

Chapter III

**ADMISSIBLE (ISLAMIC) MODES OF FINANCING
IN PAKISTAN**

Before discussing the (Islamically) permissible modes of financing approved by the State Bank of Pakistan, let us first of all, understand what Islamic banking really means, and secondly, review the historical perspective of the process of Islamization of the financial system in Pakistan. Without this background, the experiment of Islamic banking in Pakistan cannot be properly comprehended.

ISLAMIC BANKING:

The Islamic laws enunciated by the Quran and Prophet's *Sunnah* are supposed to be the guiding principles for Islamic socio-economic system. It is therefore thought incumbent upon any Islamic society to accept and implement these laws. Islamic banking, an integral part of the Islamic economic system must therefore conform to Islamic laws and should be implemented in accordance with the "ethos of value system of Islam."¹

¹Ahmad, Ziauddin, (1984), p. 1.

The Quran explicitly and emphatically prohibits *riba* and since there is complete unanimity among religious scholars and Muslim economists that the term *riba* stands for interest in all its types and forms, Islamic banking must therefore be devoid of interest and exploitation. Consequently, the Islamic banks will serve as financial intermediaries, mobilising savings from the public on the basis of profit-sharing and making advances to borrowers on the same basis. Entrepreneurs obtaining capital from banks would have to share their profits with the banks according to a mutually agreed ratio. This arrangement along with revenues in the form of fees and commissions charged by banks to its customers for other banking services and deployment of bank's own capital in business ventures shall constitute the earnings and profits of banks. Similarly, in case of a loss, it shall be borne in the ratio of investments.² Therefore the Islamic banks would not be giving loans on fixed interest basis, but shall be having stake in the business in the form of equity holders. Returns to banks, therefore, will not constitute a part of borrower's income statement, but instead would be an allocation of profit determined in the productivity of the real sector.³

²Siddiqui, M. N., (1983), pp. 59-60.

³Iqbal, Zubair and Mirakhor, Abbas (1987), p. 4.

Equity financing, as discussed above and *Qard-e-Hasanah*, a loan which is returnable at the end of agreed period without any interest, are the only two alternatives to interest based lending.⁴ The *Shariah* has, therefore, developed two specific forms of business arrangements, *Mudarabah* and *Musharakah*.

MUDARABAH

It is a form of arrangement where one of the contracting parties called *rabb-al-mal* (the financier), provides capital and acts as sleeping partner while the other party, *mudarib* (agent or entrepreneur), provides the entrepreneurship and management for carrying on any venture with the objective of earning profits. The net profit is to be divided between the *rabb-al-mal* and the *mudarib* in accordance with the agreed ratio specified in the agreement. However in case of losses incurred, they shall be charged to the equity of the *rabb-al-mal*, but his liability in such losses shall be limited to the extent of his contribution.

⁴Chapra, M. Umer, (1985), p. 68.

Musharakah (Sharikah)

Under the *musharakah* agreements two or more than two people enter into a contract by providing capital in different amounts for running a business with the provision that they will share in the profit or loss in some agreed proportion.

These forms along with other admissible modes of financing shall be discussed later. It is however, pertinent to note that although the elimination of interest is certainly a central tenet of the Islamic economic system, it is by no means the only condition for Islamic banking. Islamic banking in fact is expected to participate actively in achieving the goals and objectives of an Islamic economy by effective financial intermediation and equitable income and wealth distribution.⁵

Despite the fact that a lot of study has been conducted on the theory and practice of Islamic banking,⁶ the subject still presents puzzles for academics and policy makers, notwithstanding the fact that its viability

⁵Khan, S. Mohsin, (1986), p.2.

⁶Islamic banking is discussed in detail in Ahmad (1984) and Siddiqui (1983) as well as in the papers in Ahmad, Iqbal and Khan (1983).

is questioned by economists of Western traditions.⁷

The present system in vogue in Pakistan is far from being called Islamic banking system. We shall in the next sections, observe that since only the nomenclature has been changed no tangible results have been achieved towards Islamization of economy. We shall, subsequently study the prerequisites of Islamic banking.

