IN THE HON’ABLE FEDERAL SHARIAT COURT

(ORIGINAL JURISDICTION)

Shariat Petition No.30/L OF 1991

M/S Farooq Brothers etc. Vs United Bank Ltd etc.

Preliminary Submissions on behalf of State Bank of Pakistan

*Respectfully submitted,*

1. The Hon'able Supreme Court of Pakistan (Shariat Appellate Bench) has through its judgment passed in Civil Shariat Review Petition No.1 of 2000 and connected matters (PLD 2002 SC 800) remanded to this Hon'able Court the matter regarding the alleged repugnance of various laws to the injunctions of Islam prohibiting riba. The following issues, inter alia, arise out of the remand order for the consideration of this Hon'able Court:

i) Determination of the jurisdiction of this Hon'able Court and the maintainability of the petitions before it with reference to Articles 29, 30(2), 38(f), 81(c), 121(c), 161 and 260 of the Constitution of Pakistan, 1973 (the 'Constitution'). Reference may kindly be made to paragraph 12 of the judgment in Civil Shariat Review Petition No. 1 of 2000 and connected matters (PLD 2002 SC 800).

ii) Since Articles 29, 30(2) and 38(f) contain a non-justiciable policy framework that contemplates gradual but expeditious elimination of riba by the state can this Hon'able Court constrain the exercise of policy implementation by the State? Are matters contemplated by the Constitution as extant realities to be dealt with by the State according to non-justiciable policy decisions regarding implementable possibilities not beyond the jurisdiction of this Hon'able Court?

iii) Since it is clear that the Constitution contemplates the payment of an amount described as 'interest' on monetary obligations can this Hon'able Court make nugatory the provisions of the Constitution that contain such contemplation?

iv) Is the Constitutional scheme for the elimination of riba and the payment of interest not beyond the jurisdiction of this Hon'able Court in terms of Article 203B(c) read with Article 203D that expressly exclude consideration of any part of the Constitution by this Hon'able Court?

v) What is the distinction contemplated by the Constitution through use

of the term 'riba' in Article 38(f) and 'interest' in Articles 81(c), 121(c), 161 and 260 thereof?

vi) Given the fact that banks and other entities engaged in financial transactions are functioning in Pakistan within a regulatory framework that benefits from the constitutional advisory opinions of the Council of Islamic Ideology and that has sincerely sought to interpret and progressively give effect to the injunction against the charging of riba with very significant progress having been made in the last thirty years or so in instituting Islamic Banking in Pakistan is there any current need for judicial interference with the process that is underway? Is the legal and practical situation in Pakistan today regarding the elimination of riba not markedly different from the year 1992 when the original decision of this Hon'able Court was delivered regarding the elimination of riba?

vii) Is there a distinction between loans taken to meet a just need and those taken not out of need but with the ambition of generating profits through investment to enrich the borrower or for making funds available to the State for its ongoing expenditures? Are the returns chargeable on the distinct categories of loans not distinguishable? Reference may kindly be made to paragraph 14 and 16 of the judgment in Civil Shariat Review Petition No.1 of 2000 and connected matters (PLD 2002 SC 800).

viii) Is there an obligation on the State to not take steps that may cause chaos and anarchy? Can this Hon'able Court direct the State to take such steps? Is the welfare of the people and the elimination of *zulm* in the manner determined to be possible not the overriding duty placed on the State by the Constitution as well as the Injunctions of Islam? Reference may kindly be made to paragraphs 14 of the judgment in Civil Shariat Review Petition No. 1 of 2000 and connected matters (PLD 2002 SC 800).

ix) Is the determination of the question of the legality of indexation for inflation in the repayment of loans not necessary before any law providing for the payment of interest can be declared repugnant to the Injunctions of Islam or otherwise? Given that the Shariat Appellate Bench of the Hon'able Supreme Court had left this aspect of the matter open in its judgment reported as PLD 2000 SC 225, as noted in paragraph 15 of the judgment in Civil Shariat Review Petition No.1 of 2000 and connected matters (PLD 2002 SC 800), is it not necessary for this Hon'able Court to now decide this matter afresh? Reference may kindly be made to paragraph 16 of the judgment in Civil Shariat Review Petition No. 1 of 2000 and connected matters (PLD 2002 SC 800).

