and then to the foreign importer. The bank's purchase may be on FOB or C&F basis. The insurance premium will have to be borne by the bank as the owner of merchandise (or the foreign importer — if the original sales contract has such a provision). If the export is not against a confirmed order, risks of undesired inventory accumulation at the bank level will increase. Banks can reduce such risks through exporting subsidiaries.

One can think of a more or less similar process with a bank entering the import process as a trader. The bank may initially act as importer from the foreign seller. It may provide payment guarantees through a letter of credit. But the contract between the bank and his local customer will be that of *bai' mu'ajjal*. Both contracts can be concurrent. If there is no clear understanding with the importer about the acceptance of merchandise, the bank does not need to commit itself to the foreign seller. But there is a catch here. If the Pakistani importer later on refuses to accept the merchandise, what recourse will the bank have to its funds? It can only sell the goods in the open market. This possibility should be regarded as the common entrepreneurial risk — a buyer not being available despite justifiable hopes.

The above-mentioned options differ in terms of risks for

banks. But with more economic agents going for less risky options, the pattern of returns is bound to change. The market forces will then rationalise risk-return mixes along the entire spectrum of these and other options available to banks and their customers.

PROMOTION OF A RIBA-SAFE BUSINESS ENVIRONMENT

Had there been Islamic banks with branches in several countries or an international network of such banks, a lot of riba problems would not have arisen. In the absence of such institutions, one can contemplate an international settlements setup more conducive to riba-safe transactions. Such an arrangement can be developed along the lines of the International Monetary Fund (IMF).

Exporters and importers have concerns which are similar to those faced by countries with balance-of-payments problems. One can, therefore, imagine a national fund or syndicate with exporters and importers as subscribing members. There can be registration fees supplemented by annual membership dues set in the light of anticipated costs of the facility. In addition to the nonrefundable fees and dues, all members may make regular monthly, quarterly, biannual or annual contributions which may be refunded at par value upon expiry of the contribution period. The fund may also be supplemented by levies on exports and imports as the last resort. The operation of this syndicate can be envisioned as follows:

It may act as an intermediary in the collection or payments process for imports and exports. Whereas the usual payments services for importers may be on the basis of a service charge, the collection services can be cost-free for exporters to make it an attractive proposition for them. By ensuring prompt payment, this fund will cover the lacuna created when foreign banks commit their funds in the L/C collection process. The covering contracts with importers can be simple loan contracts, letter of credit, *mudarba*, *musharakah* or trading agreements. An actual contract would depend on the size of an importer's contribution to the fund, cost of services sought by the importer and the safeguards deemed necessary to minimise the incidence of loss on the fund. Similar

practical details can be worked out for exporters. The members may also use their stakes in this revolving fund as collateral to draw riba-free credit according to some criteria equitable for all.

The proposed arrangement is not an extension of the notion of an export-import bank operating without riba or an international interest-free commercial bank.¹ It is rather an IMF-type arrangement, but at the national level and without the special drawing rights. The membership fees and other dues would represent the price various parties place on their various legitimate concerns. Initially, the idea may be applied on a voluntary basis. If international riba pressures necessitate, it may be obligatory for all exporters and importers in an Islamic state.

SECTION IV

International Capital Movements

International capital flows fall into two broad categories. First, those which correspond to exports and imports. Second, those for the sake of earning return on one's capital whether by (a) lending it overseas, (b) employing it in foreign financial markets or (c) investing in equities and real assets abroad.² International capital flows at governmental level are a separate category due to their underlying considerations; issues related to these flows are addressed in the next section. When imports are financed by export credits from private or official quarters overseas, a capital inflow into the importing country takes place. Similarly, a capital outflow corresponds to an export financed from domestic sources of the exporting country. The nature of such flows and related Islamic options come under trade financing discussed in the previous section. Pure capital flows of the second type are examined here. International lending by commercial banks — individually or

¹ A proposal along these lines is made by Dr Muhammad Anwar in "A Call for An International Islamic Commercial Bank," *The Pakistan Banker*, January-June 1992, pp 17-26.

² A good description of International capital flows and their underlying motives can be found in *International Economics*, Third Edition by D. Salvatore (New York: Macmillan, 1990), chapters 12, 13 and 14.

as part of syndicates — is like any other loans. The Islamic position in this regard needs no fresh explanation. We, therefore, focus on flows of types (b) and (c).

Fund transfers in the international currency and bond markets are motivated by a desire to cash on exchange-rate fluctuations and interest-rate differentials across countries. Of course, one can also think of potential capital gains as another reason in the case of bonds. Some examples of these capital flows are (i) maintaining a bank deposit in a foreign country in that country's currency or in another currency (Eurocurrency accounts), (ii) forward trading of foreign exchange, including foreign exchange futures and options and (iii) Foreign Exchange Bearer Certificates (FEBCs) of the Government of Pakistan, the US treasury bills, Eurocurrency bonds or other bonds issued by corporations in international markets.

When a person maintains a bank account in a foreign country, its nature is the same as that of an account with a local bank: the person deposits money, wants to take it back at a later date and is not a legal party to the use of that money by the bank — a standard loan contract for all practical purposes. The Shari'ah position is clear. If the person deposits \$100, he has a right to only \$100 in the dollar-for-dollar exchange. Any return over and above the principal, be it fixed or variable, is *riba*. When a person deposits \$100 but wants to receive the payment in, say, German marks, it becomes a tricky matter. If the underlying contract is like a loan contract, the transaction is simply invalid. However, the depositor can look forward to receiving German marks in the context of a forward trading contract. In this case, the exchange rate has to be the one fixed at the time of depositing money. The option of depositing \$100 with a foreign bank — or even a local bank — in return for German marks from the same bank at a later date on that day's exchange rate is not admissible in view of the Shari'ah *ahkam* on *riba* and legitimate trading norms.

The idea of forward buying and selling of foreign currencies on rates fixed in advance does not have unlimited applications. For example, the existing practices of foreign exchange futures and options, both forward transactions, are

questionable. Both are tradeable instruments. Shari'ah justification for "trading" of credit is hard to come by. In addition, the following points also go against foreign exchange futures and options. The variability of the daily exchange rate in a futures contract makes it dubious on *riba* grounds. The payment of an option price to the seller for the contract effectively makes the option a *ribawi* transaction. In addition to the *riba* problem, futures and options may also be called into question on *qumar* grounds.

All kinds of bonds crowding the international financial scene are debt instruments with promises of some return for their holders. No doubt, risks are higher and real returns are anybody's guess — "variable" in a technical sense. Still there is no doubt about the existing bonds being repugnant to Islam on *riba* grounds.

Direct foreign investment in equities and real assets — at the individual and multinational corporations' levels — is a Shari'ah-permitted activity. A caution is, however, warranted on the operational side of these investments. That is, the running of foreign-owned enterprises with *ribawi* instruments will bring their legitimacy into question.

Important factors behind international capital flows are the level of return and its safety. Favourable tax treatment, economic considerations behind location of plants by multinational corporations and similar other factors also matter; but their effects again show up through the return and risk. In devising Islamic options for attracting foreign capital flows, no extraordinary effort is needed. The known solutions for domestic investors are applicable to foreign investors, too. Of course, in an international economic environment revolving around the rate of interest, the Islamic options have to be competitive on account of risk and return.

Investors seeking return in the form of interest rate are essentially looking for a "guaranteed" return. And, the more liquid an investment is, the more welcome it is. These investors may be attracted through mutual funds and bank-sponsored *mudarbas* specialising in foreign trade financing. Infrastructure and energy projects with relatively safe and favourable returns should also appeal to foreign investors.

Furthermore, equity investment can also be made attractive for foreigners by reducing the risk through good legal framework, tight accounting procedures, stiff penalties for contract violations and specialised institutions monitoring operations of local ventures for a service charge.

SECTION V

International Transactions at Government Level

Government transactions at the international level differ from the private in several respects. Many imports (exports) from (to) different parties take place in the context of a single project, while financing is usually at the project level. Complex and time-consuming legal formalities are involved because the government may change hands. Above all, government transactions represent needs of one quarter — defence or political establishment — but responsibility of another — the treasury, not to mention future generations. The decision-makers usually operate in a short run while the obligations have a long-term character. Thus, there is a symmetry in perceptions about the relative importance of needs and financial constraints. These factors imply that any solutions for the problem of riba are bound to have complex operational requirements and are likely to face resistance for all sorts of reasons. Notwithstanding these apprehensions, the problem of riba has to be faced head-on in order to obey the express orders of Allah.

Let us remind ourselves that by and large the rules for contracts and transactions applicable to the state are the same as those binding on individuals. There is no exception for government in the case of riba. The Prophet (pbuh) has already set the precedence for dealings with non-Muslims. In the present times, two things call for our attention. First, the problem of riba and probable solutions in government level transactions with foreign governments, international commercial banks and other world bodies. Second, the Shari'ah status of the membership of international financial organisations, such as the IMF and the World Bank. We concentrate on the first and just touch on the second.

It is clear from the discussion in previous sections that the purpose for which funds are acquired is immaterial from the point of view of *riba*. What is critical is the nature of transactions, especially in the light of contracts governing them. As long as the legal position of a transaction is loan against the government, it is a *ribawi* transaction if a discrepancy arises in settling the transaction. In this sense, exports and imports at the government level are not *ribawi* transactions. The real problem lies in the financial domain — mostly in financing imports and balance-of-payments deficits. *Riba* is at the hub of all existing borrowing from foreign commercial banks, aid (excepting grants) from foreign governments and other donor agencies and funds raised through FEBCs or sale of treasury bills to foreign investors.

What are *riba*-free options for the government in international transactions? The answer depends on the purpose being served by funds from foreign sources. These funds are mainly aimed at financing (i) defence needs, (ii) development projects and (iii) balance-of-payments deficits. Defence purchases can be handled through *bai' mu'ajjal* contracts directly with foreign governments rather than buying the same from the manufacturers against loans from their respective governments. We, therefore, focus on the other two cases.

Consider the 1292-megawatt Hub power project — with an estimated cost of over \$1.5 billion — in Balochistan. This is a gigantic development project by any standard. It represents a huge long-term investment. But once completed, it is expected to be a productive asset for years to come. Notwithstanding these factors, the project still has the following components:

- Feasibility report
- Acquisition of umpteen number of things such as land, bricks, steel, cement, machinery, furniture, papers, pencils, and so on
- Construction effort (services of hired labour and machinery)
- Overhead expenses for both men and material.

Practically, the project may go through many distinct phases before it becomes operational and each stage may involve

expenses of the above type. Once the project is commissioned, running expenses for both labour and other inputs will be involved. What are the options available to the Government of Pakistan from the Islamic point of view in order to materialise this project?

OPTION A

The government can seek a *musharakah* arrangement with Pakistani as well as foreign investors or some funding agencies for the entire project. Depending on how one views the project's strategic importance, it may be a *shirakah almu-tanaqisah* (decreasing participation) contract.

OPTION B

The government can arrange interest-free funding from an international source as follows:

- i) A separate *bai' mu'ajjal* (not mark-up financing) contract for every well-defined marketable component of the project with the total cost of the items being equal to the amortised value of an otherwise interest-based loan — from the point of view of the funding agency — for the same purpose. This agency can pay to the suppliers directly (or through a subsidiary) and transfer the ownership of merchandise to the government, which may repay the sum involved in instalments.
- ii) The cost component which cannot be handled through *bai'* (trading) may be covered under other Shari'ah-permitted modes. For example, *shirakah almu-tanaqisah* with suitably defined profit-sharing ratios in the perspective of the entire project.

OPTION C

The government can enter into simple *bai'* contracts with the suppliers of goods and services and parallel interest-free loan contracts with the funding country or agency. The amount of loans may equal the amortised values of funds locked from the financier's point of view. The market price charged to the government may also reflect the export incentives given by the funding country or agency to the exporters. The lending country may route the payment through the government or release it directly to the exporters. In the latter case, it may

also claim charges for payment services. This arrangement can be supplemented by Option B (ii) for those project components which cannot be covered otherwise.

OPTION D

The project may be viewed as a composite whole of well-defined sub-parts. Options A, B and C can then be explored for every part separately.

The Government of Pakistan may even consider entering into one of the above arrangements with foreigners for those parts of the project which require foreign exchange. The remainder can be covered through similar contracts with Pakistanis or through special levies for the purpose of the project.

What about the following possibility? The government might make simple *bai'* arrangements for material components of the project and cover the working capital needs through a zero-interest loan from the same party. The cost of the loan from the lender's point of view may be absorbed in the prices of goods to be paid by the government. One may support this idea as follows: in this way the interest of the financier will be served with the form of transaction Islamically okay for the government. If prices reflect interest costs from the seller's point of view, it should not disturb us. After all, this sort of costs are routinely added to prices one pays every day. This argument can be challenged on the *sabbt* (*sabbath*) analogy: is *riba* (on loan) not being concealed behind technicalities? If one studies the borrower's case in such a deal, indeed the problem is being pushed under the carpet. To conclude, only *bai' mu'ajjal* contract with one party or *bai'* and loan contracts with separate parties can be regarded as *riba*-safe arrangements. *Bai'* plus loan contract with the same party is questionable on *riba* grounds.

Zero-interest credits under trading arrangements, as mentioned above, are real possibilities. Owners of funds are interested in some return on their funds. Technicalities are not important for them, but forms of transactions are critical for us. In order to materialise these possibilities, the Government of Pakistan may petition — if necessary, through the Organisation of Islamic Countries — to the World Bank to

take the lead in adding the Islamic techniques to its existing transaction modes. The case will have a merit, too, because practically no preferential treatment would be sought for the Muslim users of funds as compared with other member countries. On the other hand, the Muslim countries will lose the flexibility for reducing borrowing costs through early settlement of accounts at revised terms, often the case in existing interest-based loans from the World Bank.

Let us now consider short-term borrowings from the IMF to redress balance-of-payments problems. These loans are denominated and repaid in terms of special drawing rights (SDRs) — an expression for the value of a basket of major currencies. These are *riba*-based arrangements. By their nature, the transactions involved are always money-to-money transactions, and in no case transfer of property rights on another good is involved. So there is no direct or indirect way of salvaging the existing arrangements with the IMF. The problem has to be addressed at its source. Ordinary exporters and importers should be allowed to create their own rights and responsibilities in a fully flexible exchange-rate environment. The government should not act as guarantor or intermediary in the deals by its citizens in their own interests. It should restrict its foreign exchange requirements to revenues generated through direct exports and levies on imports. If necessary, it may also acquire foreign exchange at existing exchange rates.

Notwithstanding the above action plan, our affiliation with the IMF and World Bank needs review from the Islamic point of view. As per their existing rules of business, both institutions do *ribawi* dealings with their members. For a Muslim country, there is the question of being a party to *ribawi* business. At the practical level, the role of the IMF can be compared with that of a central bank at the international financial level. It creates international liquidity in the form of SDRs, helps member countries in their international payments problems and acts as guardian of the foreign exchange markets all over the world. Though the SDRs are a zero-cost concept at the IMF level, interest rate plays a pivotal role in facilitating the dealings of member countries with the IMF and with one another. At best, the relation of a Muslim country with the IMF body can be similar to that of an Islamic

bank with the central monetary authority in the country — still a grey area in Islamic banking. The indispensability or otherwise of association with the IMF and the World Bank and Shari'ah-consistent modalities need special attention, outside the scope of this paper.

Conclusions

One may claim that nothing is impossible for the person who does not have to do it himself. But it is equally true that where there is a will there is a way. This paper is just an attempt to point out various options available for acting according to the *ahkam* of Shari'ah in international transactions. Any meaningful change needs a strong desire to do everything possible for the pleasure of Allah Who is the kindest of all, the most loving and the most caring. Of course, the fear of the loss of al-Akhirah can be another important factor. This life is a test: if everything was to be "free," then the concept of life as a test loses its meaning.

It has been argued in this paper that what matters from the point of view of riba is the form of transactions. For reasons best known to Allah, He wants the mankind, especially those who lay claim to Divine Guidance, to avoid any discrepancy in a direct exchange of items of the same general kind. Everyone must respect this command. Interest-based transactions are not the only medium for realising profits. Other important points raised in this paper are as follows:

- One should focus on legitimate forms of transactions and devise payment or financing arrangements which satisfy genuine needs of all concerned parties within the Shari'ah framework. The determination of optimal arrangements can be left to personal interests of the economic agents and market forces.
- The basic thinking on appraising and defining costs has to change. The role assigned to the interest rate — in order to handle all sorts of risks and other genuine concerns of various parties — has to be according to profit rate in the standard trading sense. Default risks, the risk of delays in payment and for-

eign exchange risk have to be handled as entrepreneurial risks.

- Spot and forward operations in existing foreign exchange markets are okay provided there is no violation of the *ahkam* on riba and *ghararr*.

Beyond these points, since international trade mostly involves either deferred payment or delayed delivery, the general principles stated in Ayah 281 of Surah al-Baqarah for credit transactions ought to be observed. Among other conditions, these include unambiguous documentation of the rights and responsibilities of all concerned.

Some initial efforts and sacrifices may be necessary for the elimination of riba from international transactions. But in the long run, it should be a profitable proposition in more than one ways. For example, elimination of riba does not mean that credit transactions will altogether disappear. But it will result in financial responsibility. Fiscal discipline at the government level is the first thing that one can think of. At the private enterprise level, there will be better business planning in the absence of the interest drag on revenues. Above all, elimination of interest will act as a countervailing force against the cumulative debt problem facing all nations — both at the personal and national levels.

This paper is meant to provide a meaningful dialogue on the subject of riba in international transactions and its elimination. Some areas have not been explored. These include the Shari'ah status and nature of *rahn* (collateral) in international dealings, other permissible forms of transactions — such as leasing — and their usefulness in international transactions and the emergence of debt-collection agencies over time. The delicate matter of the elimination of existing riba obligations in the international context is also not given due attention.

As far as elimination of riba at the government level is concerned, every effort has to begin with a conscious recognition of mistakes of the past and an end to the process of creating fresh riba obligations. With this, it may be noted that the *ahkam* of Shari'ah are not binding on non-Muslims. So the government may not avoid its past commitments.

However, there is the possibility of replacing existing interest-based foreign loans with interest-free loans equal to amortised value of the existing loans. This will change nothing except the form of transaction from an Islamic point of view. It should, however, serve as a token of sincerity towards the *ahkam* of Allah. The idea of debt-equity swaps may be applied to international debt obligations, but this requires a Shari'ah scrutiny of its working details.

DISCUSSION

COMMENT: Dr Tahir is suggesting that whatever be the lender's claim, whether as part of time value of money or as part of the risk premium on foreign exchange dealings, it should be fixed and included in the price. The solution is seemingly simple and from his presentation, I got the idea that the Shari'ah would have no problem with that. I would request the participants that in order to make a positive contribution they should either elaborate on his suggestion or provide alternative suggestions to the problem we are facing in the international transactions.

NAWAZISH ALI ZAIDI: Dr Tahir has talked about the discrepancy in exchange of two similar things. The point he missed is that the transaction has to be hand to hand according to the Hadith. If there is gold, it is to be exchanged for gold. But if there is a time lag, it is *riba al-fadal*. If gold is exchanged with silver and the exchange is not hand to hand, this will also constitute *riba al-fadal*. This is the boundary condition. Islam is all for trade expansion and growth and we must be very careful in putting unnecessary conditions that could restrict the flow of trade. More trade means more employment.

While dealing with international trade, we must be sure that we do not overstress things and create unnecessary restrictions. Dr Tahir has taken a very liberal view of things and tried to lump together all the costs, including the time frame and time preference. The issue whether immediate support price can be different from the credit price may come up for discussion.

When rates of exchange in spot dealings are different from rates of exchange in forward dealings, it is again a question of indexation.

Concerning rates of exchange, we usually say it is the rate of interest. But how are the rates of interest decided? when there is more inflation, the rate of interest is higher and the currency is always depreciating. This is a principle of indexa-

tion. If we accept indexation, we may be in a position to accept the principle of having forward purchases. But here, we must differentiate between forward contracts for genuine trade and for non-genuine purposes. For example, I am an importer and the government allows me to book foreign exchange for payment after six months. Here is a genuine trade transaction.

Islam does not allow speculation. But if an importer or a trader is genuinely interested in protecting himself against avoidable losses, I think the possibility exists to do that. What is important is the form of the contract; substance comes next.

DR MUNAWAR IQBAL: The way to attack the problem is just to take the simplest case and develop a model and later introduce various kinds of difficulties and differences.