HISTORICAL PERSPECTIVE OF ISLAMIZATION EFFORTS IN PAKISTAN

After the decline of the Islamic state, the decadence of moral values and spread of Western influence in the period of colonial domination of Muslim countries by Western powers, the practise of Islam became a private and personal affair. However, due to the resurgence throughout the Muslim world, serious attention was given to the social, political and economic dimensions of the Islamic system and consequently specialised works started to appear in the fourth decade of this century.

In response to an official reference about *riba* made in March 1963 by the Ministry of Finance, Government of Pakistan, Council of Islamic

⁷Pryor, (1985), for example, is one who is quite skeptical about the feasibility of such a system.

Ideology for the first time examined the issue in their meetings held in June and September 1963.

A decision on this issue was taken by the council in their meeting held in January 13, 1964 at Karachi in the following words:

"The Advisory Council of Islamic ideology agrees that '*Riba*' is forbidden but is in disagreement as to whether "Interest in the form in which it appears in Public transactions" which in the opinion of council includes 'institutional credit' as well would also be covered by '*Riba*' specified in the Holy Quran. There is, however, unanimity on the point that for the fulfillment of the Islamic requirement of social Justice and concept of human brotherhood, a system of interest less economy should be inaugurated. The Council recognises that any abrupt or sudden change will create numerous difficulties for the country. The council recommends that efforts in the direction of establishing an economy free from interest should not be unduly delayed".

During the Council's meeting held on December 10, 1966 at Dacca, a questionnaire was framed which besides other information also sought views on the Quranic definition of *riba* and on the point whether the Quranic prohibition of *riba* applied to simple interest or not.

It is rather surprising to note that it was on basis and after an official query about *riba* in 1963, that the Council of Islamic Ideology for the first time examined this issue. Secondly, in terms of decision of

Council's meeting of 1964 it is apparent that despite the fact that Quranic verses on *riba* are very clear, the Council was in disagreement as to what constituted *riba*. This implies the extent of vagueness which prevailed on the issue in the highest of forums. Furthermore the questionnaire framed by the Council in 1966 was not approved until 1976, indicating the urgency of handling such an important issue. However the Advisory Council of Islamic Ideology in its meeting held on December 23, 1969 itself took the historic decision that increase in the principal amount of a loan was *riba*, irrespective of the fact whether the transaction was between individuals or governments.⁸

The Council of Islamic ideology in its meeting held at Karachi on January 31, 1976 amended its pending questionnaire of December 10, 1966 and finalised the same for general circulation. In its meeting held on January 31, 1977 the Council examined the replies received in response to its questionnaire, and as the response was weak, decided to wait for the opinion of the *Ulama* from other Muslim countries.⁹

The Martial Law regime which came into power in 1977 after a political

⁸Chronology of events have been taken from Zaidi (1987) and (1991).

⁹Zaidi, Nawazish Ali, (1991), p. 3.

crisis undertook a comprehensive scheme of Islamization in the political, legal, economic and educational sectors of the Pakistani society. The then President of Pakistan, (Late) General Muhammad Zia-Ul-Haq, specifically asked the Council of Islamic Ideology on September 29, 1977 to prepare a blue-print of an interest-free economic system and later on the occasion of 12 Rabiul-Awal 1399 (February 10, 1979) set a time limit of three years for the elimination of interest from the economy.¹⁰ The panel of Economists and Bankers which was assigned the job of preparing an interest-free commercial banking framework in Oct/Nov, 1977 by the Council of Islamic Ideology, presented their final report to the Council in February 1980, with some modifications and substitutions, the Council adopted this report on June 15, 1980.

The beginning of the new system named as "non-interest banking system" was made in 1979.¹¹ Effective January, 1st, 1981, nationalised commercial banks in Pakistan were asked to accept 'profit and loss sharing deposits along with interest bearing accounts. However the progress made till end of 1983 was not at all appreciated by the Council. In fact there was no change in the system, the whole approach

¹⁰Please see report of Council of Islamic Ideology on "Elimination of Riba from the Economy and Islamic Modes of Financing", (1991), p. xiii.

¹¹Khan, Abdul Jabbar, (1991), p. 13.

was characterised by dualism.¹²

Based on the deliberations held in various meetings between the banks, the State Bank of Pakistan and the Ministry of Finance, it was announced by the Government that the parallel system would be ended during the course of 1984-85. The Banking Control Department, of the State Bank of Pakistan vide their BCD Circular No. 13, dated June 20, 1984 not only specified the permissible modes of financing, but also the programme under which the required shift had to take place.