x) Is an appreciation of modern 'money' and its distinction from specie or specie-linked money of the past not fundamental to are-definition of the concept of 'ras ul maal' in the context of transactions of 'qarz' or loans so as to prevent exploitation as regards the equities of the parties? Reference may kindly be made to concluding part of paragraph 15 read with paragraph 17 of the judgment in Civil Shariat Review Petition No.1 of 2000 and connected matters (PLD 2002 SC 800).

xi) Is an appreciation and resolution of the disputes regarding the presumed shariah compliant alternative to banking and loan practices in place not essential before any change can be made? Is the resolution of such dispute to be carried out by this Hon'able Court or should it be left to the democratic and consultative processes instituted by the Constitution?

xi) Are returns on 'qarz' or loan described as Riba al Fadl and Riba al Nasiyah both involved in the banking and loan practices in vogue? What are the implications of the distinction between the two categories of riba?

xiii) Without prejudice to the submissions regarding the jurisdiction of this Honable Court, further inquiry, if any, conducted by thisHon' able Court must take into account the research and comparative study of the financial systems that are prevalent in the contemporary Muslim countries of the world. Reference may in this regard kindly be made to paragraph 18 of the judgment in Civil Shariat Review Petition No.1 of 2000 and connected matters (PLD 2002 SC 800).

xiv) Without prejudice to the generality of the foregoing, the following practical difficulties may kindly be considered:

a) Government borrowing from the general public as well as the banking system. A large part of this borrowing is not for investment in productive projects with identifiable returns. Instead it is done to meet the government's general expenditures that include the payment of salaries, utility bills, pensions as well as acquisition of defence supplies. Raising of funds through issuance of asset based securities such as sukuk cannot meet all of the financing needs of the government. The assets that may be made the basis of a sukuk issue are limited in value compared to the financing needs of the government. Government's deficit financing needs have to be taken as given.

b) Issuance of government securities as a part of money market operations by the central bank. All central banks need the ability to impact the supply of liquidity in the market through market operations, including issuance of securities to absorb liquidity when money supply growth or the general availability of liquidity is considered excessive. Such operations require speed and flexibility as well as large volumes. Issuance of asset based securities by the State Bank of Pakistan is limited by the availability of assets to the SBP. Even if government assets generally were available to the SBP the value of available assets would be insufficient given the often large and sudden interventions that the SBP is required to make. Furthermore government assets are not available to the SBP for money market interventions. For instance assets owned by the federal and provincial governments or statutory corporations or incorporated companies controlled by the government cannot form the basis of asset based securities that the SBP has to issue for the purpose of liquidity management.

c) Financing by Islamic banks of the investment and running finance needs of private as well as public sector entities is limited by the availability of Approved Assets that all banks, including Islamic Banks are required to maintain as part of the stock of reserved assets. For Islamic banks this stock of assets must consist of government securities that have been declared shariah compliant. The stock of such . securities is limited by the availability of state assets and the issuance by the state of securities based on such assets.

d) Deposit taking by Islamic banks is constrained by the lack of a deep inter-bank market for Islamic banks for short term placement of funds. The issue is again the short term investment opportunities. While trade in commodities provides an avenue the volume and availability of such trade is not commensurate with the unpredictable needs of banks to make recourse to the inter-bank market for placement of funds as well as for access to funds by banks in need of immediate liquidity. The growth of the 'Islamic' inter-bank market is also constrained by the lack of a benchmark for returns on invested or borrowed funds, such as the Kibor. The role of the State Bank of Pakistan as the lender of last resort is also constrained by the limited availability of assets considered shariah compliant.   
  
2. Pakistan is today one of the world leaders in Islamic banking. The Islamic banking industry in Pakistan has grown significantly since its re-launch in 2001. The industry now accounts for over 10 percent of the country's banking system. Presently 22 Islamic Banking Institutions (IBIs) (5 full-fledged Islamic banks and 17 conventional banks having Islamic banking branches) are operating in the country with a network of over 1,500 branches. Islamic banking sector in Pakistan is likely to double its share in the banking system by 2020.

3. Over the years, SBP has developed a supportive Regulatory and Supervisory regime for Islamic banking that is in line with international best practices. SBP is continuously refining and improving the regulatory framework to meet the evolving industry dynamics. Recent measures taken by the central bank include (i) the downward revision of paid up capital requirement for Islamic banking subsidiaries from Rs.l 0 billion to Rs. 6 billion to encourage investors (ii) the conclusion of the very first OMO for Islamic banking industry to provide level playing field for liquidity management (iii) issuance of Shariah Governance Framework for strengthening of Shariah compliance on part of Islamic banking institutions and (iv) the Strategic Plan for Islamic Banking Industry (2014-18).