Let us assume for the time being that there are no foreign exchange restrictions. Take the case of Saudi Arabia and see how we can conduct international transactions. There are two international transactions: international trade which is a buying and selling document and transaction of imports or exports of goods.

There are two choices: either the importer has the money to pay or he does not have it. If he has the money to pay and foreign exchange is available, the banks become involved — they will sell the foreign exchange and pay the exporter. It will be a combination of import and self-transaction and the settlement can be made straight away. If he does not have the money, he can buy on the basis of *murabaha* which is a permissible mode of business and applies to international transactions as much as to the domestic ones.

Many Islamic banks are financing imports on the basis of *murabaha*. The other case is that a person may have the money, but the commodity is not available. There is the concept of *bai' salam* and *istasna*. *Istasna* is another form of the *salam* contract which applies with some modification to manufactured goods. These contracts are also being used by Islamic banks and are as much applicable to the international transaction as to the domestic ones.

Lately, when I was working with Rajihi Banking and Investment Corporation, they bought the cotton crop from Pakistan on the basis of *salam*. So *salam* and *murabaha* are applicable to international transactions if there is no foreign exchange problem. The other side of the international transaction is the capital movement. The movement has two sub-components. One is the direct foreign investment and the other is foreign aid. With respect to direct foreign investment, there are a number of Islamic modes available and many of them are in actual use.

One mode is equity participation. The foreigners and multinational corporations may have equity interest in the projects. In the international field, there is a great movement towards equity as compared to debt. There are debt-equity swaps widely used in international transactions. Many international investors go for equity rather than debt. The international debt crisis has made it very clear that equity is a better instrument than debt.

Therefore, many multinational corporations can come forward with their foreign investments in terms of equity. One problem could be that the borrower country may not like to have foreigners as owners of their assets. Here, the government can regulate the percentage of equity which foreigners can hold.

The potential is great since the government has to find ways or means of attracting foreign remittances or capital of nonresident Pakistanis invested abroad. The BOT (build, operate and transfer) technique can be used for nonresident Pakistanis and thereby attract foreign capital. Another direct foreign investment mode could be the output-sharing like crop-sharing in the field of agriculture.

As far as foreign aid is concerned, the answer lies in self-reliance.

More emphasis should be placed on self-reliance, though there are other instruments, like service charge which can be resorted to. Islamic Development Bank is using service charge as one of the modes of financing. If the government sets its house in order and tries to seek cooperation from the

Muslim countries, self-reliance will lessen the need for foreign capital. Part of that foreign capital can be financed through direct finance investment.

DR M FAHIM KHAN: First, Dr Tahir has advised us that we can build in all costs, including the cost of time. If we look into the Hadith literature, the earliest form of riba involved a person borrowing money and at the time of repayment if he did not pay, the lender asked him whether he should extend time.

The cost of time is the essence of riba. If we build in that cost of time into the price, it is only trying to be clever with the Shari'ah. We are in fact putting in interest without naming it and we should be careful about that.

Second, he talked about the discounting of the foreign trade bills saying it is cashing cost. I do not know what the cashing costs are. He is talking about discount with the exporter bearing the cashing costs. Are there any costs other than the cost involving the time interest? The real thing in discounting is interest. We should be discerning and very careful.

Third, Dr Tahir says the bank can claim expected costs through the fee for letter of credit services. Will the banks be prepared to do the L/C business only on service basis?

COMMENT: I think the banking transactions are very simple. For example, there are two aspects: one, where the bank is providing finance to a person who has sold the goods. Second, where the bank is providing finance to a client for the procurement of goods. These are two different transactions. As to the requirement of funds for the procurement of goods, it is very simple. In that case, we can follow the *bai' mu'ajjal*. Also, there is a difference between credit and cash prices. Another aspect is whether it is import or for the procurement of goods. In such cases, we can follow the *bai' mu'ajjal* or *musharakah*.

In the cost price, the banker would keep an account of the time factor.

In cases where the finance is needed for the realisation of

the proceeds of goods already sold, the Shari'ah experts agree that the banks should act as a collecting agent. The banks may have the collection charges and the charges may vary from bill to bill.

COMMENT: There should be no problem in foreign transactions because there is a letter of credit and a foreign exporter can get immediate payment. For imports from Pakistan, he will have to pay the amount on the receipt of goods. As far as investment is concerned, they are for equity.

For project-related foreign loans, there is no problem because we can always discuss with the lender that instead of giving us loan for procurement of machinery he can have the contract of *bai' mu'ajjal*. The only problem comes when the government is seeking funds for budgetary support. I suggest that people give interest-free loans to the state and it can compensate them by charging an equal amount in the shape of services rendered.

DR ARSHAD ZAMAN: I will ask two questions and make one comment. First is the issue of cash price and credit price. As I understood, the Shari'ah allows me to sell this pen tomorrow at five rupees and the day after tomorrow at ten. For you to accept the sale at Rs 5 or Rs 10 is perfectly all right. But for you to accept the option of buying at Rs 5 tomorrow or at Rs 10 day after is not permissible under the Shari'ah. If this is correct, there is no confusion over cash and credit prices.

Second, Dr Tahir says both spot and forward selling of rupees against dollar is permitted under the contract to sell million rupees after 6 months from now at Rs 27 to the dollar. In case, I don't have a million rupees right now, then such a contract would not be permissible under the Shari'ah. If that is true, then this statement needs to be modified.

My comment is on the general spirit of economics. The current trend is that the lifestyle of Yahud (Jews) and Nasara (Christians) can be adhered to even though violating the Shari'ah. Though never explicit, it is implicit in all discussions. There is no need to change anything. Everything that can be done with interest can be done within the confines of

Shari'ah. We are not yet prepared to say that we want to change our current lifestyle. Which essentially means that we are prepared to lower the level of consumption. In that case, there is no difficulty at all. The difficulty arises only when we want the Islamic economics to assure us the present levels of consumption promising in return that we will find you non-interest ways of raising capital or any number of other institutions of interest-based capitalism which will allow you to maintain that lifestyle. Riba-free international transactions are very simple. What we know as *haram* we will forego, at whatever cost. We will pursue what is *halal*. But we must be prepared mentally to forego such transactions, as the forward transactions, if they are *haram*.

COMMENT: This paper deserves to be discussed for the whole day because the author seeks to break new grounds of inquiry. For the first time, someone has departed from convention and opened up new vistas of thought. But there are a couple of things which are confusing. He said when Allah forbade riba, He did not ask us to shy away from economically gainful pursuits. Life is practically economics. However, both the form and substance of our actions are important in Islam. Riba is prohibited even in small amounts. You said the Prophet (pbuh) did not place any ceiling on price. I differ, for there are a lot of Ahadith which restrict the prices. For instance, hoarding is prohibited. The distress price is prohibited. The Qur'an says: do not eat up your properties in a wrongful manner but carry on trade and traffic with goodwill. There must be no exploitation of consumers, of raw materials, of farmers. That is why there is ceiling on prices.

He also referred to certain modes of transactions and payment prevailing in Arabia at that time. But one should remember that the Prophet (pbuh) had been helpless for 13 years and could not control the ways of life in Arabia. It was only after he migrated to Madinah and established a state that he was in a position to call the shots. So when you refer to the then prevailing system you should refer to that time when the Prophet (pbuh) became the master of the situation.

IRFAN SIDDIQUI: I want a clarification. I have, say, \$2,000 and I want to place them with a Pakistani commercial bank at 5 percent interest rate for one year. At the end of one year,

I would have \$2,100. The accretion of \$100 is clearly riba.

If I convert those \$2,000 in pound sterling, I go to the same bank, buy the pounds and get £1,000 in my hands. Again, I go to next bank and say I have £1,000 and need it in dollar amount a year later. How much is the bank going to give me a year later? The bank will give me a rate which will be worked through the interest rate mechanism of a soft transaction and the bank will give me a rate of \$2,100. So whether I go through the first mechanism or the second, which is a currency transaction, I end up with \$100 more in my hand. How would you rate the second transaction?

DR ZIAUDDIN AHMAD: This is a very complex question. We may divide the discussion into two parts. One is related to foreign exchange rates and forward cover and the second is how to eliminate dependence on interest-based foreign borrowing. For exchange rates, we have to find if there is some allowance in the Shari'ah. This is important, for the Pakistan government finds itself in a bind on the foreign exchange situation.

At the same time, while finding a solution in the Shari'ah if there is anything against the Islamic injunctions, we should be prepared to make sacrifices. This is the criterion on the basis of which we should try to resolve the two questions.

For the forward foreign exchange cover, there is a unanimity that such transactions are not allowed by the Shari'ah. Even the IMF reports have pointed out that a lot of what is going on in the world forward market is speculative. Many central banks have burnt their fingers in providing foreign exchange covers. I do not think this is of absolute necessity. Some countries, mentioned in reports, are not providing any forward foreign exchange cover to their importers. If the Muslim scholars agree that forward transactions are not allowed, we should cease their continuance after July 1, the deadline set by the Federal Shari'ah Court.

Currently, the foreign exchange cover is available for 3 to 6 months and at the most for one year. It is only when some people want it beyond a year or so that some central banks provide it.

The State Bank has also got a scheme in which it is providing forward cover at differential exchange rates at some higher percentage. This is akin to payment in exchange rate practice. Whether this may continue in the new situation needs to be discussed. One possibility may be that the forward cover is provided by the State Bank rather than obtained through international forward exchange markets.

The second issue is how to eliminate dependence on interest-based borrowing. Inflow of resources through equity finance has several advantages for the developing countries as compared to portfolio finance, which is interest-based and, therefore, we should discourage it. In the new privatising environment, these questions have assumed more prominence.

At the same time, we have to face the question whether it is possible to achieve self-reliance as early as suggested. What is the time frame in which we may try to achieve that, and is there any allowance in the Shari'ah?

Some Islamic scholars are prepared to permit some allowance to the governments which are hard pressed and cannot do without interest-based foreign assistance, at least for some time now.

What they are saying is that permission to engage in something in the event of dire necessity, otherwise prohibited, is possible and it is deduced by analogy from the Qur'anic verses. In interest-based borrowing, it has been suggested by the Muslim scholars that to establish dire necessity the following conditions must be fulfilled. First, the need must be real. Second, the concession is limited to the exact amount needed. Third, the borrower must continue search for ways to escape from his predicament. Fourth, he must continue to hate it and regret doing it until Allah opens a way out for him.

We should discuss whether in the present situation in which Pakistan has a huge foreign exchange gap, complete elimination from interest-based borrowing is possible to achieve or not. Can this allowance be availed of and if so with what conditions? Can we extend it by saying that the need for interest-based foreign borrowing is no basis for making use of

the allowance in the Shari'ah? Even though life may not be possible without it, if allowed it may cause *fasad* in the wider sense of the term. Islam wants us to avoid a situation which will create *fasad*. *Fasad* is very great term: great social unrest and social upheaval; it might make life miserable in a civilised society.

Subjective though it may be, the judgement has to be made. I think the Appellate Bench of the Shari'ah Court will have to consider this question.

Nevertheless, it is necessary that there should be a government commitment to eliminate dependence on interest-based foreign borrowing within a reasonable period. For this, they should be asked to commit themselves to some kind of a time horizon in which they can achieve self-reliance. There is a certain rate of export growth you project in that model; in the import payment in that model, there is a declining flow of interest-based foreign borrowing which could enable us to achieve self-reliance. That kind of a model has to be postulative. A reasonable period needs to be postulated in which self-reliance could be obtained.

It should be made incumbent upon the government to make an annual presentation in the national assembly to show how the government is proceeding towards the achievement of that goal within the period which has been set by the Federal Shari'ah Court or the Appellate Bench.

DR ARSHAD ZAMAN: I do not subscribe to the view that foreign borrowing is a must for us, or that life is not possible without such a borrowing. Would anybody hold that denying interest to the Asian Development Bank may threaten life?

The second item of expenditure is defence. Some claim can be made that the state is threatened by nonpayment of salaries to the defence personnel, but this should not make us oblivious of the fact that there is enormous fat in defence and development expenditure.

There are wages and salaries to be paid. The Qur'anic concession is limited to the exact amount strictly needed. This would be in practice rather difficult to calculate. It seems that

the government is not serious. During the past 45 years, successive governments have continued to search for ways to escape from the requirements of the Shari'ah and not from the payment of riba.

Not any of these conditions applies to the situation here.

COMMENT: The government is trying hard to attract foreign exchange especially from overseas Pakistanis. For that, it has introduced foreign currency account and foreign exchange bearer certificates. They are interest-based and are repatriable funds. They can be transferred anywhere in the world and are accepted by the overseas Pakistanis as well as the foreign managements. They are also sold in the market at a premium. Now, what alternatives do we have if we are going to get rid of the interest on the foreign exchange holdings and attract foreign exchange in Pakistan?

DR SAYYID TAHIR: What is going on in the forward markets is something more than what you call *salam*. That kind of forward selling has to be, of course, condemned and avoided but not all forward selling is speculative. Whenever we agree on a price for shoes, meat or anything, it reflects a host of factors. Our appreciation of a thing may be how it might be available after some time. To begin with, we should not be worried for future prices. I may sell a thing today for Rs 5. After six years, it would be fair if I ask Rs 60 for the same thing. Speculation is a different concept.

I agree on the time value. I suggested that we should change the terminology. A lot of confusion exists because of the terms used. Discounting has one sense in the following way: a project is worth for me, for it will yield me income over the next 50 years. That is one context of discounting. There is another context to it. For example, since recoveries involve some operational costs, it would be just for the bankers to realise the recovery cost.

When you are purchasing the bill of exchange from an exporter, you are practically telling him that he forgets collecting it. I may transfer the obligation to collect on the importer. In both cases, the bank or a collecting agency can do the job. But the service charge on *qard-e-hasan* is technically riba.

For exports you can follow all the permissible modes of transactions and even you can finance the importer by anticipating that he will be selling in the market and thus generating a lot of profit. You enter as a party in those profits and pick up the bills, i.e. give the letter of credit without any advance. You have to operate to avoid the conflict of riba.

There was a question from Dr Arshad Zaman regarding forward selling business. The one case he cited suggested certain terms of exchange for tomorrow and another term of exchange day after tomorrow, allowing the party to make a choice between the two. That will be technically adding two conditions in one communication between the giver or taker, buyer or seller. Adding two conditions of that sort is technically prohibited in the Shari'ah; that is a problem area. But I have already explained the forward selling, transactions in the proper sense of *salam* or *mu'ajjal*. Not in the sense of agreeing to the terms of exchange and then going and looking for the funds to make the gain.

Coming to Dr Ziauddin's observations, I have no disagreement. It is matter of interpretation.

Forward selling? I do not know the sense in which the *fugaha* used the term or those ulema whose *fatwa* or opinion was solicited. When speculation enters, without any other transaction going on, that is a problem area. But you have to look at the nature of the contract. I may buy dollars like I buy a pair of shoes. I give you the money to bring me dollars after 6 months. There is nothing wrong about that. There are Ahadith which come very close to this kind of a thing. For example, one of the Prophet's companions used to buy camels for dinars and sell them for dirhams. The Prophet (pbuh) said you can do that but conclude the transaction on the same day on that day's rate.

I have to say a few things about the government's problem. About the suggestion concerning *rukhsat* or allowance, the Shari'ah is clear. I cannot myself first create a problem and then go for *rukhsat*.

Our priorities have been defence and development from day one. Allah is not concerned about our problems. There is no

rukhsat.

Rather than seeking *rukhsat*, we should go for similar cases, draw the inferences and see the point. For example, if an individual makes a mistake, what is the procedure for correcting it? First, repent, i.e. realise the mistake, accept it in heart. What will be its analogy in the government's case?

Second, we should try to correct the past deeds as much as possible. Let us worry about the ways which Allah dislikes. Maybe you declare all the loans void and then enter into fresh contracts with all those agencies whom we have to pay. In technical language, you can record the new transaction as loan at zero rate of interest. That will be the proper form to show our face to Allah.

Third, take proper action to make sure these things do not happen in future. We may go for raising funds and should note that all lending or borrowing is deferred taxation.

We may start correcting our outstanding loan liability through taxation. That will be my suggestion for seeking *rukhsat*.

Look at the basic transaction between the two parties at that stage. By all counts, service fee can be charged but recovery cost can be claimed. As for the observation about the *sarrf*, my understanding is that when you are exchanging gold with silver, that is *sarrf*. There are Ahadith on the subject. How *riba* arises in *sarrf*? Again, this is a matter of interpretation of those Ahadith. The approach to interpretation of Ahadith should be to put all of them together and then look at their meanings in totality.

In a given Hadith, you may take the words as suggestive rather than obligatory. There is a difference between *amar* or *hukum* and just advice. I used the example of the Hub power project. It is a long-term project. Technically speaking, it is a long-time investment but look at its practical aspects. It involves so many goods to purchase and so many services to be hired — to set up the whole thing. Then look at the execution level — how these things could be orchestrated to perform the task.

It is a matter of our being serious and looking for the alternatives. We may have a component; a bad transaction, or *bai' mu'ajjal*. The World Bank will be dealing on the basis of contracts or on the basis of interest. For example, let us agree that a full price if taken on interest would have been Rs 500 plus 5 percent for ten years. Both Pakistan and the World Bank agree on that value as the price. You record it as zero rate of interest.

At that level, our problems are only two. One, when going for this kind of arrangement, we will be seeking loans without any interest provision. The other party could be worried about instalments — whether they will be coming or not. Or the project may not mature or may close by the due date. Another thing. The World Bank may be worried about how it can give interest-free loans to Pakistan whereas it charges interest to Ghana or other parties. That can be done, as I already mentioned, by amortising the value of interest in the contract. The problem is elsewhere, i.e. can we retain our membership with the World Bank and the IMF — the bodies that lend interest-based loans? These are the Shari'ah's area of concern. Personally, I feel we cannot join hands with such institutions or their business.

DR M FAHIM KHAN: I thank Dr Sayyid Tahir for educating us and giving us an opportunity to discuss such a complex issue. I will summarise some points for the benefit of the drafting committee. Drafting committee may not take all these points and if anybody does not agree with my summary, he may make his observations.

First, there seems to be no problem as far as the international transactions of imports and exports are concerned. *Bai' mu'ajjal* and other modes can help us conduct these transactions on assigned basis, bills of exchange and collection on cost basis. As far as foreign resource mobilisation is concerned, there is no problem on project-related loans and capital because they can be related to a just mode of financing either on mark-up basis or on raising loan basis or profit-and-loss sharing or equity basis. There is a problem in general-purpose budgetary support type loans. Though a suggestion has been made that some of the loans can be taken on service charge basis. Dr Tahir has strong reservations about it,

but I think this is a minority view and the Shari'ah has given permission for the service charges. The donors are willing to give us loans on service charge basis. There may not be a problem.

But on the other hand, we have to try to achieve self-reliance as far as it is possible. Until we do that, we may need to seek some *rukhsat* in that context, though a stronger reservation has also been made on that issue. Personally, I believe that if by some mistake, or deliberately, we have burnt our food farm, we have a choice to take *rukhsat* and build up the food farm even on interest-based loans. A point has been made though that *rukhsat* is for a short term and that too for very specific terms of reference — not a broad type of *rukhsat*.

As to foreign exchange forward cover, there is a feeling that in its present form it is not permitted in the Shari'ah nor is speculation. But there is a genuine need for the forward cover for the funds' transactions relating to trade, sale and purchase. The suggestion is that State Bank can provide this cover on the basis of foreign exchange reserves that it already has. Some Shari'ah guidance is needed, but apparently it is a workable suggestion.

Elimination of Riba: Pledges and Promises

CONCLUDING REMARKS BY DISTINGUISHED PARTICIPANTS

Prof Khurshid Ahmad

I welcome Senator Sartaj Aziz, the finance minister, and other distinguished guests to the concluding session of the Workshop on the Elimination of Riba from the Economy. We have spent three days examining the possibility and prospects of cleansing the Pakistani economy of riba in all its forms. I am grateful to paper writers, discussants and participants for this labour of love in producing well-researched and documented studies on different aspects of the problem. I am very grateful to all participants for such an active participation in this programme, working eight to nine hours every day — to me this is an act of *ibadah*. I am sure the efforts they have put in will help the process of Islamisation of the economy. Elimination of riba is an important aspect of this effort. We feel guilty that despite being Muslims we have not been able to make any significant move towards ceasefire with Allah as the Qur'an makes it very clear that the system based on riba means a state of war with Allah and His Prophet (pbuh).