The instructions regarding the shift were as under:

- a) As from January 1, 1985 all finances provided by a bank to the Federal Government, Provincial Governments, public sector corporations and public or private Joint stock companies shall be only in one of the specified Islamic Modes of Financing and during the period from July 1, 1984 to December 31, 1984 no accommodation for working capital will be provided or renewed on the basis of interest for a period of more than six months. However, as from July 1, 1984 banks will be free to make finances available on the basis of any one of the specified Islamic

¹²For detailed remarks of the Council, please refer to Council's Annual Report 1983-84. Extracts also appear in Council of Islamic Ideology, (1991).

Modes of Financing.

- b) As from April 1, 1985 all finances provided to all entities including individuals shall be in one of the specified Islamic modes of financing.
- c) As from July 1, 1985 no bank shall accept any interest-bearing deposits and as from that date all deposits accepted by a bank shall be on the basis of participation in profit or loss. Deposits in current accounts will continue to be accepted as at present and no interest or profit shall be allowed on such deposits.
- d) The foregoing instructions of the State Bank of Pakistan shall neither apply to foreign currency deposits in Pakistan nor to on-lending of foreign loans which will continue to be governed by the terms of the loans.

ADMISSIBLE (ISLAMIC) MODES OF FINANCING AND THEIR IMPLEMENTATION BY BANKS¹³

For the conduct of Islamic banking operations, State Bank of Pakistan

¹³For a synoptic view of the system in vogue, please refer to Chapter 2 of "Report on Banks and Financial Institutions" by the Commission for Islamization of Economy, Government of Pakistan, Islamabad, June 6, 1992.

vide their BCD circular 13, dated June 20, 1984 had also approved the following twelve modes of financing to be used by all banks carrying a business in Pakistan.

Financing by Lending

i) Loans Carrying Service Charge:

Under this mode of financing banks may recover a service charge not exceeding the proportionate cost of the operations, 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. The banks are not using this mode in their financing operations as it only covers the actual expenses incurred by a bank.

ii) Qard-e-Hasanah

This is given by banks on compassionate grounds without interest or service charge and the loan is repayable if and when the borrower is able to pay. The branches do not use this type of financing for their usual operations. Cases approved by Head/Controlling office and/or Pakistan Banking Council under

their directives are handled by the branches.

Trade Related Modes of Financing:

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

This mode of financing is not being followed at present by banks in Pakistan under interest free banking system except in the cases of financing of agricultural farm inputs.

- ii) Purchase of Trade Bills:

The bills are handled exactly in the same way as they were being handled under the interest-based system. The practice of purchase of trade bills on the basis of "Mark down" in price works in a similar way as "Mark up" in loans.

- iii) Purchase of moveable or immovable property by the bank from their clients with Buy-Back Agreement or otherwise.

This mode of financing has been extensively used by banks in Pakistan under buy-back arrangement. Under this mode the Banks purchase the moveable or immovable property from their clients

and the agreed price is paid by the bank to the client on the spot by credit to clients account. According to the contract agreement used by banks, the clients immediately buy-back the same moveable or immovable property from the bank at a higher price (due to addition of mark-up) payable at a future date either in lumpsum or in instalments. This method of financing has been held un-Islamic by the Federal Shariat Court in their Judgement of November 14, 1991.¹⁴

iv) Leasing

In case of leasing, the lessee has to pay not only all the instalments of lease but also the residual amount agreed to at the time of entering into leasing arrangements before becoming the owner of the asset. The mechanism of leasing is more or less the same as explained under hire-purchase excepting that in the case of hire purchase the asset becomes the property of hirer after payment of all the instalments.