4. However, given the various complex issues of jurisprudence as well as practical financial sector management, including financing of government, financing of public and corporate sectors and consumer financing, gradual approach for change is the only possibility. It will be impossible to change the whole system at once through an edict. As the points elaborated below reveal, the current approach of a gradual shift to Islamic finance seems to be the only option which can ensure gradual implementation that will bring wider acceptability and benefits to the society.

A. Islamic Banking Initiative in Retrospect

5. In early 1980s, the banking system was made non-interest-based through regulatory and legislative measures in a span of few years. Steps taken at that time are summarized in Appendix-A. However, due to concerns about resulting practice of Islamic banking in Pakistan, some products and processes were challenged in the Federal Shariat Court (FSC) and the court ordered to bring the various banking products in conformity with its then understanding of the Shariah in 1991. FSC further ordered to eliminate interest/Riba from the economy by June 1992. The government and financial institutions challenged the verdict in the Supreme Court of Pakistan but it affirmed FSCs decision and ordered changes to the prevailing system by June 30, 2001; later extended to June 30, 2002. Both the verdicts were afterwards set aside in review and cases were remanded back to FSC for hearing afresh.

6. Islamic banking was nonetheless re-launched in 2001, with a new vigor and zeal as a parallel system to conventional banking. In 2001, SBP issued an exclusive Islamic banking policy with detailed criteria for setting up Islamic banks with Shariah-complaint framework[[1]](#footnote-1). In addition, SBP over time has prescribed permissible Islamic modes of finance[[2]](#footnote-2), model Islamic financing agreements besides adopting certain Shariah Standards of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to encourage standardization and harmonization of Shariah rulings. Further, SBP has issued a comprehensive Shariah Governance Framework for the Islamic banking institutions (IBIs). Copies of the relevant circulars and directives are enclosed as Appendix-B. The framework aims at further strengthening the Shari'ah compliance environment through explicitly defining the roles and responsibilities of various organs of Islamic Banking Institutions (IBIs) including their Board of Directors (BOD), Executive management, Shari'ah Board (SB), Shari'ah Compliance Department and Internal and External auditors towards Shari'ah compliance. In addition to above, SBP also conducts Shariah compliance inspection of IBIs. The SBP has also developed a Strategic Plan for the Islamic Banking Industry of Pakistan, 2014 - 2018. The said Strategic Plan is placed herewith as Appendix-C. A Steering Committee for the Promotion of Islamic Banking set up in December, 2013 is continuing with its work. Appendix-D. The SBP Islamic Banking Department publishes a regular Islamic Banking Bulletin on quarterly basis. Copy of the issue of December

2014 is placed herewith as Appendix-E. The continuing efforts of the SBP towards promotion of Islamic Banking have built upon the findings of the Report of the Task Force for Transformation of Government Finances to Shariah Compliant Modes of June, 2002, placed herewith as Appendix-F.

7. A summary of the key steps taken to ensure and promote Shariah compliance in the banking sector is as follows:

i) Establishment of the Central Shariah Board at the SBP level

ii) Detailed Shariah Governance Framework wherein, each IBI is required to have a Shariah Board comprising at least three Shariah scholars by July 01, 2015 instead of having a Shariah Advisor

iii) Detailed set of instructions and guidelines for Shariah compliance which inter alia includes Essentials for Islamic modes of finance, have been issued

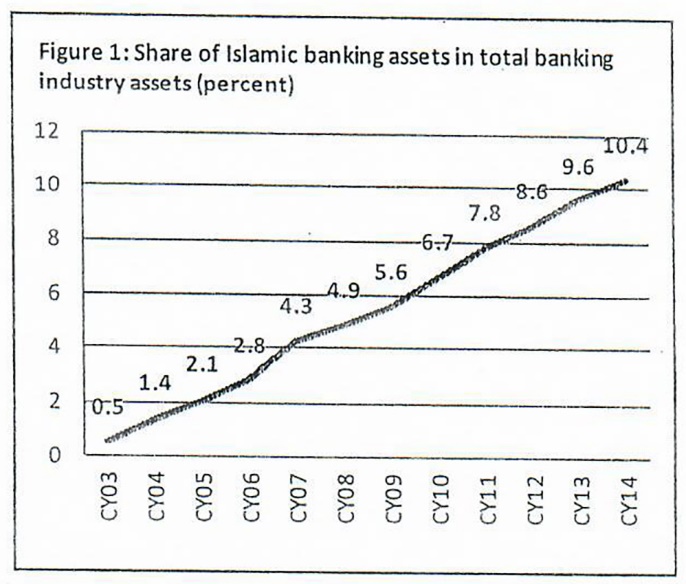
iv) Requirement of internal Shariah audit