The participants of the three-day workshop can testify that we have discussed almost all aspects of the riba problem

This chapter contains brief concluding remarks by Prof Khurshid Ahmad, Mr Abdul Jabbar Qasim, Dr Ghulam Rasool, Mr Khalid Latif, Mr Nawazish Ali Zaidi and Dr Faiz Muhammad. Dr Ziauddin Ahmad read out the communiqué.

with frankness, integrity, vigour and professional commitment. Everybody has had the chance to express his views and despite from different backgrounds, political perspectives and economic vocations, we all were committed on two issues: first, we sincerely wanted to implement what Allah and His Prophet (pbuh) laid down for us; and second, we wanted Pakistan to be economically and ideologically strong enough to play its role as part of the Muslim Ummah in creating a new order based on justice.

It has been from this perspective that we tried to deliberate on the subject. We don't claim to have readymade solutions to every problem. I do not think there are readymade solutions to such problems. Life is a continuous challenge: problems have to be faced, solutions discovered and experiments made. Despite mistakes and lapses, the struggle has to continue, for that is how great things are achieved.

The proceedings of the workshop would be published in book form. The drafting committee headed by Dr Ziauddin Ahmad has produced a communique' which has been approved in the last plenary session. I am extremely happy that finance minister Senator Sartaj Aziz has joined the concluding session. I am sure he would play his part in achieving this national objective. For us, this provides a historic opportunity. We are embarking on an experiment that can blaze new trails for mankind — not merely on moral grounds but also in economic terms. I pray that Allah gives the government *taufiq* to move in this direction. Allah does not need anyone; He can take care of His religion, His way; it is for our own good that we must strive in the direction of Islam.

Let me thank you for your openness. Despite our differences on a number of issues, I found you open to dialogue, that is a great merit and holds promise. We all have contributed in this dialogue. Many a things have been clarified. Whatever questions have been left unresolved, we shall continue to find out their solutions.

Abdul Jabbar Qasim

I felt honoured when Prof Khurshid asked me to speak be-

fore this august gathering. The day I received an invitation followed by a programme, I knew there would be something new. The papers read here were based on research and hard work. It is my *iman* (faith) that those who presented these papers would be blessed not only here in this world but in the hereinafter as well.

The prevailing consensus is that we have to get rid of the curse of *riba*. The workshop's setup and the physical arrangements were excellent. For that, IPS has to be applauded. What the government could have done but is not doing, IPS is doing. I wholeheartedly support its research programme.

Taking advantage of the presence of Dr Hussain Ahmad Hassaan, the president of International Islamic University, I would like to make a humble suggestion. There are about 50 *mudarb*as. The Islamic University should organise a course entitled audit on *mudarb*as and leasings. If there are resource constraints, let me take the initiative by saying that my company is ready to contribute Rs 10,000 to such an effort. This will be in support of the auditors' work who audit under the companies ordinance. The coming crop of people would support and supplement their efforts vis-a-vis the Shari'ah point of view.

Dr Ghulam Rasool

My three days here were highly educative and extremely useful. I have been trained in secular economics. But later in my career, I had the chance to be inducted into the process of Islamisation as I became associated with the first commission for the Islamisation of the economy. I found the dialogue between the two extreme viewpoints very candid and accommodating. The workshop was very useful specially in the context of the Federal Shari'ah Court judgement. I also had a chance of making a modest contribution in the form of a small paper reviewing the one extremely important mode of financing: *mudarb*a companies and their performance.

The upsurge that we have seen in the *mudarb*a activities during the last couple of years is an abundant evidence of the fact that the people at large and the business community in

particular are quite willing to be inducted into the process of Islamisation provided the operationally viable avenues are available to them. It is not always correct to put the blame on a certain segment of the society that they are not willing. I personally feel that though the situation is very complex, the opportunities for the Islamisation of the economic system do exist.

Though it is not an easy task, but a beginning has been made, at least in the fields of mudarba and leasing companies. The business community has greatly been supported by the fiscal incentives made available to them. These incentives helped them make a rapid progress in a very short time. The total paid-up capital of these 40 mudarbas is about Rs 3 billion but the capital value is Rs 7 billion. According to a CLA report, almost 70 percent of their funds are financing equity of the manufacturing enterprises.

The economic requirement of the day is the availability of the local funds. This financing mode is contributing tremendously by way of strengthening the stock market and the capital market in the country.

IPS has done well by bringing together the religious scholars and secular practitioners, bankers and others. My three days were well spent.

Khalid Latif

It is my privilege to be here. I must have attended hundreds of seminars during my professional life, and I feel pleasure to tell you that never before have I seen such a committed number of speakers and participants who were totally involved during the last three days in their deliberations and discussions. They were *participants* in a literal sense.

My congratulations to the Institute of Policy Studies for having conducted such a useful workshop which has opened new avenues for us to think about interest-free economy — a very important though, consciously or unconsciously neglected issue. I feel that all of us would go back much wiser, much more committed to the elimination of riba from the

economy. I had never seen so many “doctors” in my life — this was the “first operation” I had — literally taking all the knives they had and in fact started dissecting all the bankers around. I think we bankers deserve that dissection because we have contributed substantially to the introduction of interest-based economy in this country.

We have some 400 billion rupees worth of people’s money with us. We had to be very cautious in our approach towards Islamisation. May Allah give us courage and fortitude to be the first in introducing Islamic banking in this country.

I would request IPS to continue this *jihad*. I honestly believe that the day would soon come when they succeed in their efforts. All my personal association and commitment to the cause would be at their disposal. I want to be a humble associate of this *jihad* for eliminating riba from the economy.

Nawazish Ali Zaidi

The three-day deliberations on the elimination of riba have been very educative. As secretary, Commission for Islamisation of Economy, I may say that we were fully represented in this workshop — four of us have been attending all the sessions. I must feel enriched and the knowledge gained will help us in future deliberations of the commission.

I congratulate the government for the passage of the Shari’ah act as this provides a legal cover for setting up two commissions: one for the Islamisation of economy and education. The commission on economy has a vital role to play in the Islamisation of financial system as we are carrying with us a backlog of ignorance on the Shari’ah matters.

In the beginning, the bankers were not serious; they were making mockery of everything. What they were saying in public was different from what they were saying in private. The government sent a delegation to Sudan, Egypt and Switzerland headed by an additional secretary and some senior bankers. At that time, there was a lot of criticism against the mark-up practices being followed by Pakistani banks. I got a copy of the delegation’s report in which the then fi-

nance minister and later President of Pakistan wrote:

If banks in Egypt or Sudan can enforce mark-up system in a matter which is acceptable to Shari'ah, why can't it be done in Pakistan?

But nothing happened even after those remarks. This process continued until 1984 when 12 modes of financing were introduced. But because of the lack of Shari'ah advice and absence of any framework, the bankers took liberty and a buy-back agreement in addition to mark-up was introduced. In fact, the State Bank never authorised charging of mark-up in a buy-back agreement. The Federal Shari'ah Court has now found the mark-up system under buy-back un-Islamic, and we are trying to redesign it.

The bank's main function is to finance trade and industry which is very much Islamic but they are doing it in a wrong manner, i.e. on the basis of riba. If we can revise our contracts, then the main function of the banks will be to finance trade and industry which is Islamic and I think the Islamisation of the banking system is the easiest one. We hope that we will be able to make a headway.

Dr Faiz Muhammad

I thank the Institute of Policy Studies for organising the workshop. I would also like to thank the organiser of this workshop, Prof Khurshid Ahmad. I am not thanking him just because he has organised this workshop but for the fact that if people like me are here it is because of his efforts. I represent the International Institute of Islamic Economics, which came into being because of his dedicated efforts. I also owe a lot of thanks to the first director-general of this institute, Dr Ziauddin Ahmad, whose efforts gave direction to that institute and to the discipline of Islamic economics in this country. I am very proud to be treading their path.

Since coming from an educational institution, I cannot avoid assuming the position in which people generally have visions only, sometimes romantic ideas and dreams. I think the educational institutions are meant for that; there should be

some people in the society who have dreams and visions. Therefore, I look at this process of Islamisation of the economy more from a broader perspective. I am very glad that when we come to an interaction with the practitioners of economics, our romantic ideas are blended with realism and pragmatism. This is a place for cross-fertilisation.

During the last three days, we have discussed a number of issues relating to Islamisation of the economy. To my mind, Islam offers the only alternative for this country because it was created in the name of Islam; there are no two choices. I am fully conscious of the fact that this ideal of having an Islamic society involves social transformation. Every process of social transformation is likely to encounter some practical difficulties. Therefore, when we are talking of Islamising the economy we are not just talking from the ideological angle but also from the point of view of what practical difficulties are involved and why there is a need on purely pragmatic reasons that there should be a concurrent Islamic transformation of our people.

If we look at the mode which we have adopted for the last 45 years, it speaks amply of the fact that the western-inspired economic model has not delivered the goods. The essential element of that model was the interest-based financial system, linked with the vested interests of one narrow set of options in the international arena, and that was only the West. The recent debt crisis at the international level once again conveys very clearly that the debt-based development of Third-World countries has not produced the results. In fact, I don't have to dwell on that. Everybody is seized by the problem, i.e. how to overcome this international debt crisis. Although we in Pakistan are not realising how serious this crisis is and how it goes on stealing into our system. Anybody who does a careful analysis would conclude that we are not out of debt crisis; we are very much part of it. Therefore, I will submit that the economic managers of this country will have to take notice of the interest problem, both domestic and international, from the ideological viewpoint.

We discussed the issue of interest in the international context and we recognised a few difficulties. At the same time, there was a consensus that there is a room for a creative re-

sponse to the element of profit. Unfortunately, if we fall prey to the prevailing system and close our minds, nothing, then, will look bright to us. But if we somehow just look back and avoid falling prey to political expediency, there is definitely a room for manoeuvring and change. At the same time, we should always expect support from Allah; this is our belief.

There was a consensus on the existence of alternative measures to regulate the international conventions on imports and exports against the government or private account or may be on international capital movement. Details can be spelled out in some other presentation but the measures suggested in the papers presented here should be given serious thought and somebody assigned to put them into practice. Then it is a practitioner's job how to facilitate the implementation of those measures. I am sure with dedication and commitment and with encouragement of the people, who are at the helm of affairs, the social transformation on the Islamic lines can be achieved.

Dr Ziauddin Ahmad

Just a few words before reading out the communiqué. The task of the chairman drafting committee is a delicate and complex one, particularly for a Muslim, because it is nothing short of the *amanah*; I am supposed to be the custodian of whatever has been said in this forum for the last three days.

I am grateful to my colleagues in the drafting committee who worked with me even in late hours for two nights in order to reflect the consensus on various issues discussed in this forum. Also, it was very nice of IPS chairman to have changed the seminar programme at last minute to accommodate a plenary session in which the draft of the communiqué was read out and changes were made. With these words, I read the communiqué.

Communiqué

A Workshop on the Elimination of Riba from the Economy was held in Islamabad on April 11-13, 1992, under the auspices of the Institute of Policy Studies. The workshop was attended by 83 participants coming from various professions including Shari'ah scholars, bankers, insurance experts, chartered accountants, economists and businessmen who hold senior positions in their respective fields.

The workshop was convened in the perspective of the recent decision by the Federal Shari'ah Court regarding elimination of riba from the economy. Various subjects that were discussed related to riba-free alternatives in commercial banking, alternative arrangements for financing government transactions and international dealings and review of mudarba floatations in Pakistan.

The workshop considered the FSC judgement in some detail. It was generally agreed that the judgement reflects the opinion of a vast majority of Shari'ah scholars and Muslim economists that riba in all its forms is prohibited, be it commercial bank interest or interest on government loans, etc. It was noted that in the last two decades, a number of alternatives to interest-based activities have been devised. While there is need to develop and use different alternatives in different situations, the backbone of an interest-free financial

system in the long run remains profit-and-loss sharing.

The participants noted that the progress with regard to the Islamisation of the financial system was quite encouraging till 1984-85. However, certain developments in subsequent years brought about a retardation in this process. Permission given to the banks to invest even their PLS deposits in interest-bearing government securities and large-scale replacement of participation term certificates by term finance certificates were specifically mentioned in this connection. The participants also noted that serious consideration was being given to the issue of eliminating interest from government transactions in 1984-85. Subsequently, the matter was not pursued vigorously and the movement towards a completely interest-free economy lost its dynamism and even its sense of direction.

The practice of mark-up and buy-back arrangement by the banks in Pakistan came under discussion. It was observed that the practice does not fulfil the Shari'ah requirements of the contract of *bai' mu'ajjal* and *murabaha* and in many cases is being used simply as subterfuge for interest. It was, however, noted that mark-up (*bai' mu'ajjal*), if properly applied, can play a useful role as one of the permissible modes of financing. There are certain areas where *mudarba* or *musharakah* may not be feasible. In such cases, mark-up in its acceptable form may very well be applied.

Examining the progress of the Islamisation process in the country the participants noted that one of the fundamental reasons for some of the deviations from Shari'ah requirements that crept into practice was non-existence of a Shari'ah board to supervise the implementation of the system. It was noted that Islamic banks in other countries have Shari'ah supervisory boards. The participants, therefore, recommended the creation of a Shari'ah supervisory board through special enactment. In addition, individual banks, DFIs, *mudarbas* and leasing companies may have Shari'ah advisers or Shari'ah committees. All formats of contracts must be cleared by the Shari'ah supervisory board before implementation.

The participants agreed that the *mudarba* and *musharakah* are the ideal substitutes for interest in an interest-free econo-

my. They were disappointed to observe that only marginal use has been made of these techniques by the banks so far and almost the entire interest-free operations of the banks are concentrated on a particular system of mark-up financing with buy-back arrangement which has been declared un-Islamic by the Federal Shari'ah Court.

The participants discussed the various factors which stood in the way of greater use of *mudarba* and *musharakah* as financing techniques by the banks. Apprehensions on the part of the bankers that businessmen may not disclose their correct profit position under the *musharakah* system and lack of enthusiasm on the part of business community for this mode of financing were identified as the two major factors. It was also observed that the present taxation system is responsible to a great extent for forcing the businessmen to under-declare profits which seriously militates against the adoption of *musharakah* type of financing by the banks. The participants stressed the need for basic reform in the tax system to overcome this hurdle in the way of a more widespread use of *mudarba* and *musharakah* techniques.

The participants welcomed the recent upsurge in *mudarba* floatations which constitutes a significant contribution towards mobilising equity-based financial resources from the public. *Mudarba* floatations have become popular only during the last couple of years demonstrating public desire for and confidence in Islamic financing modes, supported by fiscal incentives made available to them by the government. They recommended continuation of this government support. The participants felt that there existed tremendous potential for promoting venture capital financing through *mudarbas*, particularly with reference to highly labour intensive small or medium industries and the informal sector activities. It was recommended that the government should place greatest reliance on *mudarba* technique of financing in self-employment scheme launched recently. The participants also felt that ways and means be devised, enabling *mudarbas* to adequately augment their funds.

The participants stressed for an adequate legal framework to be provided for various modes of Islamic financing so that the interests of both the banks and business parties are prop-

erly safeguarded. They called for the evolution and adoption of standardised documents relating to various modes of Islamic financing which are in full conformity with the tenets of Islam and duly approved by the Shari'ah board. They also felt that considerable scope exists for innovation and introduction of new contracts within the permissible modes.

The participants felt a need for reform of the capital market. It was noted that the conventional commercial banks alone may not be sufficient to cater to the needs of all kinds of investors or depositors. It was recommended that, besides the commercial banks and DFIs, consideration should be given to intensifying the activities of the investment banks. Similarly, steps should be taken to strengthen the stock markets, establishment of new unit trusts, investment institutions and agencies, mutual funds and similar financial institutions. Establishment of such institutions will bring breadth and depth in the capital markets. Such diversification is very much needed for the success of an interest-free financial system.

The participants attached great importance to proper training of bank executives and staff in various Islamic financing techniques in order to enhance their expertise in this field and also to provide stimulus to the Islamisation process. It would be useful to set up an Islamic banking institute sponsored by the commercial banks and DFIs and strengthen existing training programmes.

The participants devoted considerable time to discuss the practical difficulties that the government may face in implementing the decision of the Federal Shari'ah Court in eliminating interest from the economy. It was noted that eliminating interest from foreign transactions is particularly difficult since it involves dealings with non-Muslims and interest-based institutions. The participants discussed as to whether the "doctrine of necessity" can be invoked in this case. It was noted that the conditions for invoking the doctrine of necessity are very restrictive and the government should be extremely cautious in resorting to that doctrine. Giving a blanket permission to the government for using the "necessity doctrine" was completely ruled out, even its selective application would need a very strong justification and constant supervi-

sion. The participants did note that it may create some difficulties in the short run but were of the opinion that even if some sacrifices may have to be made in the short run, with the passage of time things will change for the better. It was noted that the problems created by interest-based international debt for many countries testify that the short-run sacrifices in implementing an interest-free system will pay rich dividends in the long run in terms of self-reliance, development and stability.

In the context of elimination of interest from foreign transactions, the participants discussed a variety of methods which can be employed in the field of international transactions without recourse to interest. In the field of international trade the use of *bai' mu'ajjal*, *bai' salam* and *istasna* can easily cope with the flow of imports and exports. In case of capital movements, the project-related loans can be handled on the basis of mark-up financing, leasing, joint ventures and equity financing. Considerable scope also exists for attracting the savings of Pakistani nationals abroad on the basis of equity participation through mechanisms such as BOT (build, operate and transfer). In the case of ways and means of support or general foreign assistance, there may be some difficulties. However, if the government pursues a policy of self-reliance and introduces financial discipline in its expenditure, these needs can be minimised. In extremely difficult situations loans on interest may be tolerated strictly under the doctrine of necessity, i.e. *iztirar* as repugnant but temporarily acceptable, subject to strict limitations, in the Shari'ah, on a very selective and restricted basis.

The participants were seriously concerned that no tangible steps have been taken so far to eliminate interest from the government transactions which is at the root of the existence of interest in the economy as also identified by the Council of Islamic Ideology. The participants felt that there was a clear rationale for providing interest-free loans to the government by the State Bank of Pakistan and the commercial banks to meet the essential financing requirements of the government. As for mobilisation of resources from the general public, the interest-bearing financial instruments must be replaced by Islamic financial instruments like *muqarza* bonds. There was some discussion whether a return could be given

on government bonds which might be linked to the growth in the gross national product. The participants noted that there was a widespread consensus that this will not be in conformity with Shari'ah. However, income tax concessions and other incentives can be provided in order to encourage people to take up interest-free government securities. Consideration was also given to whether some kind of compensation could be provided to people subscribing to interest-free government bonds for erosion of the purchasing power over time. Various possibilities were considered including the issuance of some fixed value units but it was felt that the matter deserves further consideration.

The participants took serious note of escalating budgetary deficits and consequent creation of money on massive scale which has produced high rates of inflation. It was noted that inflation is repugnant to Islam. The government should, therefore, make every effort to control inflation. It is necessary to rationalise the use of credit resources of the banking system by the private sector and impose strict control on government deficit financing. It was felt that fiscal discipline would be helped if provision is made through an act of the parliament setting an obligatory limit on budgetary deficit and deficit financing.

The participants reviewed insurance practices prevalent in the country and felt that necessary action had not been taken so far to reform these practices in the light of Islamic teachings. They urged the government to give this matter due attention and enact appropriate legislation to ensure that insurance practices in the country fully conform to Islamic injunctions.

The participants attached great importance to complete elimination of interest from the economy at the earliest. In this context, they recommended enactment of necessary legislation to ban all interest-based transactions. They also favoured enactment of a self-reliance law to reflect national commitment to reduce dependence on external assistance for achieving national developmental objectives. They stressed the need for a systematic and widespread educational effort to inspire all sections of the society to provide full support to the Islamisation process of the financial system.

Concluding Speech by Finance Minister

May I begin by thanking very whole-heartedly and sincerely the Institute of Policy Studies for organising this workshop. The timing of this workshop could not have been better because we are engaged in a very thorough and active phase of this process and we were ourselves planning under the aegis of Commission for Islamisation of Economy to convene similar workshops, international seminars and symposia on the subject. This has been a very valuable contribution and we will read with care all the papers and the conclusion that have been presented.