The practice in Pakistan is concentrated on financial leases, whereby the lessee's instalments not only constitute the rentals but also the cost price, unlike in case of operating lease whereby

¹⁴Federal Shariat Court Judgment on Interest (Riba), Lahore, PLD Publishers, p. 145.

only rentals are charged by the lessor and which is held quite in line with *Shariah*.

v) Hire-Purchase

The assets acquired by the client under hire-purchase arrangements, whether the acquisition value is provided by the bank fully or partially, remains under the joint ownership of the bank and the client or its exclusive ownership is held by the bank. The payment of asset is made directly to the vendor. The instalment composes of a part of the acquisition value and also the profit is paid by the client on periodical basis as agreed upon.

vi) Financing for development of property on the basis of a development charges.

Transactions under this mode are similar to the ones under buy-back agreement. Banks are however not using this as an instrument for financing.

Investment Type Modes of Financing

i) Musharakah or Profit and Loss Sharing:

This mode of financing has been rarely used in Pakistan. The banks and the clients who have the option to use any of the twelve modes of financing prefer the mark-up mode.

ii) Equity Participation/Purchase of Shares:

Sometime banks participate in equity and also take up participation term certificates in case of consortium financing. Banks purchase shares, participation term certificates, *mudarabah* certificates and NIT (National Investment Trust) units by way of bank's investment. This mode of investment is seldom used.

iii) Purchase of Participation Term Certificates (PTCs) and Mudarabah Certificates.

Participation term certificates described under redeemable capital take the place of debentures and bonds of the interest-based system and have been devised to facilitate the system of interest free banking. The holders of PTCs participate in the profits as

well as in the losses in each financial year of the company. However it is pertinent to note that the actual form in which PTCs have been issued does not fully conform to the *Shariah*. For example, a project which has been financed by a Development Bank having gestation period has to issue more PTCs to cover the interest charges during construction period of the project.

On the other hand Term Finance Certificates issued, which are also a part of the redeemable capital of a company, yield a fixed return to their holders as against participation in the profit and loss of the company, thereby making them inconsistent with the principles of *Shariah*.

Mudarabah Certificates are the share certificates issued to the subscribers of funds for the business of a corporate body registered as *Mudarabah* Company under *Mudarabah* Companies and *Mudarabah* (Floatation and control) Ordinance, 1980. The business activities of a *mudarabah* company are supervised by Registrar Corporate Law Authority and Federal Religious Board. Although this mode has gained momentum over the past few years due to tax exemptions and reliefs but serious reservations are held by the people regarding its viability and success during

the long run. At present there are about 42 *Mudarabah* Companies quoted at the stock exchanges, out of which about 31 companies are paying dividends. Generally these companies are engaged in the trading business. In light of the reservations of general public, the government has not only raised the equity contribution of the sponsors' from 10% to 30%, but has also made the sponsors' shares non-transferable for a period of two years, with the provision of exercising the right to remove the management of the *Mudarabah* Company, if it has reasons to believe that misappropriation of funds has taken place.

It shall however, be premature to comment upon its acceptability in general by the public at this stage.

iv) Rent Sharing

Commercial banks are permitted to finance for construction and purchase of houses and flats on rent sharing basis. Share of the bank in the net rental is calculated according to the ratio of bank's investment along with weightage thereon as agreed.

Keeping in view the difficulties involved in determination of the actual cost of construction and rental value banks are not using this mode and as such, markup mode of financing is used.

PRESENT FUNCTIONING OF BANKS IN RELATION TO THEIR COMPATIBILITY WITH *SHARIAH*:

The Council of Islamic Ideology has pointed out that the ideal alternatives to interest in an Islamic economic system are profit/loss sharing and *Qard-e-Hasanah*. However in view of the difficulties in the practical application of the system of profit/loss sharing in certain spheres it had endorsed the recommendations of the Panel of Economists and Bankers that certain other methods like leasing, hire-purchase, *Bai' Muajjal* financing on the basis of normal rate of return with a clear provision for adjustment on the basis of actual operating results may also be used in interest-free banking operations, and with cautioning against the danger that these modes could be misused as a means for opening a back door for interest.

Evaluating the present banking system in terms of its Islamicity, it transpires that more than 80% of the financing is being provided by

banks under the Buy-Back Agreement with markup in price.¹⁵ The mechanism of conducting markup transaction is similar to that followed under the interest based system. It is unfortunate to note that despite the fact that Markup as a device was to be used only in unavoidable cases, has been made the pivot of the new arrangements.