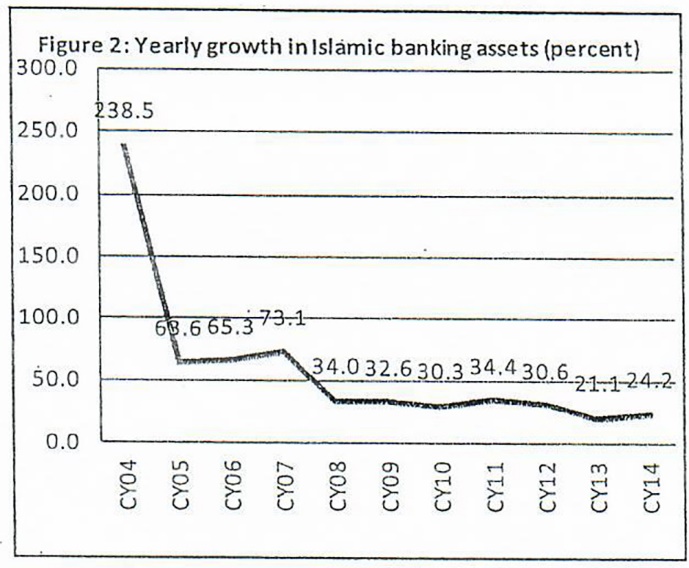
v) Requirement of external Shariah audit

vi) Mandatory Shariah compliance inspection by SBP team

vii) Adoption of Shariah standards of Accounting and Auditing Organization of Financial Institutions (AAOIFI) to standardize Shariah practices of the Islamic banking industry both domestically and internationally

viii) Detailed instructions for 'Profit and Loss Distribution and Pool Management for IBIs’ for deposits have been issued.

8. As a result of conscious and well-thought approach adopted by the Government and State Bank of Pakistan, Islamic banking in Pakistan has grown steadily. As summarized in Figure 1 and Table 1 in Annexure A, the share of deposits and assets of Islamic banking have increased from 0.4 and 0.5 percent in December 2003 to 10.4 and 11.6 percent in December 2014 respectively of the banking industry. This is an impressive progress by international comparison.[[3]](#footnote-3) The compound annual Growth Rate (CAGR) of deposits and assets of Islamic banking in Pakistan during 2003 -14 was 51.5 and 56.1 percent respectively[[4]](#footnote-4). This was much higher than the growth in conventional interest-based banking, whose deposits and assets both grew by around 15 percent per annum during this period. 

9. The growth in Islamic Banking Institutions (IBIs) has, however, moderated recently. As given Figure 2 and Table 1 in Annexure A, annual growth rates of deposits and assets have fallen sharply from above 70 percent till December 2007 to about 24 percent at end December 2014. On the other hand, the banking industry has grown at much slower pace both in average and year on year comparison. The recent moderation in growth of Islamic banking has resulted in deceleration of its growth but its market share is steadily increasing. Given the current trends, it does not appear that IBIs would be able to maintain the "remarkable" growth trajectory of the initial years until new areas are explored and challenges to Islamic banking and finance are overcome. Thus, it will be increasingly difficult to continue to outpace the growth in commercial banking by a great margin. Nevertheless, two banks are planning to convert into full-fledged Islamic Banks, one bank has got license for Islamic Banking Subsidiary and others are expected to follow, which can provide further impetus to the growth trajectory of Islamic banking industry in coming years.   
10. To get some idea about how long it may take for Islamic banking to match the size of conventional interest-based banking and overtake it to eventual full transformation the SBP has assumed, for illustrative purpose only, growth rates for Islamic banking at 15, 20, 25 and 30 percent. The conventional banking growth rate is taken at its 10-year CAGR--as a measure of its long term growth prospect. The purpose of this exercise is to provide useful information about expected time. Islamic banking can take at assumed growth rates to match the size of conventional banking (i.e. 50 percent share in total banking assets) and it will be gearing to become dominant player in financial system.   
11. As shown in Table 6 of Annexure A, taking 10-year CAGR for conventional banking, it may take about 39, 20, or 13 more years from December 2014 for Islamic banking to reach share of 50 percent respectively for growth rate of 20, 25, and 30 percent respectively (the 15 percent growth case is almost redundant because of similar growth rates). The complete conversion may take substantially longer period of time. It may be inferred from this illustrative exercise that decades are required for Islamic banking to catch up with the share of conventional banking in the country in current circumstances. Nonetheless, speedy resolution of challenges faced by Islamic banking industry can increase the growth momentum and speed up the process of Islamization. Notable among these challenges are prevailing issues in legal and taxation framework, lack of liquidity management solutions, Islamization of country's domestic and external debt, and human capacity building.