In my own experience particularly with foreign bankers and institutions, there is a misconceived notion that there is something backward or unrealistic about Islamic economics. Generally when they discuss this subject they do not seem to be fully aware; they think there is something impractical about the whole thing. It is very important that through workshops like this we spell out the right message that the basic principles of justice, of morality and of economics which underline Islamic economic system are not only sound but absolutely essential if one wants to save the world from exploitation of the weak by the rich, or wishes justice in distribution of rewards. Whenever I have an opportunity to give

The concluding speech was made by Senator Sariaj Aziz, the then finance minister of Pakistan, who was the chief guest on the occasion.

some examples to foreign audiences they are, sometimes pleasantly sometimes unpleasantly, surprised depending on their vantage point and raise questions not of principle but of technicalities. I don't have to explain all this to an audience like this who is better informed and probably have done more research on the subject than I have.

That the basic underlying principle for the elimination of riba is to ensure that the strong, that is, one who has control over resources, does not take undue advantage of the weak, the borrower, in making that resource available and, therefore, under an Islamic system of *musharakah* or *mudarba* or even of leasing the lender is well off only if the borrower is also better off. In other words it creates a stake in the lender in the well-being of the borrower. This is a fundamental principle if you want to eliminate exploitation. From that point of view, the basic principles are very sound. And, therefore, as for any Muslim this particular objective without question is also the objective before the ulema.

As the communiqué points out, we did make some good progress in the early '80s in studying this subject thoroughly and in 1985 introduced 12 Islamic modes. We should be satisfied that a large number of transactions were converted to Islamic modes, particularly if we look at the growth of financial sector since 1985 in the number of *mudarb*as and leasing companies. In fact, some western banks such as Citibank and Grindlays Bank have floated *mudarb*as and leasing companies which they find most useful forms of financial transactions.

While at the inauguration of new building of International Islamic University two months ago, I convened an informal meeting to discuss this subject. I would mention two conclusions. The first was that no Islamic country today, including those which have good resource position and do not need to borrow, has introduced an Islamic system, i.e. Islamic economic system or interest-free economic system. The two countries which are ahead of all other Islamic countries are Iran and Pakistan, which have made more progress than others. Second, Islamisation of economy has to be gradual process. There is no sure way to surmount all the difficulties in a short span of time. Last year we set up a commission for the Islamisation of the economy under the Shari'ah Act, and

this was long before the judgement of Federal Shari'ah Court. The commission made a great deal of progress particularly on the Islamisation of banking and has prepared a report. So after a lapse of about seven years, the progress towards the Islamisation of the economy has started in a much more active and emphatic manner.

I hope that with the help of the kind of proposals and ideas that have come in this workshop we will be able to make very significant progress in the coming months. But I would, however, like to make some points which arise from this workshop.

The communiqué says that the concept of compensation to protect the purchasing power over time has been accepted, although it needs more consideration to find out how it should be done. This to me is the crux of the problem. The next paragraph says that inflation and budget deficit should be kept to the minimum. But reality is that there is no country with zero inflation. May be for a short period, Singapore or Japan had had no inflation. But across the board the way the process of development takes place, the lengthening of the process of production and investment, money supply does increase before you get the corresponding increase in goods and services. Depending on the efficiency of investment and the degree of wastage, if you can keep inflation down to 2 or 3 or 4 percent — below 5 percent it would be a remarkable feat.

I can say with full responsibility as an economist that to maintain and sustain, and not for a short period, an inflation rate of below 5 percent is a major accomplishment. And to keep a single digit that we are trying to do is also quite significant. Because a very large number of countries have inflation running to 20, 30, 50 or 100 percent. Now in this situation you cannot lend in a manner that when you get back a year later you get 30 percent less or 10 percent less or even 5 percent less. That is injustice from Islamic point of view to take something and return less. While the other side which is *riba*, addition is again un-Islamic. So you have to have some system: you may call it compensation or else but that is there.

Having accepted this, I think the suggestion in communiqué saying that there is a clear rationale for providing interest-free loans to government by the State Bank and the commercial banks to meet essential needs of the government is not fair. The two recommendations are not consistent because once you accept that you have to protect the real value of money by any formula, then the question of interest means returning at the face value which is not consistent with the formula you have, whether you use GDP deflator or have some other index.

Similarly, the communiqué says that a great difficulty in the introduction of *musharakah* is the taxation system. That may be one reason. But there are much deeper reasons that deal with our very system of moral values, the degree of honesty of business, the degree to which Islam as a way of life is permeating the society as a whole; taxation system may be a small part. It is true that if there is no taxation to be paid then people would not have to conceal their profits. But, besides this, there are many other motives which prompt concealment of profits. Therefore, whether banks try an existing system or come out with a modified form the problem of misrepresentation would remain there. One should recognise that there are other problems with the *musharakah* agreement; that is why *mudarba* is more successful and so is leasing.

We have to keep in mind that the funds with the financial institutions are collected from small investors and their security is a prime concern of the banks and financing institutions. The financial institutions cannot afford to give these funds in the hope that the borrower is going to be quite honest and he will declare the profit and give a return which he has promised as a profit to the lender. This is also an issue which requires an in-depth study. But there is no question that a *musharakah* system is much more preferable. However this has to be supplemented with an efficient system of monitoring which would allow quick detection of misrepresentation by dishonest borrowers. I fully support other recommendation stressing the need to modify the mark-up system which is covering a large number of transactions in line with the recommendation here.

I agree with the rest of the conclusion except for these three points. One has to take the practical side of things into account and I made these points to illustrate that we need more time to achieve the desired results. The subject of the Islamisation of the economy and elimination of *riba* must be put in a broader context. Our population is growing rapidly and if we are not able to mobilise investment and accelerate the growth rate we will not be able to meet social objectives. There are also other injunctions of Islam which have an equal bearing on these objectives, because elimination of *riba* is just one of the objectives. The positive side of this system has elements like *sadqat*, which require equal emphasis. Only then, elimination of *riba* will become practicable.

On the other hand, if we say that we have only to eliminate *riba* and take a very narrow view, then everybody would say: well, now that interest has been declared illegal, 100 billion rupees that we owe to the banks are no longer payable. This is untenable because you cannot take that position. The pre-1985 interest transactions are worth Rs 60 billion and post-1985 mark-up-based transactions are worth Rs 40 billion and people say now that Federal Shari'ah Court has declared that these are un-Islamic so we don't have to pay. This amounts to going back to that situation in which the loan was originally taken on interest basis. With the monetary situation as it is the lender cannot be put in that position. The point is that the borrowers knew at that time that it was un-Islamic and now they want to take recourse of Islam. There is going to be no such relaxation in which people, who borrowed during interest-based system, are relieved of their obligations. Islam teaches us that whatever obligations we have undertaken must be fulfilled. Also, there's a clause in constitution that when a law is declared un-Islamic, the past obligations will be fully protected.

Foreign transactions have been, as the workshop points out an important issue because while living in the world, we have to abide by certain rules. I agree that if from the beginning we had followed a very austere policy and a policy of self-reliance, things would have been different. There are countries, China for example, which have achieved high rate of savings without recourse to foreign borrowing; but they followed a very different system. If you want to accelerate

growth and also need technology, then foreign assistance is needed; borrowing is not just for supplementing the savings. We are now in a situation where we are returning about \$1.6 billion, as debt servicing annually and borrowing only \$2 billion; the net borrowing is not very large. But can we become a capital exporting country in one year or two? Not yet. We are at a level of income where we cannot transfer our savings and bring down our investment level from 18 to 12 percent because we are now investing 15 percent and 3 percent go out to repay our foreign loans. We need to move carefully and gradually.

I fully support that we must become more self-reliant and reduce our budget deficit. We must reduce reliance on borrowing but at the same time being realistic.

There are areas which are clearly un-Islamic and prohibited. But there are others like leasing and mudarba, which are totally Islamic. In between, there is a series of transactions where there are grey areas; a definitional problem. Some are easily managed; others more difficult to manage. This is where we hope the Commission for Islamisation of Economy will guide us.

Many valuable suggestions have come up from the scholars and participants. I can undertake on the part of government that the suggestions which are practicable and keep in view the broad objectives will be implemented as quickly as possible.

I will again like to thank the institute for organising the workshop and hope that this is not just a one-time effort. I am already in touch with the Islamic Development Bank to organise symposia because this is a continuing process in which we have to play our role. With these words, I thank the IPS for giving me the opportunity to come here, meet all of you and present my views.

Note of Thanks by Prof Khurshid Ahmad

We are now coming to the end of this workshop but I assure you that the end of this working group represents a beginning of fresh efforts. It would be a continuous struggle and we look forward to participation and cooperation of all of you. I am happy that finance minister Sartaj Aziz, although joining us only in the concluding session, has participated in the dialogue. My effort was that ministers, secretaries, advisers, bankers who feel that they are facing certain difficulties, should be part of a workshop like this — so that we can discuss the problems and try to evolve a solution.

One may not agree with Mr Sartaj Aziz's views, yet we should always be prepared to consider all these issues and questions. Before I discharge the pleasant responsibility of thanking all of you I would like to say that in the communiqué we have touched upon the question of indexation as we discussed this issue again and again in the workshop. We devoted several hours to the complex issue of indexation and the communiqué does not advocate the idea of indexation. We have very strong reservations about that. What we have suggested is that there is an issue which has been created by wrong policies and wrong strategies yet the solution lies in rectifying the mistake at its source. Nonetheless, results of this problem are there and have to be faced. Yet we have not arrived at any positive recommendation on that and only

suggested further discussion and research till we are able to find out a solution that is compatible with Shari'ah and could resolve the difficulty in which we find ourselves.

As far as interest-free borrowing from the central bank or commercial banks is concerned, I do not see any contradiction between these two. Instead, what has been suggested is that if government is performing certain duty to the society, the government also has a right to draw resources not merely upon the income of individuals and corporations but also institutions including the central bank and the commercial banks particularly when commercial banks are earning a very high profit due to creation of credit. In an interest-free society, the government can have a right to share a part of that. This is what is referred to in communiqué.

I welcome Mr Aziz's resolve of implementing Islamic teachings, which is positive; we all want to move in this direction. That is what we expect from a government that has been elected by the people on a manifesto which commits to elimination of riba and establishment of Islamic sociopolitical and socioeconomic system. Elimination of riba is only one aspect of Islamic economic programme. We realised that besides elimination of riba our objective is creation of all those conditions and pursuit of all those policies which lead to the establishment of a strong healthy resilient economy based on justice, which could become a model for others. That is our objective. We are sure that elimination of riba would strengthen this process. I fully share Mr Aziz's concern and assure him that this working group and the following working groups would continue to address themselves to the multifarious problems. At the moment, elimination of interest became much more central and critical; yet we have to see that all other aspects of Islamic economic system and even the entire Islamic way of life are established. That is how the moral uplift of the individual in a society may be brought about.

With these words I again extend to you my greetings, for being with us. I would fail in my duty if I do not thank Mr Sartaj Aziz for joining us in the concluding session and Mufti Shujaat Ali Qadri and Dr Hussain Ahmad Hassaan for making themselves available to us for Shari'ah guidance. I

would also thank all the bankers, insurance experts, accountants, economists, university professors, academics who participated in the working group and without whose effort and participation this could not have been productive.

I would also like to thank those institutions which have sponsored some of the dinners and lunches. The finance minister was kind enough to host a dinner in your honour. My thanks to the International Islamic University, the Saudi-Pak Investment Co, the Prudential Bank and Askari Bank. Copies of papers would be made available to the Commission for Islamisation of Economy and the press but we are sure that a more detailed report on the workshop will be produced.

Finally, I thank Allah Subhanahu wa Ta'ala for giving us the opportunity to be a part of this effort, to share experiences and I pray that Allah enables us to continue these efforts. With this prayer I conclude and hope that you will continue to extend cooperation. I am sure with this spirit of cooperation we would definitely be able to move a long way towards our destination.

PART II

Evolution of Islamic Banking

PROF AUSAF AHMED

One of the significant developments in the Muslim world during the last decade and half is the emergence of Islamic banking which has appeared as a powerful movement. Although, some attempts to reorganise banking activities along the Islamic lines go back to early '60s, the concept of Islamic banking is even older. In fact, the strong disapproval of interest by Islam and vital role of interest in the modern commercial banking system led Muslim thinkers to explore the ways and means how commercial banking could be organised on an interest-free basis. However, for a long time, the idea of Islamic banking remained a mere wish. Some papers were written and some professional economists even worked out theoretical models of Islamic banking. However, they were quickly dismissed by the highbrow economists as wishful thinking, describing them as attempts to put the history in reverse gear.

The establishment of the Islamic Development Bank (IDB) in 1975 gave a big boost to the Islamic banking movement. IDB was established as an international financial institution in pursuance of the declaration of intent issued by a conference of finance ministers of Islamic countries held in Jeddah in Dhul Q'ada 1393 H (December 1973). According to article 1 of the agreement establishing the bank, the purpose of the IDB is to "foster economic development and social progress

of the member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah." Its present membership consists of 45 countries. The authorised capital of the bank is two billion Islamic dinars. The value of an Islamic dinar, adopted as a unit of account at the IDB, is equivalent to one special drawing right of the International Monetary Fund.¹

It was for the first time in modern Muslim history that an international financial institution was committed to conduct its activities in conformity with Shari'ah. According to the article 20 (3), the bank was authorised to levy a service fee to cover its administrative expenses. According to one of the official publications of the IDB, "the bank is clearly and unequivocally committed to the principles of Shari'ah in the conduct of all its financing operations and performance of its activities... the bank has made constant endeavour to identify the modes of financing that conform to Shari'ah."²

Since the establishment of the IDB, a number of Islamic banking institutions have been established all over the world. At present, more than 50 Islamic banking institutions are working in different parts of the world, and three countries viz. Iran, Pakistan and Sudan have taken necessary steps to reorganise their entire banking system along the Islamic lines. Islamic banking is no more a mere idea, just a blueprint or wishful thinking. It is said to "have arrived." Even the "hig-brow" West finds itself compelled to take the notice of Islamic banking. This could be guessed from the fact that the IMF published a monograph on Islamic banking.³ It is also not uncommon to see various seminars being organised on Islamic banking in the western universities as well as in other economic, business and banking circles. Many graduate students have written their PhD dissertations on various aspects of Islamic banking. All this hub of activity is bound to enhance the curiosity about Islamic banking. What is Islamic banking? How is it different from the usual commercial banking? How does it function? Is it really free from interest? These are some of the questions being asked not only by

¹ For more details, see S.A. Meenai: *Islamic Development Bank*, 1989.

² *The Islamic Development Bank: Achievement and Activities*, 1982, p.5

³ Zubair Iqbal and Abbas Mirakhor: *Islamic Banking*: occasional paper No 49, International Monetary Fund, Washington D.C., 1987.

the curious non-Muslims but also by the concerned Muslims. This essay is an attempt to answer some of these questions.

The paper is divided into five sections. Section I discusses the meanings of prohibition of interest (*riba*) in Islam. Section II examines the theoretical basis of Islamic banking. Next section is devoted to tracing the evolution of the concept and practice of Islamic banking. In Section IV, current business practices of Islamic banks are discussed at some length. The last section endeavours to clear some common misconceptions about Islamic banking.

SECTION I

Prohibition of Interest

It is commonly known and acknowledged that Islam has strictly prohibited interest. It disapproves both giving and charging interest. The Arabic word used in the Qur'an for interest is *riba* which has been condemned in the strongest possible terms.⁴ *Riba* is often translated as usury but its literal meanings are an excess, addition or growth.⁵ Islamic jurists have classified usury into two types:

- Usury of debts (*riba al diyun*)
- Usury of trade (*riba al bai'*)

The usury of debts was an established practice amongst Arabs during the pre-Islamic period. It is also known as usury of delay (*riba al nasia*). It may arise in two situations: first, as an excess over and above the amount of principal loan which is incorporated as an obligatory condition of giving loan. In this situation it is called *riba al diyun*. In the second situation, an excess amount is imposed over and above the amount of the principal loan if the borrower fails to pay the principal on the due date. Thus, more time is allowed for payment in return of the excess amount. If the bor-

⁴ Following verses of the Holy Qur'an prohibit *riba*: 2:275, 276, 279, 280; 3:130, 30:39.

⁵ Abdullah Yousuf Ali: *The Translation and Meaning of the Holy Qur'an*. See the explanations of the verses cited above.

rower fails to pay again, a further excess amount over the principal (usually the double of the first excess) is imposed and so on. This kind of usury may occur through debt or trade. This is what is known as *riba al nasia*.

Riba al bai' is also known as *riba al fadl*. It was also practised by the Arabs in the pre-Islamic period and was prohibited by the Prophet Muhammad (pbuh). Following tradition of the Prophet (pbuh) is cited as an evidence thereof:

It is related that Abu S'aid al Khudri said:

"The Prophet (pbuh) said: Gold for gold, silver for silver, wheat for wheat, barley for barley and dates for dates, the like for like, hand to hand (immediately). Whoever increases or asks for an increase hath (practised) usury, the receiver and giver alike (are guilty)."⁶

It is the considered opinion of the experts of Islamic jurisprudence that interest charged by commercial banks "is identical with the excess stipulated as an obligatory condition in the contract, which is one of the two types of usury prohibited by the Islamic Shari'ah."⁷

Keeping in line with the above tradition, the Islamic Fiqh Academy established by the Organisation of Islamic Conference (OIC) in its second session held in Jeddah, Saudi Arabia, during Rabi Thani 10-16, 1410 H (December 22-28, 1985) declared that "any increase or profit on a loan, which has matured, in return for an extension of the maturity date, in case the borrower is unable to pay, and the increase or the profit on the loan at the inception of the loan agreement, are both forms of usury (*riba*) which is prohibited under the Shari'ah."⁸

⁶ For further details, see Hassan al Inani: *The Cause of the Prohibition of Usury and Its Relation to Functions of Money*, Cairo: International Association of Islamic Banks, undated, p.12

⁷ For details, see Al Amin H.A: *Defining Interest Versus Usury*, International Institute of Islamic Banking and Economics, (mimeo) undated.

SECTION II

Theoretical Basis of Islamic Banking

In order to be justified Islamically, the banking system has to avoid *riba*. Consequently, much of the literature on theory of Islamic banking has grown out of concern that how monetary and banking system would function if interest is abolished by law. The literature on Islamic banking shows two different and distinct strands of thought. The literature developed in the Middle East, mostly in Arabic, is preoccupied with the functioning of a single bank and has adopted a micro approach. On the other hand, the literature developed in the Indian subcontinent, mostly in English, has generally taken a macro approach and has been concerned with the development of an interest-free banking system dealing with issues such as nature and functions of money in an Islamic economy, role, goals and instruments of monetary policy in an interest-free framework, etc. In this section, theoretical basis of Islamic banking will be briefly reviewed.

Modern commercial banking activity is based on the creditor-debtor relationship between the depositors and bank on the one hand and between the borrower and the bank on the other. Interest is viewed as the price of credit reflecting the opportunity cost of money. Islamic view about loan (*qard*) is that it should be given or taken, free of charge to meet any contingency and creditor should not take any advantage from the borrower. When money is lent on the basis of interest, more often than not, it ends up in some kind of injustice. The Islamic principle in these kinds of transactions is that "deal not unjustly, and ye shall not be dealt with unjustly" (al-Qur'an, 2:279). Hence, commercial banking in an Islamic framework could not be based on the creditor-debtor relationship.

The other Islamic principle in the matters of financial transactions is that there is no reward without risk. This principle is applicable both to labour and capital. As no payment is al-

¹ Resolution No 10 concerning the ruling on banking transaction with interest and the ruling on dealing with Islamic banks, *Resolutions and Recommendations of the Islamic Fiqh Academy* published by the Organisation of Islamic Conference, p.19.

lowed to labour unless it is applied to work, no reward for capital should be allowed unless it is exposed to business risks.

Financial intermediation in an Islamic framework could take place using these two principles. Consequently, Islamic financial relationships are participatory in nature. It has been suggested by several theorists that commercial banking in an interest-free system be organised on the basis of principle of profit-sharing which is referred in the Islamic jurisprudence as *mudarba*.

The principle of *mudarba* could be explained by a simple illustration. Suppose there are two persons, one of them has capital but no special skills in trade, while the other has been bestowed with some special insight and dexterity in the matters of trade but possesses no capital. These two persons can cooperate in any one of the following two ways:

- (a) The trader can borrow the money from the capital owner and invest in his trade. The capital owner shall get back his principal and an additional amount worked out on the basis of a fixed rate called interest rate as his compensation for parting with the liquidity. This is debt financing. Usually, the loan will be granted for a fixed period. The claim of the creditor for repayment of the principal and payment of the interest becomes viable only after the expiry of this period. This is irrespective of the fact whether the trader has made a profit using the borrowed money or not. In the event of a loss, the borrower has to repay the principal amount of the loan as well as the accrued interest from his own resources. This is viewed by Islam as an unjust transaction.
- (b) The other possibility is that the two persons cooperate with each other not on a creditor-debtor basis but on the basis of partnership and cooperation in which the capital owner shall provide his capital and the other party will put his skill and management into trade. The capital owner shall not be involved in the actual and day-to-

day operation of business but shall be free to stipulate certain conditions which he may deem necessary to ensure the best use of his funds. After the expiry of the period which may be the termination of the contract or till such time that returns are obtained from the trade, the capital owner shall get back his principal amount along with a share of profit.