The picture on the liabilities side of the banking system is also not different. Although banks declare profits payable on deposits at six monthly intervals based on their operating results and consequent assignment of different weights to liabilities according to their relative maturities, these return to depositors are not Islamically legitimate as the same had been earned on markup basis. The banking system has to operate in terms of *Shariah* from both sides. The Islamic financial intermediation must be as per *Shariah* from deployment of money on the asset side and mobilisation of resources from liability side. It has also been observed that some of the deposit mobilisation schemes of banks and financial institutions are not based on profit and loss sharing as they pay a predetermined fixed rate of return on such deposits. It is also important to note, that the Government is still mobilising resources from the public through National Savings Scheme on fixed return basis by

¹⁵Zaidi, Nawazish Ali, (1991), p. 11.

having changed the name of return from interest to profit.

One can easily infer from the experience of non-interest banking system in Pakistan that other than change in name the essences has remained similar to interest based banking. It appears that we did not probably prepare ourselves before embarking upon the path to this change. The prerequisites of effective change were undermined and we adopted a partial and fragmented approach to achieve an objective requiring an overall reformatory measure. Let us now discuss the factors causing retardation in the process of Islamization and broadly classify them as the prerequisites for achieving the objectives of Islamic banking.

PREREQUISITES OF ISLAMIC BANKING

1. Elimination of interest, reformatory measures at moral building and eradication of false values of life is the base on which edifice of an Islamic banking is raised. Honesty and fair play are the basic ingredients for Islamic banking to function effectively and successfully. Unlike in the interest based system where the major deterrent for wilful default is possibly the security mortgaged with the lender, in Islamic banking it should be the fear of Allah and the people

must be guided by the teachings of the Quran and *Sunnah*.

2. From the Government side increasing budgetary deficits is the main impeding factor for abolition of interest especially in the absence of non-interest based instruments for financing such deficits. In fact a banking system not based on interest will suffer from severe limitations if it has to operate in an environment where interest continues to prevail in other major sectors of the economy . The principle of honesty and fair play equally applies to the Government as well which has to conduct its affairs strictly in accordance with Islamic prescriptions. If inefficiency and waste were to be eliminated and people pay the dues to the Government honestly, the resultant fiscal deficit, which one can predict to be a meagre amount, can be financed easily by the Government from the banking system through non-interest based instruments.

3. One of the necessary prerequisite for functioning of Islamic banking system is the familiarity of businessmen and entrepreneurs with Islamic business ethics, and the high degree of expertise of banking personnel not only in field of banking and finance but also in terms of various modes of Islamic financial transactions.

4. In order to safeguard the interest of savers, banks and borrowers, well defined laws and legal system are to be enacted as per the legal requirements of the new system and the *Shariah*. Expeditious disposal of legal cases to enforce Justice to all is what shall make the system a success.

The essence of the matter is that there should be a Will and determination from all segments of the society to bring about the change and support it with the firm conviction that as the change is as per the teachings of Quran and *Sunnah*, it is imperative for a Muslim to accept it and that there are benefits in it.

CONCLUSIONS

It is a fact that since the introduction of Non-Interest Banking system there has hardly been any progress in the sphere of Islamization of banking. Almost the entire commercial banking operations are conducted on the basis of mark-up which is not only objected to by *Shariah* experts, the Federal Shariat Court has also declared the markup system in vogue as un-Islamic in its Judgement on interest (*Riba*). The obvious question which arises here pertains to the viability and practicability of an Islamic

banking based upon profit/loss sharing rather than fixed predetermined rate of return.

From the foregoing It is evident that the policy makers did not fully envisage the complexities of the matter and without attending to the prerequisites for the implementation of Islamic Banking, adopted a fragmented approach to Islamise banking. Revolutionary changes require extraordinary efforts and measures at all levels and a complete support from all segments of the society. Morality, accountability, appropriate and just expenditure policies, tax rationalisation policies, effective and efficient Judicial system, less dependence on foreign aid on interest basis are some of the major areas which need to be attended to in the wake of the change to make it practical and successful. Islamic principles are required to be accepted and practised as regards to Islamic economics and Islamic banking. They are to be practised in sincerity and honesty.

In the next chapter, we shall briefly discuss Theories of Interest, before evaluating the equity based system in an Islamic framework.

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