**B. Challenges to Islamic Finance and Banking in Pakistan**

12. As mentioned above and despite making impressive progress, the complete conversion of financial and banking system to Islamic modes will necessarily require overcoming some crucial practical challenges. The existing major challenges include; (1) concentration of Islamic banking activities in only a few Islamic financial products, (2) conversion of government domestic debt to Shariah-compliant modes, (3) development of Islamic benchmark rates linked with rates of return in real economy, (4) monetary/liquidity management under Islamic returns, (6) making the current environment of business ethics/disclosure conducive for Islamic finance, (7) increasing awareness among educated-elite and the masses, (8) conversion of external debt to Shariah-compliant modes, (9) research on new modes of financing through close involvement with clients' business, and (10) increasing the supply of human resources skilled with knowledge and practice of Islamic finance. The future growth of Islamic banking and finance will depend on how these challenges are tackled.   
**B1. Concentration of Islamic financial activities in a few Shariah-compliant modes**

13. Although Islamic banking has introduced several products during last many years, however, most of the financing remained concentrated in two products. As shown in Table 2 in Annexure A, Murabaha and Ijarah (Diminishing Musharaka financing also includes an Ijarah arrangement based on co-ownership of assets) have remained the dominant modes of Islamic financing since the beginning. Rest of the Islamic modes observed slight growth in the total share over the years. The Islamic banks have largely focused on providing products that are relatively easier to be structured in a Shariah compliant manner and similar in features to the conventional financing counterparts but other modes are also catching up. Murabaha and Ij arah provide convenient Shariah compliant way to do that but with proper controls to distinguish them from interest based financing. This has somewhat limited the role of Islamic finance in optimally exploiting its potential.   
14. The participatory modes of financing, Musharaka and Modaraba, are very flexible tools as these can be used to finance every permissible economic activity from working capital finance to financing of huge infrastructure projects. Banks are reluctant to become partners with businesses as the current environment lacks proper disclosures and business ethics. Moreover, banking becomes more complex in catering to business partnerships; this will require banks to have adequate human and material resource capacity to assess and monitor business activities of fund takers under Islamic modes. However, it is encouraging to note that CY14 has witnessed increase in financing by banks through Musharaka as its share in overall financing has reached double figures.   
15. In addition, the Islamic finance modes of Salam and Istisna have great potential to finance infrastructure projects such as construction of dams, roads, hospitals etc., if these are backed by adequate guarantees and effective monitoring. Growth of Islamic banking can be accelerated by greater use of participatory modes besides Salam and Istisna particularly by public sector and private public partnership projects. However, a shift towards these modes might take many more years to fully realize as Islamic banks have to side by side create capacity to handle these modes of financing.   
B2. Conversion of domestic debt to Shariah-compliant liabilities under weak fiscal system and high fiscal deficits   
16. The tax-to-GDP ratio has been historically low in Pakistan. It has been at an average of around 10 percent of GDP for the last five years. Low tax revenue coupled with high and non-discretionary expenditure results in persistently high fiscal deficits. The persistent financing of these deficits then raises the debt levels continuously over the years. While the management of public debt is an issue of fiscal policy and the constraints within which this policy functions significant and increasing levels of debt have to be accepted as a given. Reference may be made to Tables 4 and 5 in Annexure A).   
17. The current outstanding level of the government domestic debt 1S high (at Rs 12,045 billion at end March 2015) and it will be difficult to eliminate it or convert it to Shariah compliant modes in a short period of time. This difficulty is largely because of lack of enough real assets with the government, coupled with large and recurrent fiscal deficits. This challenge remains even after legislation enhancement in SBP Act to contain excessive government borrowing. The government has to credibly commit and adhere to SBP Act and Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 for containing debt burden.   