The ratio, in which the total profit of the enterprise is distributed between the capital owner and the manager of the enterprise, has to be determined and mutually agreed at the time of the contract before the beginning of the project. In the event of loss, the provider of the capital shall bear all the loss and the principal will be reduced by the amount of the loss. In a way, it is the possibility of the loss which makes the capital owner entitled for a share in the profit of the enterprise. This is in essence the principle of *mudarba*.

The Islamic legality of *mudarba* is based on the Sunnah as it is reported that *mudarba* was practised in the city of Madinah and elsewhere during the time of the Prophet (pbuh) and he did not disapprove of it.

The creditor-debtor relationship is viewed as an unjust one because it gives more leverage to creditor in contrast to debtor. The interests of creditor are protected at the cost of debtor. In contrast, the *mudarba* agreement is based on justice as it grants an equal position to both parties of the agreement.

There could be at least three reasons for considering *mudarba* relationship to be more just than the creditor-debtor relationship:

First, both parties have an equal position in the determination of the ratio in which profits will be shared between them.

Second, treatment of both parties in uniform in the event of loss in which if provider of the capital suffers a reduction of his principal amount, the worker or manager in the *mudarba* contract is deprived of the

reward of his labour, time and effort.

Third, both parties are treated equally if there is any violation of the agreement. If the worker or manager violates anyone of the stipulated conditions or if he does not work hard, or is instrumental in causing loss to the business due to negligence or bad management; he will have to bear the responsibility for the safe return of the whole amount in question. If on the other hand, provider of the capital violates any of the stipulated conditions (for example, he withdraws his funds before the stipulated time, or does not provide part or full funds at the promised time, etc.), he will have to pay the worker or manager a reward equivalent to what he would have earned in a similar work.

It has been suggested that *mudarba* be the basis of reorganising the banking activity, in an interest-free framework. This can be done by entering into a two-tier *mudarba* agreement which may be explained as follows:

The first tier of *mudarba* agreement is between the bank and the depositors who agree to put their money in the bank's investment account and to share profits with it. In this case the depositors are the provider of the capital and the bank functions as the manager of funds.

The second tier of *mudarba* agreement is between the bank and the entrepreneurs who seek finance from the bank on the condition that profits accruing from their businesses will be shared between them and the bank in a previous mutually-agreed proportion, but the loss is borne by the financier only. In this case the bank functions as the provider of capital and the entrepreneur works as the manager. In case there are more than one financier of the same project, i.e. one project is jointly financed by several banks, profits shall be shared in mutually-agreed proportion previously determined but loss shall be shared in the proportion in which different financiers have invested their capital. There could also be a partnership (*sharikah*) agreement between the bank and the en-

trepreneur in which loss is to be shared by the contracting parties in the proportion in which they have invested their capital but profits shall be shared in the agreed ratio determined beforehand.

The principle of *mudarba* as a basis of financial intermediation in the Islamic economy is offered as a viable alternative of interest-free banking system. The creditor does not earn interest on a fixed rate in this system, but participates in the business risk and earns a share of profit. Thus, under Islamic banking system, the cost of capital is not zero as some people wrongly assume it to be analogous to zero interest rate. The only difference between the Islamic banking and interest-based banking in this respect is that cost of capital in the interest-based banking is expressed in terms of a predetermined fixed rate while in Islamic banking, it is expressed as a ratio of profit. Some writers have even suggested that profit-sharing ratio in an Islamic economy could discharge the same functions which are performed by the interest rate in a capitalist economy. Thus profit-sharing ratio could work as an allocative device as well as a control variable.

SECTION III

Evolution of the Concept and Practices

A question which may legitimately be asked by any observer of Islamic banking is: the Islamic injunction against *riba* is at least 1400 years old while Islamic banks have emerged on the scene only 15 years ago in the middle of 1970s. Why the Islamic world took so long to come up with an alternative to interest-based banking?

The answer is necessarily based on historical factors. The history of commercial banks in the western world itself is not very old. Development of commercial banking in the West has synchronised with the emergence of industrial civilisation in the last two and a quarter centuries. With the industrial revolution, there was a tremendous expansion in the number of traders, manufacturers, industrialists and other entrepreneurs who wanted to expand their businesses and set up

various kinds of firms but their own financial resources were not enough for it. Hence, a method was to be found which would give finance users access to the finances of others.

Thus, the needs of financial intermediation gave birth to commercial banking which very soon became the backbone of modern industrial and financial system. An efficient and smoothly functioning banking system is today one of most basic prerequisites for having an efficient economic organisation. However, all these happened within the backdrop of western cultural tradition which had shrugged off the moral and ethical considerations of Christianity from economic and business relations in its early stages of development.

When the Muslim world, in the early 19th century, as a result of western imperialism and colonialism, came into contact with the industrialisation and other associated institutions of capitalism including the commercial banking system, Muslims had any one of two choices:

- (1) Accept the institution of commercial banking as it is and argue that interest charged by the commercial banks does not contain the elements of riba prohibited by Islam. Hence, commercial banking would become permissible and Muslims would have no reservation against it.
- (2) Accept the verdict that interest charged by commercial banks is riba and, in view of indispensability of commercial banking, made an attempt to develop an alternative system of banking which would not violate any tenets of the Islamic Shari'ah.

During the middle of the 19th century, several ulema (religious scholars) in Egypt, Indian subcontinent, Indonesia and in other Islamic lands made an attempt to take the first position. This was a period when the Muslim world, after suffering through colonialistic domination, was on the retreat and Muslim intelligentsia had developed a defeatist mentality. There was a tendency to rationalise all fads coming from the West. Hence, it was not surprising to see that some attempts, albeit unsuccessful, were undertaken to dilute the strong in-

junctions against *riba*.

It was argued that *riba* condemned and prohibited by the Qur'an is really usury and not the interest which is the basis of functioning of modern banks. It was also held that its prohibition is mainly aimed at eliminating the excesses and exploitation involved in the consumption loans when given on interest. Since commercial banks give loans mostly for productive purposes, prohibition of *riba* may not cover the bank loans. The advocates of these views neglected the fact that Qur'an categorically declares any surplus (or excess) over the principal amount as *riba* and clearly mentions that creditors are entitled only to their principal amounts. It was also forgotten that Islam does not make any distinction between the consumption loans and productive loans. The prohibition of *riba* has to apply irrespective of the purpose for which loans have been raised.

However, it is also a historical fact that these views were held by a minuscule minority in the Muslim countries and did not cut much ice either with the majority of Muslim scholars or ordinary believers who had serious reservations about the correctness of these positions and permissibility of bank interest.

As a consequence, modern commercial banking could not make much headway in the Muslim countries the way it did in the western world and even in some Asian countries. This is corroborated by the fact that commercial banking in the Muslim world is mainly confined, even today, to large urban centers where western culture and civilisation has made deep inroads. Even in the cities, a significant number of population stays away from the commercial banks for religious and moral reasons respecting the injunctions against *riba*. Even among those who have to deal with the banks, under the force of circumstances, or due to nonavailability of any Islamically permissible banking facility, there is a large number of people who believe it to be a violation of faith. Consequently, they do not make any use of interest earned by their funds. Either they leave it at the bank unclaimed, or give it to someone else.

The other approach of evolving a banking system consis-

tent with the requirements of Shari'ah has become lately more important although the idea to establish an interest-free bank dates back to as early as 1940s. The conditions, however, then were not ripe enough for actual establishment of an Islamic bank as not much thought had been given to technical details and actual operation of an interest-free bank. In fact, in the absence of any breakthrough in theory of interest-free banking, the idea of interest-free banking remained only a desire, not even a blueprint, for a long time.

In 1952, when the Saudi Arabian Monetary Agency (SAMA) was created by a royal decree to function as a central bank in Saudi Arabia, it was not permitted to pay or receive any interest.⁹ Probably, this was for the first time that prohibition against interest was figured in an official document of any Muslim country in the modern times. Although, SAMA's charter has been modified several times since then, "the SAMA or other government bodies, however, cannot legally accept interest on money they lend."¹⁰ Nevertheless, SAMA being a central bank could not perform the usual commercial banking function in an interest-free framework.

An Early Experiment

A pioneering experiment of putting the principles of Islamic banking into practice was conducted in Mit-Ghamr, Egypt, from 1963 to 1967. The experiment combined the idea of German saving banks with the principles of rural banking within the general framework of Islamic values. Mit-Ghamr was essentially a rural area and the people in general, like elsewhere in the Islamic region, were quite religious. They did not put their savings into any bank because interest is forbidden in Islam. Moreover, hardly any financial institution was available to them. Under these circumstances, the task was not only to respect the Islamic values regarding interest but also to educate the people about the use of banking.¹¹

⁹ R.E. Looney: *Saudi Arabia's Development Potential*, Toronto: Lexington Books, 1982, p.49

¹⁰ *Ibid.* p.51

¹¹ Shahrukh R. Khan: *Profit-and-Loss Sharing: An Economic Analysis for an Islamic Financial System*, PhD dissertation, University of Michigan, 1983, p.207

A western observer describes the significance of Mit-Ghamr experiment in the following way:

“The majority of population had never been dealing with the financial institutions. Because of this, capital formation had been impaired. Basically rural and religious, they tended to distrust the bankers operating in the western style and, what is more, there were few local branches they could patronise. Since a substantial part of their income was not spent immediately, but put aside for social events, emergencies and the like, this idle capital could not be used for productive investment. A precondition, however, for any change of behaviour from hoarding and ‘real-asset saving’ to ‘financial saving’ was the creation of financial institution which would not violate the religious principles of large segments of population. Only then could the rest of the majority of population be integrated into the process of capital formation.”¹²

Thus, an attempt was made to integrate rural population into financial system and “developmental nature of this early experiment made it very prominent.”¹³

In Mit-Ghamr project the following types of accounts were accepted: saving accounts; investment accounts; and Zakah accounts. No interest was payable to depositors in the saving accounts but they were allowed withdrawals on demand. They were also eligible for small, short-term interest-free loans for productive purposes. The funds deposited in the investment accounts were subjected to restricted withdrawals and were invested on the basis of profit-sharing. The Zakah account attracted the amount of Zakah for redistribution amongst the poor.

The Mit-Ghamr project of Islamic banking had an unexpected success as saving deposits increased from 25,000 Egyptian pounds to 125,000 Egyptian pounds during 1963-66. During the same period, investment deposits increased from 35,000 to

¹² T. Wohlers-Scharf: *Arab and Islamic Banks: New Business Partners for Developing Countries*, Paris: OECD, 1983, pp.79-80

¹³ R.K. Ready: *The Egyptian Municipal Saving Bank Project*, International Development Review, Vol.9, No.2, 1967, pp.2-5

75,000 Egyptian pounds.¹⁴ It is also reported that "the bank functioned on cautious basis, rejecting, on the average, 60 percent of the loan applications in the first three years. The default ratio was zero in economically good times."¹⁵

Although Mit-Ghamr project made good start, it was abandoned due to certain political factors.¹⁶ Its importance is only historical now. Nevertheless, it was the first experiment which showed that commercial banking activity could be organised on the basis of Islamic principles respecting the prohibition against riba without indulging in interest.

A Unique Financial Institution

In terms of historical evolution of Islamic banking, mention should also be made of a unique financial institution which is generally not mentioned in the discussions of Islamic banking but whose significance, importance and uniqueness demands it. This financial institution is the Pilgrims Management and Fund Board of Malaysia, popularly known as Tabung Haji.

Reason for the establishment of this institution was the desire of Malaysian Muslims that "money spent on pilgrimage must be clean and untainted of riba." Since this was not possible by putting the money with the ordinary commercial banks, this desire necessitated the establishment of a special financial institution. Consequently, a pilgrims' saving corporation was established in 1963 which was later incorporated into the Tabung Haji in 1969.

- The goals of the Tabung Haji are:
- To enable Muslims to save in order to provide their expenses for performing the pilgrimage (Hajj) or for other expenses beneficial to them;
- To enable Muslims through their savings to participate in investment, industry, commerce and plantations as well as in real estate, according to Islamic principles; and

¹⁴ T. Wohlers-Scharf: *op cit*, pp.79-80

¹⁵ *ibid*, pp.79-80

¹⁶ For details, see Shahrukh R. Khan: *ibid*, pp.205-209

- To provide for the protection, control and welfare of Muslims while on pilgrimage through various facilities and services of Tabung Haji.¹⁷

To achieve these goals the board is assigned to collect savings through its branch offices and other agencies such as post offices, and to invest the depositors' savings in "accordance with the investment principles and tenets of Islam."

Tabung Haji started with 1,281 depositors in 1963 and a total of M\$46,600 in deposits. By the end of 1985, it had 65 branches all over the country, the number of depositors 867,220 and total deposits exceeding one billion Malaysian dollars.¹⁸ Financial activities of the Tabung Haji are managed by a department of finance and investment which has six divisions, viz. finance, saving and withdrawals, securities, land and buildings, property management and computer. It has also established five subsidiary companies dealing with plantation, pilgrim transportation, construction and housing and property management.¹⁹

As far as the management of funds is concerned, Tabung Haji works as a saving and investment institution. It basically operates on the principle of *al wakalah al mutlagah* (absolute power of attorney) through which the depositors give their consent to Tabung Haji to manage their deposits for the purposes of investment. It had several schemes to attract the deposits, e.g. direct deposits, deposits through branches and post offices, salary deduction schemes, children's saving schemes. Withdrawals are allowed up to 100 percent of the cash balance with the fund. However, normally only one withdrawal is allowed within six months. The persons who are registered to perform Hajj during a given year are not normally allowed to withdraw in that year.²⁰

For making investments in accordance with the Islamic principles, Tabung Haji uses *mudarba*, and *musharakah*

¹⁷ Proceedings of the Workshop on the Organisation and Management of the Pilgrims Management and Fund Board of Malaysia, Islamic Research and Training Institute, Jeddah, 1987, p.3

¹⁸ *Ibid* p.3

¹⁹ *Ibid* p.1

²⁰ *Ibid* pp.22-23

as modes of investment. In order to assure that it does not violate any Islamic principle, it used to consult the National Fatawah Committee of Malaysia. However, after the establishment of the Bank Islam Malaysia, it uses the services of the Shari'ah supervisory board attached to this bank.²¹ The investment of Tabung Haji has taken four forms: investment in shares, in subsidiary companies, in land and buildings and short-term investment.²² After subtracting the operating expenses and the payment of Zakah, profits are distributed among the deposit holders. Generally, the rate of dividend has been around 8 and 8.5 percent.²³

Although Tabung Haji is not a bank, it works very much the same way as an Islamic bank does. It also performs two important banking functions, i.e. accepting the deposits and making investment. In fact, Tabung Haji is a good example of how a specialised financial institution could work successfully in accordance with the Islamic principle.

Emergence of Islamic Banks

The first Islamic bank in the urban setting was established in Cairo. Nasser Social Bank was established in 1971 and started its operations in 1972. The bank is a public authority with an autonomous status. Its purpose is mainly social, such as granting of interest-free loans for small projects on a profit-sharing basis, assistance to the poor and the needy, and loans to needy students for university and higher education. Because of the social functions, Nasser Social Bank was granted exemption from the banking and credit law of 1957 in its initial stages. The bank was originally under the ministry of treasury but it is now functioning under the ministry of social affairs and insurance. Its capital comes from the funds allocated by the president from extra-budgetary resources, appropriation from state budget and contributions from the ministry of awkaf.

Next to follow was Dubai Islamic Bank in 1975. This bank

²¹ *ibid* p.54

²² *ibid* p.88

²³ *ibid* p.94

is a public limited company having its head office at Dubai with a capital of 50 million dirhams. The governments of Dubai and Kuwait have contributed 20 percent and 10 percent of the capital, respectively. Since then, a number of Islamic banks have been established in different parts of the world and are successfully functioning.

There are two major holding companies, viz. Dar al Mal al Islami (DMI) group and Al-Barakah group controlling a number of Islamic banks. The DMI is a holding company registered under the laws of Bahamas. It was established in 1981 with an authorised capital of US\$1 billion divided into 10 million shares of equal value. Today, the DMI is operating in 14 countries through 22 institutions which include Islamic investment companies, Islamic banks and Islamic insurance companies.²⁴

The Al-Barakah group was established in 1982. It has 12 affiliates and financial interests in some other sister institutions. There are certain Islamic banks in the Gulf such as Dubai Islamic Bank, Kuwait Finance House and Qatar Islamic Bank which do not belong to anyone of these holding companies. There are Islamic banks in some other Islamic countries such as Bank Islam Malaysia and Bangladesh Islamic Bank which have been established with the active support of the governments of these countries. Some Islamic banks are functioning in non-Muslim countries too, like Philippines Amanah Bank, Islamic Bank International, Denmark, and Islamic Finance House Universal Holding in Luxembourg. The Al Rajhi Banking and Investment Company is operating as an Islamic investment company in Saudi Arabia.

In addition to these and several other institutions, certain conventional institutions are also operating the so-called "Islamic windows" through which they offer to their clients certain services using various Islamic financing techniques. Among them, National Commercial Bank of Saudi Arabia, Bank Misr of Egypt and Bank of Credit and Commerce International (BCCI) need special mention.

* Daili Dar al Mal al Islami (Arabic)

SECTION IV

Business Practices of Islamic Banks

Islamic banks, like other banks, attract financial resources from individuals and institutions and direct them towards business firms which need external finance to support their productive activities. Thus, Islamic banks also perform the same functions of financial intermediation as performed by the traditional banks. The basic difference between the Islamic banks and interest-based banks is in their functioning, i.e. how they raise financial resources and then use them. For the sake of analytical convenience, let us distinguish between the sources and uses of funds.

SOURCES OF FUNDS OF ISLAMIC BANKS

It is well known that interest-based banks accept deposits of different maturities, paying different rates of interest on different kinds of deposits. Islamic banks do not pay interest on deposits. How Islamic banks operate different kinds of deposits is described below:

CURRENT ACCOUNTS

All Islamic banks operate current accounts for their customers as traditional banks do. These accounts govern what is known as demand deposits, i.e. these deposits are payable on demand without a notice being given to the bank. The bank guarantees full return of these deposits on demand. The bank may use these funds in its business operations at its own risk. Since all risk is borne by the bank, the depositors are not entitled to any share in profits earned by the bank.

SAVING ACCOUNTS

Islamic banks also accept saving deposits from individuals. Four different methods of operating saving accounts by Islamic banks have emerged: (i) accepting saving deposits on the principle of *al wadia* requesting the depositors to give the bank permission to use the funds at its own risk, but guaranteeing full return of the deposits and sharing any profits volun-

tarily; (ii) accepting saving deposits with an authorisation to invest and share profits in an agreed manner for the period in which a required minimum balance is maintained; (iii) treating saving deposits as *qard-e-hasan* (benevolent loan) from the depositors to the bank and granting them pecuniary or non-pecuniary benefits; and (iv) accepting saving deposits into an investment pool and treating them as investment deposits which are explained below. Generally speaking, the depositors are given a right of withdrawal without notice in saving accounts but are not entitled for any share in the profit for the period in which withdrawal is made.

INVESTMENT ACCOUNTS

Investment deposits are the Islamic banks' counterpart of term deposits in the conventional system. They are also called profit-and-loss sharing (PLS) or participatory accounts. These accounts could be opened either by individuals or companies for any specified period such as six months, one year or even longer. The depositors do not receive any interest. Instead, they are entitled for a share in actual profit accrued from the investment operations of the bank. The profits are shared by the depositors according to their amounts and the period they are held by the bank in an agreed proportion. As an accounting practice, the amount held in the account is multiplied with the period for which it has been employed. The profits are distributed on a pro rata basis on this product. Usually withdrawals are not allowed from the investment accounts except under special circumstances for which some notice period is required. The depositor will have to forego his share of profit for the withdrawn amount.

JOINT OR GENERAL INVESTMENT ACCOUNT

Some Islamic banks establish some kind of an investment pool in lieu of fixed term deposits. The investment pool takes the form of a general investment account in which investment deposits of different maturities are pooled together. They are not tied to any specific investment project but are utilised in dif-

ferent financing operations of the bank. The profits are accounted and distributed at the end of the period on a pro rata basis.

LIMITED-PERIOD INVESTMENT DEPOSITS

Some Islamic banks also accept investment deposits for a specified period determined by the mutual consent of the depositor and the bank. The contract may terminate at the end of the period but profits are distributed and accounted at the end of the financial year.

UNLIMITED-PERIOD INVESTMENT DEPOSITS

These investment deposits are automatically renewable without specifying the period. They could be terminated by giving a specified notice to the bank. Usually the notice period is three months. No withdrawals or increases in the amount of deposit are permitted during the period. Profits are calculated and distributed at the end of the financial year.

SPECIFIED INVESTMENT DEPOSITS

Some Islamic banks have evolved an investment deposits scheme with specific authorisation to invest in a particular scheme or a specific trade. In this case the profits of this specific activity are distributed between the depositor and the bank. In this case the bank works as an agent of the investor. It may agree to perform this function against an agreed fee or may opt to have a share in the profit.

USES OF FUNDS BY THE ISLAMIC BANKS

Islamic financing techniques on the uses of funds side of the balance-sheet marked a more significant departure from the traditional banking. This is mainly because of the prohibition of interest rate. Most of the traditional banks use lending on interest as their major financing tool which is modified with respect to interest rate charged, period of loan, conditions of repayments, etc. to suit the requirements of various clients and different sectors. Since Islamic banks cannot use lending on interest as a financing device, they were compelled to find out innovative ways of financing which would not involve interest.

Consequently, Islamic banks have drawn up the rich treasure of Islamic theory of contract to come up with the financing techniques which would conform to various requirements of the Islamic Shari'ah. These contracts were originally devised for commodity trade and deal with the contracts between two individuals. The application of these contracts at the institutional level and in the financial sector is a new phenomenon. In course of these applications, some of the contracts have been slightly modified from the point of view of Islamic jurisprudence. However, this is not the place to discuss the judicial nature of these contracts. Instead, present discussion shall remain confined to application of these contracts to financial sector as actually put into practice by contemporary Islamic banks.

Financing techniques used by Islamic banks may be summarised as follows:

MURABAHA (MARK-UP OR COST-PLUS-BASED FINANCING)

This is the most popular technique of financing among the Islamic banks. It has been estimated that 80 to 90 percent of financial operations of some Islamic banks belong to this category. It works in the following way:

The client approaches the Islamic bank to get finance for the purchase of a specified commodity. The bank, either itself or through some agent (who could be the client himself), collects all the required information about the commodity itself, such as price, nature and specification of the commodity, names of dealers, etc. The bank informs the client of these details as well as of the margin it would like to charge on the original price.

In case, these conditions are acceptable to the client, a contract of *murabaha* transactions will be signed between the bank and the client. The bank will purchase the specified commodity from any seller of its choice paying the price of commodity in cash. In case a

sale deed is required (e.g. in case of car or house) the registration is in the name of the bank. Once the ownership of the commodity is transferred to the bank, it sells the commodity to the client on the basis of deferred payment basis against an agreed price.

The new price at which the bank sells the commodity to the client includes the original price (which is cost to the bank) plus the mark-up the bank is charging (which is the profit margin). The client pays this price either in instalment or in lump sum at an agreed later date.

There are certain requirements for the *murabaha* contract to be valid. It is necessary that profit margin (or the mark-up) the bank is charging must be determined by mutual agreement between the parties concerned. Similarly, the good in question should be in the physical possession of the bank before it is sold to the client. Then transaction between the bank and the seller should be separate from the transaction between the bank and the purchaser. There should be two distinct transactions. That is why certain Islamic banks effect a *murabaha* transaction in two stages using two separate contract forms. The first form is a request to the bank through which the client informs the bank of his intention to carry out the *murabaha*. In this contract, the client promises to buy the good from the bank. It should also be noted that a promise is not legally enforceable. Hence, the client has a right to change his mind and the bank runs the risk of losing the money it has invested in this particular *murabaha*. The second contract deals with the sale of good by the bank to the client on deferred payment basis, the terms and conditions of which are clearly spelled out in the contract form.

The *murabaha* form of financing is being widely used by the Islamic banks to satisfy various kinds of financing requirements. It is used to provide finance in various and diverse sectors, e.g. in consumer finance for purchase of consumer durables like cars and household appliances, in real estate to provide housing finance, in the production sector to finance the purchase of machinery, equipments, raw material, etc. However, probably the most common use of *murabaha* techniques is in financing short-term trade. *Murabaha* contracts are also used to issue letter of credit and to finance import trade.

MUSHARAKAH (PARTNERSHIP)

Musharakah is another technique of financing used by Islamic banks. In this form, two or more financiers provide the finance for a project. All partners are entitled to a share in total profits of the project according to a ratio which is mutually agreed upon. However, the losses are to be shared exactly in proportion to capital proportion. All partners have a right to participate in the management of the project. However, they also have the right to waive this right in favour of any specific partner.

There are two main types: permanent *musharakah* and diminishing *musharakah*. In the first case, the bank participates in equity and relieves an annual share of profit on a pro rata basis. The period of termination of the contract is not specified, so it can continue as long as the parties concerned wish it to continue. The technique of diminishing partnership is getting quite popular with Islamic banks because of its potentialities. In permanent *musharakah*, funds may be committed for a long period, but it is not so in case of diminishing *musharakah*.

Diminishing *musharakah* allows equity participation in the first place and share of profit on pro rata basis. However, the contract also provides a further payment of a sum of money over and above the bank's share in profits as a payment of the part of the equity held by the bank. In this way, the equity held by the

bank keeps on getting reduced progressively with time. After a certain time, bank will have zero equity and shall cease to be a partner. Islamic banks have found it quite suitable to finance commercial buildings in this way.

Islamic banks in Sudan, particularly Sudanese Islamic Bank (SIB), have evolved yet another application of *musharakh* which has tremendous potential for rural and agricultural development in the Islamic countries. SIB has been experimenting in providing finance to farmers under *musharakah* arrangements.

It works in the following manner: the SIB and the farmer enter into a *musharakah* contract under which the bank provides the farmer with the fixed assets such as ploughs, tractors, irrigation pumps, sprayers, etc. and working capital such as fuel, oil, seeds, pesticides, fertilisers, etc. Farmer's equity is confined to provide land, labour and management. Since it is a partnership contract, there is no need of collaterals or guarantees other than personal guarantees. First, the farmer is paid 30 percent of the net profit as a compensation for his management. Rest of the net profit is shared between the bank and the farmer on a pro rata basis for each side's respective share in the equity.

Musharakah technique of financing is also used to finance domestic trade, imports and to issue letters of credit.

MUDARBA (PROFIT-SHARING)

Several theorists of Islamic banking have postulated *mudarba* to be a dominant mode of financing under the scheme of Islamic banking. However, this technique, for various conceptual, practical and legal hindrances, has not been able to find wide application by the Islamic banks. The Jordan Islamic Bank (JIB) is one among the few banks which use *mudarba* as a financing technique. The law of the JIB mentions two kinds of *mudarba*: individual and joint.

In case of individual *mudarba*, the JIB provides finance to a commercial venture run by a person or by a company on the basis of profit-sharing. The joint *mudarba* may be between the investors and the bank on a continuous basis. The investors keep their money in a special fund operated by the bank in continuous joint financing. The investors receive a proportionate share of the net profit realised even without the liquidation of those financing operations which have not reached the stage of final settlement.

IJARAH (LEASING)

Leasing is also one of the approved method of earning income according to Islamic law. In this method, a real asset such as a machine, a car, a ship, a house, etc. can be leased by the lessor to the lessee for a specified period against a specified price. The benefit and cost of each party should be clearly spelled out in the contract to avoid any element of uncertainty (*gharar*) with respect to the responsibility of each party.

Leasing is emerging as a popular technique of financing among the Islamic banks. Some of the important Islamic banks which use leasing as a technique of financing include Islamic Development Bank, Bank Islam Malaysia and commercial banks in Pakistan.

Under this scheme of financing, the bank purchases a real asset (the bank may even purchase the asset as per the specifications provided by the prospective client) and leases it to the client. The period of lease may be determined by mutual agreement according to the nature of assets. In general, it may be anywhere between three months to five years or more. During the period of lease, the asset remains in the ownership of the bank but physical possession of the asset and its right of use are transferred to the lessee. After the expiry of the lease agreement, these also revert back to the original owner.

At present, Islamic banks are experimenting with various forms of leasing, one of which is lease purchase

agreement. In this scheme, the lessee can purchase the equipment at the end of the lease period at an agreed price. In certain cases, the rental paid during the period of the lease may constitute part of the price.

LOANS WITH SERVICE CHARGE

Some Islamic banks give loans with service charge. The Council of the Islamic Fiqh Academy, established by the OIC, in its third session held in Amman on Safar 8-13, 1407 H (October 11-16, 1986), in a response to a query from the Islamic Development Bank resolved that it is permitted to charge a fee for loan-related services offered by the bank. However, this fee should be within actual expenses and any fee in addition to the actual service-related expenses is forbidden because it is considered to be usurious.

Hence, the amount of the service charge should be carefully calculated. According to this ruling, it may be calculated in the following manner:

$$\text{Service charge} = \frac{\text{Actual administrative expenditure}}{\text{Average assets during the period}} \times 100$$

$$\text{Average assets} = \frac{A_1 + A_2}{2}$$

where

A1 = Total assets at the beginning of the period.

A2 = Total assets at the end of the period.

Service charge in this manner may be calculated only after the end of the period because it is only then that actual expenditure on administration will be known. Under the circumstances, it is possible to levy an approximate service charge on the clients, then reimburse or reclaim the difference at the end of the period when actual expenses on administration are known.

QARD-E-HASAN (INTEREST-FREE LOANS)

Most of the Islamic banks also provide interest-free loans to their customers. Practices, however, differ. Some banks provide the privilege of interest-free loans to the holders of investment accounts at the bank. Some other banks have the provision to provide interest free loans to needy students and other economically weaker sections of the society. Yet some other banks provide interest-free loans to small producers, farmers, entrepreneurs who are not qualified to get financing from other sources. The purpose of these loans is to help them start independent life or to raise their income and standard of living.

In Pakistan, a distinction is made between ordinary loans which are granted with a service charge and *qard-e-hasan* loans which are granted without any service charge.

SECTION V

Some Misconceptions

It should be clear that Islamic banking is one of the several institutions of the Islamic economy. However, it is neither necessary nor sufficient condition for the existence of an Islamic economy. In certain quarters, there is a misconception leading to the naive belief that advocates of Islamic economy want to establish the Islamic economic system but by establishing a few Islamic banks here and there. For example, a German observer of the Islamic banking scene remarks:

“The hope is that the Islamic banks will turn out so successful in economic terms, i.e. so profitable for capital owners as well as depositors and without any adverse (but a number of beneficial) effects for the funds demanding entrepreneurial partners of the bank that (in the long run) everybody will turn away from interest-based banks and towards Islamic banks. The result would be an evolutionary instead of a revolutionary transformation of the economic order, basical-

ly caused by individual decisions and market forces and not by political decisions and government interventions."²⁵

One should keep in mind that banking activity is required only when economy has achieved a certain level of development resulting in the separation of savers and investors. Hence, it is possible to have an Islamic economy in which savers and investors are the same people. In such an economy, banking which is necessarily a form of financial intermediation, may become redundant. In this sense, Islamic banking is neither a necessary nor sufficient condition of Islamic economy which even may exist without Islamic banking. However, it remains one of its important ingredients. This assertion should not be confused with the prohibition of riba which is a necessary condition for existence of Islamic economy. An Islamic economy no matter how primitive or advanced could never be permitted to practise riba and still remain Islamic. Commercial banking is not the only way to organise financial activities on a non-riba basis. State ownership of banking institutions is another method of elimination of interest from the economy in which case the state will ration the credit according to requirements of various sectors.

Furthermore, Islamic banking cannot be regarded as a sufficient condition of Islamic economics either. Mere presence of a few Islamic banking institutions would not make the whole economy any more Islamic than the present, for which far-reaching structural changes and reforms would have to be carried out in almost all spheres of social and economic activities. Not only that, probably a number of new institutions will have to be created, Islamic banks being only one of them.²⁶

If Islamic banking is neither a necessary nor sufficient condition for the existence of an Islamic economy, then what is

²⁵ Volker Nienhaus, "Profitability of Islamic PLS Banks Competing with the Interest-Based Banks: Problems and Prospects," *Journal of Research In Islamic Economics*, Vol. 1 No.1 Summer 1983, p.38

²⁶ S.N.H. Naqvi: *Ethics and Economics — An Islamic Synthesis*, Leicester: The Islamic Foundation, 1981. Also see S.N.H. Naqvi, H.U. Beg, Rafiq Ahmad and M.I. Nazir: *An Agenda for Islamic Economic Reform: the report of the Committee on Islamisation* appointed by the finance minister, Government of Pakistan, Islamabad: Pakistan Institute of Development Economics, 1980, 28p.

really the significance of Islamic banks?

The answer to this question depends upon correctly understanding the nature of banking business and prohibition of *riba* in Islam. Banks are financial intermediaries which function as a bridge between the savers and investors if they are not the same people. They mobilise the saving of the people and provide it to those who have productive outlet for these funds. Traditional commercial banks perform this function on the basis of interest. The significance of Islamic banking institutions is that they aspire to perform the same functions as those of modern commercial banks without indulging in *riba*. To this extent, Islamic banks provide an alternative to interest-based banking for religious reasons.

If there are certain other economic advantages accruing from their functioning on the basis other than interest, they add to the usefulness of Islamic banks as an institution. Similarly, nothing forbids Islamic banks to carry out some other functions, in addition to their normal banking functions, as would contribute to establishing the Islamic economic order and propagating the most cherished Islamic values in the field of economic and business activities. But it would be presumptuous to think that mere establishment of a few Islamic banks would automatically lead, through market forces or otherwise, to the establishment of an Islamic economy.

Contemporary Experiences of Islamic Banks: A Survey

PROF AUSAF AHMED

During the past 15 years a number of Islamic financial institutions have been established in different Muslim as well as in non-Muslim countries. These include Islamic banks, investment companies and insurance and reinsurance companies. The basic motivation for the establishment of these institutions is the desire of Muslims to reorganise their financial activities in a way to preclude violation of any canon of Islamic Shari'ah in general and enable them to conduct their financial activities without dealing in *riba* in particular. However, this paper is mainly concerned with the Islamic banks, although passing reference to other Islamic financial institutions may also be made.

The purpose of this paper is to present a survey of contemporary questions about Islamic banks like what is an Islamic bank? Where are the Islamic banks and what they are doing? Hence, the paper is divided mainly into two parts. Section I deals with a portrayal of current Islamic banking scene and Section II describes some of the major techniques used by Islamic banks.

The contemporary Islamic banking scene essentially consists of three different and independent elements.

The paper was presented at the seminar on "Financial Institutions in accordance with Islamic Shari'ah," Jakarta, Indonesia.

- i) Islamic banks and Islamic financial institutions (IFIs) in different parts of the world which have been mainly established in the Middle East and elsewhere during the past 15 years or so.
- ii) Countries where attempts have been undertaken to restructure the whole banking system along the Islamic lines.
- iii) Islamic credit societies which exist in the unorganised banking sector in several countries.

However, this paper is mainly concerned with the financial institutions which mostly belong to the first category, although occasionally some reference may also be made to the financial institutions in other two categories.

SECTION I

Current Status of Islamic Financial Institutions

NUMBER OF IFIs

What is the total number of Islamic financial institutions operating currently in the world? It is not possible to answer this question with a degree of certainty. The set of IFIs in the world would include all the institutions in the above-mentioned three categories. However, the number of institutions in some of these categories is not known exactly. Nevertheless, it is possible to make some reasonable guess.

Keeping in view the fact that all commercial banks in at least three countries, viz. Iran, Pakistan and Sudan are required to conduct their activities in accordance with the Islamic principles and also including the IFIs operating in the unorganised sector in some Muslim as well as non-Muslim countries, the total number of institutions which adhere to Islamic principles and could be described as IFIs may be close to a thousand. However, due to lack of reliable information it is preferable to confine this section only to IFIs operating in the organised private sector.

Statement I attached with the paper lists 56 Islamic financial institutions operating in different parts of the world along with their year of establishment. These include Islamic banks and investment and insurance companies. However, the actual number of IFIs in the organised private sector may be much more than this. In fact, certain observers of the Islamic banking scene believe that total number of such institutions may not be less than 100. However, reliable information is not available on all of them. Hence, the list supplied in the Statement I may be accepted only as a working list of these institutions. Financial indicators and addresses of selected Islamic banks have also been provided in the Statements II and III respectively.

GEOGRAPHICAL SPREAD OF IFIS

Islamic financial institutions are not confined to any specific geographical region. They are located in the Arab world as well as in the non-Arab world. There are IFIs in the capital-surplus economies as well as in the labour-surplus economies. They are working in the developing countries as well as in the advanced industrial countries. Thus, it could be said that IFIs, despite their small number, are spatially well-diversified.

The country-wise distribution of IFIs is reported in the Table I. Out of 56 institutions on which some data are available, 43 institutions are located in 18 Muslim countries. Among the Muslim countries, the Arab world has the lion's share of IFIs with 30 institutions. Within the Arab world, Sudan has the maximum number of IFIs (six) while Bahrain and Egypt have five and four respectively, and Jordan, Qatar and UAE have three each. Bangladesh, Guinea, Malaysia, Niger and Senegal have two IFIs each, while Iran, Kuwait, Mauritania, Saudi Arabia, Morocco and Tunis have one each. Among the non-Arab Muslim countries, Turkey has three IFIs.

There are 11 IFIs functioning in nine non-Muslim countries like Bahamas, Cyprus, Denmark, India, Luxembourg, Philippines and South Africa. Both Switzerland and UK have two institutions each. This information has been summarised in Table 2.

TABLE I
Number of IFIs in Muslim Countries

Country	Number of IFIs
Bahrain	5
Bangladesh	2
Egypt	4
Guinea	2
Iran	1
Jordan	3
Kuwait	1
Malaysia	2
Mauritania	1
Morocco	1
Niger	2
Qatar	3
Saudi Arabia	1
Sudan	6
Senegal	2
Turkey	3
Tunis	1
UAE	3
Total	43

TABLE 2
Number of IFIs in Non-Muslim Countries

Country	Number of IFIs
Bahamas	1
Cyprus	1
Denmark	1
India	1
Luxembourg	1
Philippines	1
Switzerland	2
South Africa	1
UK	2
Total	11

The progress in the establishment of Islamic financial institutions can be known by looking at Table 3. It shows that movement of establishing IFIs started in the second half of 1970s and reached its peak in the mid-'80s. By the end of 1980, there were 17 Islamic financial institutions working in different parts of the world. However, during 1981-85, 32 new institutions were established. Within this period, 11 institutions were established in 1983 and 12 in 1984.

TABLE 3
Establishment of Islamic Banks/IFIs

Year	No of IFIs Set Up During the Year	Name of Islamic Bank/IFI
1963	1	Pilgrims Management and Fund Board of Malaysia (Tabung Haji)
1971	1	Nasser Social Bank

1975	2	Islamic Development Bank; and Dubai Islamic Bank
1977	4	Faisal Islamic Bank of Egypt; Kuwait Finance House; Islamic Investment Co. of the Gulf; and Faisal Islamic Bank, Sudan
1978	2	Jordan Islamic Bank; and Islamic Finance House Universal Holding
1979	3	Bahrain Islamic Bank; Iran Islamic Bank; and National Investment Trust, Pakistan
1980	3	Islamic Investment Co, Bahrain; Islamic Finance House Co, Jordan; and Banker's Equity Ltd, Pakistan
1982	3	Faisal Islamic Bank, Cyprus; Philippine Amanah Bank; and Islamic Finance House, UK
1983	11	Faisal Islamic Bank, Bahrain; Bangladesh Islamic Bank; Islamic Bank International, Denmark; Bank Islam Malaysia; Qatar Islamic Bank; Islamic Investment Co, Qatar; Islamic Bank for Western Sudan; Islamic Coop. Dev. Bank, Sudan; Al-Barakah Islamic Bank, Sudan; Saudi-Tunisian Finance House; and Sudanese Islamic Bank, Sudan
1984	13	Al-Barakah Investment and Dev. Co, Saudi Arabia; Al-Barakah Islamic Bank, Bahrain; Faisal Islamic Bank, Guinea; Faisal Islamic Bank, Niger; Islamic Investment Co, Niger; Tadamon Islamic Bank, Sudan; Islamic Investment Co, Sudan; Dar al Mal al Islami, Geneva; Islamic Invest Service Co, Geneva; Faisal Islamic Bank, Senegal; and Al-Barakah International Bank, UK
1985	3	Al-Barakah Islamic Bank, Mauritania; Faisal Finance Institution, Turkey; and Al-Barakah Turkish Finance House
1986	1	Al-Ameen Finance & Invest. Co, India
1988	3	Saudi-Egyptian Finance Bank, Egypt; National Islamic Bank, Jordan; and Islamic Bank, South Africa
1989	1	Turkish-Kuwait Finance House, Qatar.
1990	1	Arab-Islamic Bank, Bahrain
Total	56	

Types of Islamic Financial Institutions

Islamic financial institutions may be classified into two categories:

- i) Islamic banking institutions
- ii) Non-banking Islamic financial institutions

While the former includes those institutions which have come to be known as Islamic banks, the second category may include a host of other institutions such as Islamic investment companies, Islamic insurance companies as well as specialised financial institutions.