18. Renowned Islamic finance scholar Muhammad Ayub has stated rightly, "Almost all Islamic countries are still borrowing through the conventional interest-based system and only a negligible part of their needs has been financed through Shariah-compliant instruments"[[5]](#footnote-5). Nevertheless it is noteworthy that many countries are now issuing Islamic government securities for some of their financing and development needs.   
19. As an alternative to conventional instruments, such as T-bills, the launch of Rupee denominated Government of Pakistan Ijara Sukuk in September 2008 has seen initial progress. Ijara Sukuk not only has the potential to meet the demands of Islamic banks to fulfill their SLR requirements and liquidity management, it can help in the conversion of existing stock of government debt to a limited extent.   
However, in recent years government has found it difficult to rollover the existing stock of Sukuk because it is finding it hard to identify new unencumbered assets. Hence, the main challenge for the government is to identify assets, with full documentation and valuation, which can be based to structure the required Ijara Sukuk. However, State Bank is developing other Shariah compliant structures for issuance of short term Sukuk which requires support from relevant government departments and institutions.   
20. The real challenge is to assess the size of real assets held by the government (federal, provincial and other tiers). A ballpark estimate of the value of government real estate capital stock was Rs.2,413 billion in FY10, where the stock of government domestic debt was Rs.4,722 billion in June 2010.[[6]](#footnote-6) Domestic debt excluding SBP held portion is Rs.9,794 billion as of end-March 2015. This means that even after retiring SBP debt, government assets may not prove sufficient to replace the existing domestic debt with Shariah-compliant instruments.   
21. What is needed is a complete census of all government assets (held by federal, provincial and other tiers of government) for the purpose of identification, documentation, and valuation of each asset. While this may prove to be a tedious task for the government, it is necessary to undertake this to speed-up the progress of transformation towards Islamization of existing debt. It will be demanding to credibly commit and deliver a deadline to convert domestic debt into Islamic modes. As mentioned above, recent experience suggests that government is facing difficulty in identifying assets to rollover even the existing stock of Sukuk.   
**B3. Developing Islamic Benchmark rates of return**22. Currently, the Islamic banking products/instruments are benchmarked with the yields on similar conventional interest-based banking products/instruments. Although allowed by Shariah scholars, this creates misconceptions in the minds of

vanous stakeholders especially the educated elite. Hence, there IS dire need to

have an Islamic benchmark rate for IBIs.

23. Some options are nonetheless available. Usufruct derived from a real estate can be valued at the potential rent it can earn when rented out. Annual rate of rental would be the annual rent amount expressed as percent of the value of real estate. Surveys in major cities can be conducted to establish an "Office Price Index" and an "Office Rent Index". Annual rental rate can be easily derived from these indices.[[7]](#footnote-7) An extensive purposive survey can be done initially to establish these rentals, which can be updated periodically to keep the benchmark rate current with structural changes taking place in the real estate sector. What is more important is the careful selection of property and the quality of process that ensures soliciting market values of both real-estate and rents. Transparency of survey methodology and timely public availability of updated indices every six month would be of paramount importance. An alternative approach, based on surveys of small number of knowledgeable real-estate agents, can also be considered.

24. Similar survey-based techniques may also be used to establish benchmarks for Musharaka-based instruments by estimating profit rates in appropriate sectors of the economy. It would be hard to change the existing practice of adopting riba-based benchmark for Shariah-compliant instruments. It is difficult to visualize that a benchmark, once established, will change by itself in future. The evolution of an Islamic benchmark rate can therefore take decades to establish itself credibly. Thus, the task is challenging and can take a considerable period of time to evolve.