ISLAMIC BANKING INSTITUTIONS

The Islamic banks may be classified according to their purpose in the following categories:

DEVELOPMENT BANKS

The main purpose of development banks is to foster the process of social economic development amongst its members. Usually its clientele includes the governments. Among the existing Islamic banks, the example of such link is the Islamic Development Bank which is an international financial institution of 45 member countries.

SPECIALISED ISLAMIC BANKS

Some Islamic banks may be established to achieve specific purpose or to serve special class of clientele. Such banks may be termed as specialised Islamic banks and may further be classified into Islamic social banks, Islamic agricultural banks, Islamic industrial banks, Islamic cooperative banks, etc.

The specialised banks offer a wide scope in the Islamic countries. If appropriately established and mobilised, they can succeed in solving several economic problems in the Muslim countries and could be an important potential vehicle of transformation of social and economic life. For example, in many Muslim countries, saving ratios are low mainly because a large number of Muslims, particularly in the

rural areas, avoid the use of banking facilities, even if available, because they wish to avoid *riba*. This leads to hoarding of saving. This situation could be remedied by opening Islamic saving banks whose main function would be to promote small savings and invest them through Islamically permissible modes of investment. This could go a long way in mobilising resources for economic development in these Islamic countries.

Among the existing Islamic banks there are several Islamic banks which could be described as specialised Islamic banks. Islamic Bank for Western Sudan has been established to promote specifically the development of western Sudan. The Sudanese Islamic Bank is fast emerging as an Islamic financing institution which is specialised in the area of rural development, agricultural financing and small-scale industries. Similarly, Islamic Cooperative Development Bank is devoted to the development of cooperative societies in Sudan. However, the emergence of specialised Islamic banks is still a limited phenomenon. Full potential of this type of Islamic banking remains to be utilised.

ISLAMIC COMMERCIAL BANKS

The purpose of Islamic commercial banks is to provide normal commercial banking service in accordance with the Islamic *Shari'ah*. The basic motive behind the operation of these banks is profit earning. They are distinct from other commercial banks. These institutions do not trade in *riba* and conduct only those business activities which are permissible by the *Shari'ah*. Thus, these Islamic banks offer alternative banking service to those who like to avoid *riba*-based banking. Most of the existing Islamic banks belong to this type.

NON-BANKING ISLAMIC FINANCIAL INSTITUTIONS

The commercial banks and specialised banks do not and cannot satisfy all kinds of financial needs. Hence, other non-banking financial institutions are required. These non-banking financial institutions could also be either established or or-

ganised on Islamic principles without indulging in *riba*. The non-banking financial institution could be established for various purposes, for instance, to provide long-term finance for the industries, or to support specific activity in the economy such as housing. Among the existing institutions, Tabung Haji and House Building Finance Corporation of Pakistan are good examples of non-banking Islamic financial institutions.

Classification on the Basis of Ownership

Any particular ownership pattern is not specific to Islamic banks. Even the existing Islamic banks reveal a diversified ownership structure.

On the basis of ownership, Islamic banks could be classified into international Islamic banks, privately-owned Islamic banks, publicly-owned Islamic banks and joint-venture Islamic banks. The Islamic Development Bank is an international bank in the sense that the governments of different member countries have subscribed to its share capital. All Islamic banks in Iran and some major banks in Pakistan are in the public sector. Most of Islamic banks in Sudan are joint-venture banks between the Sudanese capital and foreign capital. Most other existing Islamic banks are privately owned.

Organisational and Financial Structure

Most of the existing Islamic banks are joint stock companies. The organisational structure of Islamic banks is not much different from the usual structure of such companies. The company is floated either by a few individuals or governmental agencies. Sometimes certain restrictions are imposed on subscription of these shares according to law of the land or as the situation may demand. For instance, only Kuwaiti nationals are allowed to hold the shares of the Kuwait Finance House, or in the case of the Jordan Islamic Bank the law requires that the total number of the shares held by any individual should not exceed 5 percent of the total capital of the bank unless such excess results from inheritance or any other

such method and is approved by the law. Such restrictions do not have much to do with the nature of Islamic banking but reflect the general philosophy and business ethos of the country concerned.

The operation of Islamic banks is also quite similar to the operation of joint stock companies. The shareholders elect a shareholders' committee and a board of directors headed by a managing director or chairman who is responsible for the day-to-day functioning of the company.

In terms of ownership of shares also, the existing Islamic banks show a varied pattern. The Nasser Social Bank is hundred percent government-owned. Various ministries of the Kuwaiti government have 49 percent equity in the Kuwait Finance House. In a number of cases, the governments have subscribed to the capital of Islamic banks. For example, the financial structure of the Bahrain Islamic Bank is as follows: Kuwait government 17.4 percent, Bahrain government 10.4 percent, Islamic Development Bank 13.0 percent, Kuwait Finance House 8.7 percent, Dubai Islamic Bank 4.4 percent and private shareholders 3.7 percent. In some cases, religious bodies and governments have subscribed to most of the capital. In case of Bank Islam Malaysia, the government contributed 37.5 percent, Pilgrims Management and Fund Board 10 percent, Muslim welfare organisations of Malaysia 5 percent, state religious councils 17 percent, state religious agencies 6 percent and federal agencies subscribed 12 percent. The government of Bangladesh has 51 percent shares of the subscribed capital of the Islamic Bank of Bangladesh.

Thus, we see that holding companies, governments, religious organisations, government bodies, etc. have subscribed to the capital of different Islamic banks. Some Islamic banks have subscribed the capital of some other Islamic banks. The Islamic Development Bank has also equity shares in a number of Islamic banks working in different countries.

Some Islamic banks, about whom relevant data is available, have been ranked by the shareholder equity. This information has been presented in the Table 4. The DMI tops the list which has an equity of US\$283 million. Top five Islamic banks ranked by equity are: DMI (\$283 million), Kuwait

Finance House (\$146 million), Faisal Islamic Bank of Egypt (\$97 million), Al-Barakah International Bank, London (\$81 million) and Faisal Islamic Bank of Sudan (\$53 million).

TABLE 4
Islamic Banks Ranked by Shareholders' Equity

Name of the Bank	Equity in US \$ mn	Ranking
Dar al Mal al Islami, Bahamas	283.00	1
Faisal Islamic Bank, Bahamas	3.41	21
Faisal Islamic Bank, Bahrain	26.17	9
Al-Barakah Islamic Bank, Bahrain	51.56	6
Bahrain Islamic Bank	19.11	13
Bangladesh Islamic Bank	3.31	22
Islamic Bank International, Denmark	9.51	16
Faisal Islamic Bank, Egypt	97.20	3
Islamic International Bank, Cairo	8.47	17
Jordan Islamic Bank	29.65	8
Kuwait Finance House	145.96	2
Bank Islam Malaysia	33.55	7
Qatar Islamic Bank	20.33	11
Faisal Islamic Bank, Sudan	53.31	5
Tadamoon Islamic Bank, Sudan	9.57	15
Islamic Bank for Western Sudan	5.33	20
Sudanese Islamic Bank	11.46	14
Bait-ct-Tamwil Saudi Tunisi	25.78	10
Faisal Finance Institution	8.09	18
Al-Barakah Turkish Finance House	7.35	19
Dubai Islamic Bank	19.24	12
Al-Barakah International Bank, London	81.60	4

A large number of Islamic financial institutions are working in the unorganised financial markets of several countries, particularly in the Muslim minority countries such as India, UK, US and other countries of Europe. These include saving and loan associations, credit associations, cooperative societies, cooperative funds, Islamic funds and cooperative credit societies. All these institutions make an effort to conduct their activities without dealing in interest and in conformity with the Islamic principles. However, to date very little is known about these institutions. There is a need to collect more data about these institution in a scientific manner.

The banking system in Pakistan and Iran has been reorganised in the last decade to operate along the Islamic principles. Since such efforts have been undertaken at the economy-wide level and raise a number of issues, it has not been included here and interested reader may refer to other chapters in this book or relevant literature available elsewhere.

Experience of Islamic Banks: Some Conclusions

For a number of reasons, it is difficult to compare the performance of different Islamic banks. First of all, there is omnipresent problem of lack of relevant, appropriate and reliable data. The most common source of information on Islamic banks is annual reports of Islamic banks which contain their balance-sheets and income statements presented to annual meetings of shareholders. These balance-sheets and income statements, however, are also not comparable. Major points of difference may be noted below:

- i) Different Islamic banks use different accounting periods as point of references. Most of them use Hijri calendar while some of them use Gregorian calendar.
- ii) Most of the accounts are presented in terms of national currencies. Fluctuations and instability in the foreign exchange markets pose a number of conceptual and empirical difficulties in their conversion to a common denominator such as US dollar.

- iii) Islamic banks use different accounting concepts subject to their national rules and regulations and accounting practices. Because of the differences in the accounting policies adopted by the Islamic banks, same magnitude reported by two different Islamic banks may not be exactly comparable. Lately, however, Islamic banks are taking necessary steps to adopt uniform accounting standards. At present, efforts are under way to set up an accounting standard board of Islamic banks, responsible for issuing relevant accounting standards.
- iv) Differences could also be noticed in the components of the balance-sheets and names of elements and accounts included in the balance-sheets and income statements.
- v) Some Islamic banks present their yearly and financial accounts based on primary accounts only while others include more details in their financial statements.

Notwithstanding what has been stated above, the International Association of Islamic Banks has been preparing aggregate balance-sheets for about 20 Islamic banks which are its members. Although the data prepared by it should be carefully interpreted, keeping the above provisions in mind it could be helpful in identifying some trends at least tentatively.

The data collected by the association suggest that at present those Islamic banks which are its members handle financial business close to a billion US dollars. If the coverage of the reporting banks could be enlarged, this figure would significantly be revised upward.

Studies conducted so far indicate that Islamic banks (i) use predominantly *murabaha* technique of financing (ii) provide mostly short-term finance (iii) finance short-term domestic and foreign trade more than anything else.

The evidence based on the data suggests that Islamic bank-

ing movement is a dynamic movement and even the characteristics described above and criticised elsewhere in the literature are changing. Table 5 gives the sectoral composition of finance provided by some selected Islamic banks. It suggests that industry has also started attracting finances from various Islamic banks, Faisal Islamic Bank of Egypt provides 30 percent of its total finance to industry. In case of Faisal Finance Institution, this figure goes up even more. Sudanese Islamic Bank is doing extremely valuable and innovative work in providing finance to agriculture. In 1988, 34 percent of its total finance went to the agricultural sector. Hence, it could be said that although for most of the Islamic banks, trade and services sector claim bulk of finance provided, the sectoral composition is nevertheless changing for some other Islamic banks, particularly in the countries where the national economic situation demands so.

Similarly, in terms of use of financial techniques, reliance on *mudarba* has started declining for certain banks. They are more and more relying on *musharakah* as a financing technique. In this connection, the cases of the Jordan Islamic Bank in the field of industry and of the Sudanese Islamic Bank in agriculture need special mention.

However, the term structure of investment made by the Islamic banks still needs some attention. The data given in the Table 6 on term structure of about 20 Islamic banks reveal that short-term investment still dominates the scene. The medium- and long-term investment is only about 10 percent of total investment. In order to be able to play an effective role in the social and economic development of the Muslim countries, the Islamic banks will have to find the ways and means to increase their proportion of medium- and long-term productive investment. However, it may be argued that this cannot be done overnight. As Islamic banks gather more experience and improve their financing techniques, they will venture into new areas or assume a more socially relevant role.

In conclusion, it may be said that we should not adopt a static view of Islamic banking. Banking is an activity where one is concerned with the management of other people's money. That is why bankers all over the world are conservative and cautious people. Hence, changes coming to the bank-

ing sector are usually slow. Furthermore, Islamic banking is just 15 years old. It needs more time to grow and mature. Nevertheless, current scene of Islamic banking is dynamic in which changes within the system are continuously occurring. The need of the hour is to strengthen these emerging trends.

TABLE 5
Sectoral Composition of Finance Provided by
the Selected Islamic Banks, 1988

Name of the bank	Industry	Trade	Agriculture	Services	Other	% of total
Faisal Islamic Bank, Egypt	30.6	30.4	3.0	36.0	NA	100
Dubai Islamic Bank	NA	90.6	NA	7.6	1.8	100
Sudanese Islamic Bank	23.5	10.8	34.0	10.0	21.7	100
Faisal Finance Institution, Turkey	79.9	30.4	16.9	NA	NA	100

Source: Compiled from the information contained in the aggregate balance-sheets prepared by the International Association of Islamic Banks presented at 6th expert-level meeting on Islamic banking on May 26-28, 1990, Bahrain.

TABLE 6
Term Structure of Investment by
20 Islamic Banks, 1988

Type of investment	Amount	% of total
Short term	4,909.8	68.4
Social lending	64.2	0.9
Real-estate investment	1,498.2	20.9
Medium- and long-term investment	707.7	9.8

Source: Aggregate balance-sheets prepared by the International Association of Islamic Banks, Bahrain, 1988.

STATEMENT I
List of Islamic banks and IFIs

Country	Name of Islamic bank or IFI	Year of establishment
Bahrain	Bahrain Islamic Bank	1979
"	Faisal Islamic Bank	1983
"	Islamic Investment Company	1981
"	Al-Barakah Islamic Bank	1984
"	Arabic Islamic Bank	1990
Bangladesh	Bangladesh Islamic Bank	1983
"	Al-Barakah Islamic Bank	1987
Bahamas	Faisal Islamic Bank	1980
Cyprus	Faisal Islamic Bank	1982
Denmark	Islamic Bank International	1983
Egypt ⁽ⁱ⁾	Nasser Social Bank	1971
"	Faisal Islamic Bank	1977
"	Islamic International Bank for Finance and Investment	1980
"	Saudi-Egyptian Finance Bank ⁽ⁱⁱ⁾	1988
Guinea	Financial Islamic Bank	1984
"	Islamic Investment Company	1984
India	Al-Ameen Finance & Investment Company	1986
Iran ⁽ⁱⁱⁱ⁾	Iran Islamic Bank	1979
Jordan	Jordan Islamic Bank	1978
"	Islamic Finance House Company	1981
"	National Islamic Bank	1988
Kuwait	Kuwait Finance House	1977
Luxembourg ^(iv)	Islamic Finance House Universal Holding	1978
Malaysia	Bank Islam Malaysia, Berhad	1983

(i) In Egypt, there are a number of commercial banks which operate Islamic branches or Islamic windows. It is reported that there are more than 60 Islamic branches of various commercial banks throughout Egypt. The Misr Bank was the first Egyptian bank to start an Islamic window which started operating in 1980.

(ii) It was previously known as Al-Ahram Bank.

(iii) All Islamic banks function in accordance with the Islamic principles.

(iv) The previous name of the company was Islamic Banking System.

Malaysia	Tabung Haji ^(v)	1963
Mauritania	Al-Barakah Islamic Bank	1985
Morocco	Bank Al-Agecdah	1985
Niger	Faisal Islamic Bank	1984
"	Islamic Investment Company	1984
Pakistan ^(vi)	National Investment Trust	1979
"	Banker's Equity Ltd.	1981
Philippines	Philippine Amanah Bank	1982
Qatar	Qatar Islamic Bank	1983
"	Islamic Investment Company	1983
"	Qatar International Islamic Bank	1990
Saudi Arabia	Islamic Development Bank	1975
	Al-Barakah Investment & Dev. Co.	1982
Sudan	Faisal Islamic Bank of Sudan	1977
"	Tadamon Islamic Bank	1984
"	Islamic Bank for Western Sudan	1983
"	Islamic Coop. Dev. Bank	1983
"	Al-Barakah Islamic Bank	1983
"	Islamic Investment Company	1984
Switzerland	Dar al Mal al Islami (DMI)	1984
"	Islamic Investment Services Co.	1984
Senegal	Faisal Islamic Bank	1984
"	Islamic Investment Company	1984
South Africa	Islamic Bank	1988
Turkey	Faisal Finance Institution	1985
"	Al-Barakah Turkish Finance House	1985
"	Turkish-Kuwaiti Finance House	1989
Tunis	Saudi-Tunisian Finance House	1983
UAE	Dubai Islamic Bank	1975
"	Islamic Invest. Co. of the Gulf	1977
"	Arab Insurance Company	1980
UK	Islamic Finance House	1982
"	Al-Barakah International Bank Ltd	1984

(v) Former name of Tabung Haji is Pilgrims Management and Fund Board of Malaysia. Although not exactly an Islamic bank, it is an important financial institution which accepts deposits and invests them according to Islamic principles.

(vi) The commercial banking system in Pakistan has been reorganised along the Islamic lines.

Source: Aberraham Lahlou: *La Banque Islamique à la Recherche de l'Excellence*, Casablanca.

STATEMENT II

Financial Indicators of Selected Islamic Banks

(in thousand US dollars)

Name of the Bank	Authorised capital	Paid-up capital	Shareholders equity	Total assets	Total deposits	Profit
DMI Bahamas (1987)	100,000	279,995	283,086	343,552	NA	8,716
Faisal Islamic Bank, Bahamas (1986)	2,000	2,000	3,417	4,834	NA	1,055
Faisal Islamic Bank, Bahrain (1985)	30,000	30,000	26,177	45,298	NA	2,022
Al-Barakah Islamic Investment Bank, Bahrain (1987)	200,000	50,000	51,566	239,999	157,618	2,281
Bahrain Islamic Bank (1986)	61,186	15,296	19,116	187,379	158,728	8,398
Bangladesh Islamic Bank (1985)	20,312	3,229	3,310	79,909	79,678	317
Al-Barakah Bank, Bangladesh (1987)	19,480	4,870	NA	NA	NA	NA
Islamic Bank International, Denmark (1987)	6,000	6,000	9,512	36,994	16,470	5,39
Faisal Islamic Bank of Egypt (1987)	500,000	70,000	97,200	195,100	1,505,500	10,000
Islamic Int'l Bank for Investment and Development, Cairo (1985)	100,000	11,420	8,477	723,832	474,609	NA
Jordan Islamic Bank (1987)	15,227	10,151	29,656	589,304	473,146	2,462
Kuwait Finance House (1987)	79,287	79,287	145,980	1,879,598	2,510,308	10,307
Bank Islam Malaysia (1987)	200,144	31,623	33,552	373,196	330,510	1,801
Qatar Islamic Bank (1987)	54,947	13,736	20,330	355,230	334,350	3,571
Faisal Islamic Bank (1987)	40,000	23,360	33,316	243,876	159,766	270
Tadamon Islamic Bank Sudan (1985)	50,000	13,200	9,577	60,262	33,710	624
Islamic Bank for Western Sudan (1987)	100,000	5,000	5,333	34,952	21,422	49
Sudanese Islamic Bank (1986)	20,000	19,365	11,463	52,942	36,258	1,530
Beit-et-Tamwil Saudi Tunisi (1986)	50,000	25,000	25,780	108,787	50,408	1,37
Faisal Finance Institution, Turkey (1986)	9,579	9,579	8,098	89,514	67,805	3,91
Al-Barakah Turkish Finance House (1987)	1,307	9,019	7,354	101,588	69,934	3,449
Dubai Islamic Bank	16,100	16,100	19,249	427,299	385,696	10,236
Al-Barakah International Bank	177,525	35,505	81,608	101,477	77,037	32

STATEMENT III**Addresses of Islamic banks****KUWAIT FINANCE HOUSE**

Chairman	Sheikh Ahmed Bazie al Yasin
Managing Director	Mr Bader al Mohsin Mukhazcem
Postal Address	P.O. Box 24989, Al Safar 13110, Kuwait
Telex	23331 KT BAITMAI.
Fax	(00965) 2455135
Phones	2445050-2445070-2447668

DUBAI ISLAMIC BANK

Chairman	Sheikh Syed Ahmed Lootah
General Manager	Mohammad Ayub Mohammad
Postal Address	P.O. Box 1080, Deira, Dubai, UAE
Telex	487743 or 45889 ISLAMI EM
Fax	237243
Cable	ISLAMI DUBAI, UAE
Phone	2148888

QATAR ISLAMIC BANK

Chairman	Sheikh Ahmad Abdul Rehman bin Abdullah al Mahmoud
Managing Director	Mr Khalid bin Ahmad al Swaidi
General Manager	Mr Ahmad Ebrahim Seddiqi al Emadi
Postal Address	P.O. Box 559, Doha, Qatar
Telex	5177-5176 ISLAMI DH
Fax	412700
Cable	ISLAMI DOHA
Phones	409409-439339

AL-BARAKAH ISLAMIC INVESTMENT BANK, BAHRAIN

Chairman	Dr Hassan Abdullah Kamel
General Manager	Mr Abdullah Abolfatch
Postal Address	P.O. Box 1882, Manama, Bahrain
Telex	8220 BARAKA BN
Fax	252039
Phone	250641

FAISAL ISLAMIC BANK, BAHRAIN

Chairman	Sheikh Abdullah Ahmad Zainal Ali Reza
Managing Director	Mr Nabeel Abdullah Nassief
Telex	97270 FAIBK BN/9411 FAIFX BN
Fax	275040
Cable	MASFASLAM
Phone	275040

JEDDAH OFFICE

Managing Director	Mr Nabeel Abdullah Nassief
Postal Address	P.O. Box 9707, Jeddah 21423
Telex	603763 DARMAL SJ
Fax	6516552
Phones	6525920-6516900-6513496-6518092

RIYADH OFFICE

Office Director	Mr Abdel Aziz A. Abalkhail
Postal Address	P.O. Box 252, Riyadh 11411
Telex	401180-4653319
Phones	4651063-4633895-4652255

BAHRAIN ISLAMIC BANK, BAHRAIN

Chairman	Sheikh Abdul Rehman M.R. Al Khalifa
Managing Director	Mr Abdul Latif A.R. Janahi
Postal Address	P.O. Box 5240, Manama, Bahrain
Telex	9380-9388 BESMEH BN
Fax	275734
Cable	BANKISLAMI
Phones	231402-2330909

FAISAL ISLAMIC BANK, SUDAN

Chairman	Prince Mohammad al Faisal al Saud
Managing Director	Mr Baqir Yousif Mudawe
Postal Address	P.O. Box 10143, Khartoum, Sudan
Telex	22519-22163 FEBS SDN
Cable	BANK ISLAMI, KHARTOUM
Phones	77772-81970-81982

ISLAMIC BANK FOR WESTERN SUDAN

Chairman	Mr Ibrahim Moncim Mansour
Managing Director	Mr el Sharif el Khatim Mohammed
Postal Address	P.O. Box 3575, Khartoum, Sudan

Telex 23046 WISB SDN
Cable BANKAL GHARB, KHARTOUM
Phones 79918-73952-76839

AL-BARAKAH BANK, SUDAN

Chairman Mr Mahmoud Jamil Hassouba
General Manager Mr Moawia Abdel Wahab Taha
Postal Address P.O. Box 3583, Khartoum, Sudan
Telex 22479-22555 BARAKA SD

TADAMON ISLAMIC BANK, SUDAN

Chairman Mr Khidir Hasan Kamball Hassouba
General Manager Mr Salah Ali Abu Najah
Postal Address P.O. Box 3154, Khartoum, Sudan
Telex 22687-22688-22158 DAMAN SD
Cable TDBANK
Phones 74432-81877-70417

SUDANESE ISLAMIC BANK

Chairman Mr Ahmad Ali el Mirghani
Managing Director Mr Mohammed Osman Khalcefa
Postal Address P.O. Box 6442, Khartoum, Sudan
Telex 22043 SMAKKAH SD
Cable ISLAMASRAF
Phones 81284-81891-74552

ISLAMIC COOPERATIVE DEVELOPMENT BANK

Chairman Prof Mohammed Hashim Awad
Managing Director Mr Tajelsir Abdel Rehman Abdullah
Postal Address P.O. Box 62, Khartoum, Sudan
Telex 22906 ISCOB SD
Cable ISCOBANK
Phones 80223-80505-75366

FAISAL ISLAMIC BANK OF EGYPT

Chairman Prince Mohammed al Faisal
Managing Director Mr Ahmad Zindo
Postal Address P.O. Box 2246, Cairo, Egypt
Telex 93877-93878 FBANK UN
Fax 777301
Cable FAISALBANK CAIRO
Phones 753109-753165-742113

ISLAMIC INT'L BANK FOR INVESTMENT AND DEVELOPMENT

Chairman	Mr Mahmoud Mohammed Yousef
General Manager	Mr Adel Khalifa Tantawy
Postal Address	P.O. Box 180, Orman, Cairo, Egypt
Telex	94248 IBID UN 22442-22443 IBID UN
Fax	3498501
Cable	ISLAMASSRAF
Phones	3486609

NASSER SOCIAL BANK, CAIRO

Chairman	Mr Nasef Abdel Maksoud Tahoun
Managing Director	Mr Hussein al Tounsi
Postal Address	P.O. Box 277, Cairo, Egypt
Telex	92754 NSR BK UN
Fax	3498501
Cable	NSRBAK
Phones	3921930-3924484-3939868

JORDAN ISLAMIC BANK FOR FINANCE AND INVESTMENT

Chairman	Sheikh Saleh Abdullah Kamel
Managing Director	Mr Musa Abdel Aziz Shihadah
Postal Address	P.O. Box 926225, Amman, Jordan
Telex	21125-23993 ISLAMI JO
Fax	9626/666326
Cable	677377-666325
Phones	677377-666325-676944

AL-BARAKAH MAURITANIAN ISLAMIC BANK

Chairman	Sheikh Saleh Abdullah Kamel
Managing Director	Mr M. Sidi Mohammed Elemine
Postal Address	P.O. Box 650, Avenue du Roi Faysal, Nauakchott
Telex	535 MTN or 706 MTN
Fax	9626/666326
Phones	51424-52266

BEIT ET-TAMWIL SAUDI-TUNISI

Chairman	Dr Hassan Kamel
Managing Director	Dr Moncef Sheikh Rouhou
Postal Address	90-92 Avenue Hedi Chaker 1002, Tunis
Telex	535 MTN or 706 MTN
Fax	780235
Phones	790000-275275

ISLAMIC BANK OF BANGLADESH

Chairman	Commodore (R) Mohammad Aatur Rahman
Managing Director	Mr Azizul Haq
Postal Address	71, Dilkusha Commercial Area G.P.O. Box 233, Dhaka 1000, Bangladesh
Telex	642525 IBANK BJ
Cable	ISLAMI BANK
Phones	243040-259817-258917

BANK ISLAM MALAYSIA, BEHRAD

Chairman	H.M. Raja Tan Sri Mohar Raja Badiozaman
Managing Director	Dr Abdul Halim Ismail
Postal Address	P.O. Box 11080, Kuala Lumpur 50, Malaysia
Telex	MA 31785 BIM-ADM MA 31783 BIM-OPS
Fax	(603) 2535566
Cable	BANKISMA KUALA LAMPUR
Phones	2935569-2535566

**ISLAMIC FINANCE HOUSE UNIVERSAL
HOLDING, LUXEMBOURG**

Chairman	Mr Abdel Rahmaan Salem al Atiqui
Managing Director	Mr Galal Osman
Postal Address	Monetary Palace, 11 Boulevard Joseph II L-1840, Luxembourg
Telex	1898 ISBAHO LU
Fax	454074
Phones	(00352) 453983-453984

ISLAMIC BANK INTERNATIONAL OF DENMARK

Chairman	Mr Abdel Rahmaan Salem al Atiqui
Managing Director	Mr Eli Therkidsen
General Manager	Mr Poul Tage Madsen
Postal Address	P.O. Box 271, Jernbanegade 1608, Copenhagen
Telex	16478 ISBABNK DK
Fax	(45) (33) 3207144074
Cable	ISLAMI BANK
Phones	01-451-114777

AL-BARAKAH TURKISH FINANCE HOUSE

Chairman	Sheikh Saleh Abdullah Kamel
Managing Director	Mr Yalcin Oner
Postal Address	Buyukdere Cad. No 78 Akabe Tic. Merkezi 80300 Mecidiyekoy Istanbul, Turkey.
Telex	31257 SALBT TR-27061 ABRT TR
Fax	(90-1) 1670737
Phones	(90-1) 1749900 (23 lines)

FAISAL FINANCE INSTITUTION INC., TURKEY

Chairman	Prince Mohammad al Faisal
Managing Director	Mr Ekrem Onal
Postal Address	Kemetralt Sir. 46, Tophane 8003 Istanbul, Turkey.
Telex	2569 FFK TR-25729 FFKS TR
Fax	4556337
Cable	FAISAL, TOPHANE ISTANBUL
Phones	(90-1) 1516520 (10 lines)

FAISAL ISLAMIC BANK, SENEGAL

Chairman	Dr Mahmoud el Helw
Managing Director	Mr Assane Diop
Postal Address	P.O. Box 3381, Dakar, Senegal
Telex	255 DMISG
Phones	219920-219802

FAISAL ISLAMIC BANK, NIGER

Chairman	Dr Mahmoud el Helw
Managing Director	Mr Al Amine al Mokhtar
Postal Address	P.O. Box 12754, Niamey, Niger
Telex	5440 NI
Cable	DMI NIGER
Phones	735720-735722

KUWAIT-TURKISH AWAKAF FINANCE HOUSE

Chairman	Sheikh Ahmad Bazie al Yassin
Managing Director	Mr Fehmi Akin
Postal Address	Buyukdere Cad. 97, 80300 Mecidiyekoy Istanbul, Turkey.
Telex	39182 KUEV TR-39171 TTEF TR
Fax	(1) 1666348-1752419
Phone	(1) 1752435

AL-BARAKAH BANK BANGLADESH LTD.

Chairman	Sheikh Saleh Abdullah Kamel
Executive President	Mr A.N. Hamidullah
Postal Address	Kashfia Plaza 35/C, Naya Paltan, VIP Road Dhaka 1000, Bangladesh.
Telex	632118 AIB HO BJ
Fax	880-2-411322-1752419
Phones	2430261-4

AL RAJHI BANKING AND INVESTMENT CORPORATION

Chairman	Sheikh Salah bin Abdul Aziz Rajhi
Managing Director	Sheikh Sulayman bin Abdul Aziz Rajhi
Postal Address	P.O. Box 28, Riyadh 11411, Saudi Arabia
Telex	406317
Fax	4034407
Phone	4054244

ARAB ISLAMIC BANK (E.C.)

Chairman	Sheikh Hisham Ali Hafiz
Managing Director	Sheikh Hedar Mohammad bin Laden
General Manager	Dr Umar Zohair Hafiz
Postal Address	Bahrain Chamber of Commerce and Industry Building, 3rd Floor, P.O. Box 2145, Manama, Bahrain.
Fax	210399
Phone	213030

1. Principal subsidiaries of the DMI are: Islamic Investment Company of the Gulf, Sharjah; Islamic Investment Company of the Gulf, Bahrain; Faisal Islamic Bank, Bahrain; Faisal Islamic Bank, Niger; Faisal Islamic Bank, Senegal; Faisal Islamic Bank and Trust, Bahamas; Islamic Investment Company, Niger; Islamic Insurance Company, Bahrain; Islamic Insurance Company, Luxembourg; Islamic Insurance and Reinsurance Company, Bahamas; DMI, Geneva; Shari'ah Investment Services, Geneva; and DMI Investment Services, Jersey. In addition to these, the DMI also has interests in different Faisal Islamic Banks in many countries such as Faisal Islamic Banks in Sudan, Egypt and Faisal Finance Institution in Turkey.

2. The Al-Barakah Holding Company consists of the following: Al-Barakah Investment and Development Company, Saudi Arabia; Beit-et-Tamwil Saudi-Tunisi, Tunis; Al-Barakah International Ltd., England; Al-Barakah International Bank Ltd., England; Al-Barakah Turkish Finance House, Turkey; Al-Barakah Islamic Investment Bank, Bahrain; Al-Barakah Bank Sudan; Arabian-Thal International Company, Thailand; Al-Barakah Islamic Bank of Mauritania; Al-Barakah Islamic Bank, Bangladesh; Al-Barakah Bancorp, Texas, USA; and Al-Barakah Bancorp, California, USA. It also has financial institutions in Djibouti, India and Pakistan.

ANNEXURES

Financing by Lending with Service Charge as Defined by the State Bank of Pakistan

This is a charge which the banks will recover from their customers on the loans advanced to them and is mainly applicable in the case of financing of:

- exports, under the State Bank export finance scheme, and the scheme for financing locally manufactured machinery;
- other priority areas where either participation in profit or loss is not possible or the possibility of loss is imminent, e.g. financing for agricultural inputs to small farmers; and
- for lending small loans to salaried class for consumption purposes who do not qualify for *qard-e-hasan* on compassionate grounds or cannot be financed on the basis of any other mode of financing, such as small amounts of temporary overdrafts created in a current account due to unavoidable payment for a cheque.

The maximum rate of service charge which a bank or DFI may recover on its loans other than *qard-e-hasan* during an accounting year shall be calculated by dividing the total of its expenses excluding cost of funds and expenditure relating to bad assets and income taxation by mean of its total assets at the beginning and the end of the year and rounding off the result to the nearest decimal of a percentage point. This is illustrated below:

The service charge recovered during a particular year is

Annexures I & II explain Dr M Fahim Khan's paper, *Riba-Free Alternatives for Transactions in Commercial Banking: A Blueprint*, on page 117.

subject to adjustments according to the rate determined on the basis of the actual audited expenses incurred during the accounting year. A maximum rate of service charge permissible to each bank will be determined by the State Bank from time to time in the following format:

Name of the bank

Maximum rate of service charge recoverable
for the year ended...

CALCULATION SHEET

(In million Rs)

1.	Total expenditure (total income less balance of profit, i.e. gross profit, as per audited profit-and-loss account)	4,775
2.	Less:	
	i) Interest and return on deposits borrowing, etc.	3,600
	ii) Income tax and provision for it if charged to expenses account	50
	iii) Bad debts provision and write-offs by direct debit to expenses account	25
	Total:	3,675
3.	Administrative expenditure, i.e. 1 minus 2	1,100
4.	Total assets at the beginning of year	29,000
5.	Total assets at the end of year	35,000
6.	Average of the total assets at the beginning and end of year	32,000

Service charge in percentage terms to the nearest decimal point (3 divided by 6 and multiplied by 100)

$$= \frac{1100 \times 100}{32,000} = 3.4 \%$$

STATE BANK OF PAKISTAN
Banking Control Department Central Directorate,
Karachi
BCD circular No. 34 November 26, 1984

All banks and development finance institutions

Dear sirs:

Elimination of riba from the banking system and
determination of rates of profit on various types
of PLS liabilities of the banks and DFIs

In exercise of the power vested in it under the Banking Companies Ordinance, 1962, the State Bank of Pakistan is pleased to direct that a banking company or development finance institution receiving PLS deposits shall declare rates of profit on various types of its PLS deposits on a half-yearly basis for the half year ending June 30, and the half year ending December 31, each year after obtaining clearance from the State Bank in regard to the rates of the profit proposed to be declared. The proposed rates should be worked out after compiling the relevant information in the enclosed proformas 'A', 'B', 'C', 'D' and 'E' which also give numerical illustrations for guidance in determining the rates. Proposals along with information in the aforesaid proforma in regard to the rates proposed to be declared for each half year shall be submitted to the State Bank by the 20th of the month succeeding the half year.

As explained in the proforma 'E' enclosed, while distributing non-interest income in the manner spelt out therein, the following weightages will be given to PLS deposits, PLS borrowings and equity:

The amount of non-interest income distributable on PLS deposits of each type and maturity will be converted into an annual percentage rate of profit and the rate rounded off to the nearest one-tenth of a percentage point as illustrated in proforma 'E'.

It would appear that if the non-interest-earning assets are low as compared to PLS deposits, the rate of return on such deposits will be low as in such a situation a part of the funds will remain unutilised. The bank/DFIs should carefully watch the growth of PLS deposits and ensure that their investments in non-interest-bearing assets are substantially higher than the deposits. If for any reason this is not feasible at any stage, the unutilised funds should be deposited with the State Bank on PLS basis as already permitted under BCD circular No. 27 dated December 24, 1980, in the case of banks, which facility is being extended to DFIs also.

Seminar Programme

April 11-13, 1992

Venue: IPS Seminar Hall

A P R I L 1 1 , 1 9 9 2

8:30 **Recitation from the Holy Qu'ran**

8:45-9:45 **Introduction**
Senator Prof Khurshid Ahmad
Chairman
Institute of Policy Studies

10:00-12:30 **Review of FSC Judgement**
Mr Mohammad Akram Khan
Director-General
Audit & Accounts Training Institute
Lahore

**Present state of the Islamisation
of the Financial System in Pakistan**
Dr Ziauddin Ahmad
Former Deputy Governor
State Bank of Pakistan

12:30-14:00 *Lunch and prayers*

14:00-18:30 **(Chairman: Haji Abdul Jabbar)**

Bankers' Response to Islamic Banking
Mr Zaigham M Rizvi
Saudi-Pak Industrial and Agricultural
Investment (Pvt) Ltd

14:00-18:30

Practical Ways to Interest-Free Banking

Mr Muhammad Yusuf
Former Managing Director
Federal Bank for Cooperatives

**Riba-Free Alternatives in
Commercial Banking**

Mr Nawazish Ali Zaidi
Secretary
Commission for Islamisation of Economy

**Blueprint of Riba-Free Alternatives
for Existing Transactions in
Commerical Banking**

Dr Ghulam Qadir
Economist
World Bank

Dr M Fahim Khan
Head, Research Division
Islamic Development Bank

19:00

Dinner

A P R I L 1 2 , 1 9 9 2

8:30-10:30

(Chairman: Dr M Fahim Khan)**Alternative Arrangements for
International Transactions**

Dr Sayyid Tahir
Professor, International Institute of
Islamic Economics
International Islamic University
Islamabad

11:00-13:00

(Chairman: Dr Ziauddin Ahmad)**Preserving the Real Value of Bank
Deposits/Deferred Payments**

Dr Munawar Iqbal

Dr M Fahim Khan

13:00-14:30 *Lunch and prayers*

14:30-19:30 **(Chairman:** Dr Arshad Zaman)

Practical Options for Central Banking

Dr Hasanuz Zaman
Research Department
State Bank of Pakistan

Financing Government Transactions

Dr Ziauddin Ahmad

Dr Faiz Muhammad
Director-General
International Institute of Islamic
Economics, IIU, Islamabad

20:00 *Dinner*

A P R I L 1 3 , 1 9 9 2

8:30-10:30 **(Chairman:** Mr Ebrahim Sidat)

**Review of Mudarba Floatations
in Pakistan**

Dr Ghulam Rasool
Former Economic Adviser
Ministry of Finance

**Mudarba Ke Karobar Ka Jaiza: Mazi,
Haal, Mustaqbil**

Dr Abdul Malik Irfani
Member, Council of Islamic Ideology

11:00-12:30 **Review of Insurance Practices
and Their Islamic Alternatives**

Mr M A Chishtie
Managing Director
Delta Insurance Company

12:30-14:00 *Lunch and prayers*

14:00-16:00 (Chairman: Mr Mohammad Yousuf)

**Legal Framework for An Islamic
Financial System with Special
Reference to Company Law &
Mercantile Law in Pakistan**

Mr Ebrahim Sidat, FCA
Sidat Hyder Aslam and Co

16:45-18:45

Chairman

Mr Sartaj Aziz
Finance Minister
Government of Pakistan

**Elimination of Riba:
Pledges and Promises**

Communique and Concluding Remarks
by Distinguished Participants

- Prof Khurshid Ahmad
- Mr Abdul Jabbar Qasim
- Dr Ghulam Rasool
- Mr Khalid Laif
- Mr Nawazish Ali Zaidi
- Dr Faiz Muhammad
- Dr Ziauddin Ahmad

19:30

Dinner

Participants

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