**B4. Transforming Monetary and liquidity management towards Shariah-compliance**25. Liquidity management is a long standing challenge for the IBIs. There is no short-term tradable Sukuk available in the Islamic banking interbank market. Consequently, IBIs are sitting on liquidity surpluses that cannot be invested in Shariah compliant instruments. The need is to introduce short term Sukuk that can be used for investment and trading. These Sukuk can also be used by SBP to conduct Open Market Operations with the IBIs. SBP has recently issued a framework under 'Bai Muajjal (credit sale) of Sukuk' with approval of SBP Shariah Board and its Central Board which has provided much needed relief to Islamic banking industry in terms of its liquidity management.   
26. The recent trends in Sukuk market are, however, not encouraging as the government has not been able to issue further Sukuk to meet the growing need of IBIs. This is adding to the already surplus liquidity with IBIs that is hurting profitability and returns to the depositors who demand Islamic banking. The surplus liquidity is also a reflection of lack of financing avenues, financial instruments and/or willingness on part of IBIs to cater to the needs of sectors such as agriculture, housing and Small and Medium-Sized Enterprises.   
27. With the future conversion of the financial system, the SIze of the Islamic interbank market will also grow and it will start having consequences for overall liquidity/money supply in the economy. The SBP will need Shariah compliant liquidity/monetary management tools. This will require SBP to hold sufficient stock of Sukuk on its books for doing open market operations (OMOs). Since identification of assets is a problem, SBP might have to issue its own Sukuk against its own assets however, real assets of SBP are not yet of the size that this task can be undertaken meaningfully.   
B5. Addressing depositors' concerns under Islamic finance   
28. So far depositors in Pakistan are used to getting a pre-determined rate of return on their savings. Under the Islamic system they will be required to become investors, sharing in the profit and loss of banks. It is difficult to assess how many depositors will be willing to give their consent to the bank to act as their agent or attorney on a real profit and loss sharing basis. There is a strong apprehension that this consent may not be given by a large majority of depositors who would not like to risk their principal or forego their returns. Therefore, over time they might shift their savings to other channels such as real estate, gold and possibly to some speculative activities thus putting their capital to a much higher level of risk. Although where conventional branches of some banks were converted into Islamic branches, a large number of active depositors converted their deposits to Islamic modes, nevertheless, most appropriate course of action, under this situation, is to continue with existing parallel approach in adopting Islamic finance. Depositors should voluntarily switch towards Islamic banking.   
**B6. Inculcating business ethics and promoting disclosure in line with spirit of Shariah** 29. The success of participatory modes of financing, in Islamic banking and finance, presupposes the existence of certain social values and a business environment with the highest possible levels of integrity and truthful disclosure; business efficiency, ethics and supporting efficient recovery system. The current social environment perhaps considerably falls short of these needs. Future progress, in this regard, is likely to be slow. There is a culture of indiscipline on the part of borrowers in repaying their loans resulting in a high level of nonperforming loans of banks. Historically, the infected loans ratio has remained on a higher side in Pakistan, which is further aggravating due to striking down of section 15 of Recovery Ordinance 2001. Nonperforming loans of the banking sector have increased to Rs.605 billion at end December 2014 compared to Rs 211 billion in December 2003. The non-performing financing (NPF) to total financing of Islamic banking industry as at the end of December 2014 was 4.7% against the overall banking industry's ratio of 12.3%. This is reflection of relatively a better asset quality of Islamic banking industry.   
30. The promotion of participatory modes of financing will also require devising some mechanism for speedy resolution of conflicts arising out of disagreement between the Islamic banks and businesses. The regulators and government will have to take lead in creating and steering such conflict resolution mechanism.   
 **B7. Spreading Islamic finance knowledge among educated elite and the masses**31. The central bank is playing an important role in raising awareness and building capacity of the industry. Paradoxical as it may seem, but it is a fact that misconceptions and pre-conceived notions about Islamicity of Islamic financial products are rampant among educated Muslim elites of Pakistan and many other Islamic countries.   
32. Masses, on the other hand are mostly unaware about modalities of Islamic finance, except that interest/Riba is haram. To address awareness and tackle misconceptions about Islamic banking, SBP in collaboration with many national and international institutions is conducting seminars, conferences, targeted programs and focused discussions for different stakeholders. SBP, through its training subsidiary, is not only offering regular certification courses for Islamic banking, but is also extending customized programs for national and international participants. The industry has recently launched media campaign to promote awareness of Islamic banking amongst the masses.   
33. The problem is that individual investors might not be aware of the existence of these Islamic financial instruments. Unless these are publicized by the issuer (Government of Pakistan), manager (State Bank of Pakistan) and retailers (mainly Islamic banks), we may see a situation in future where tradable Islamic financial instruments will primarily be held by financial institutions, despite increased supply. Individuals' awareness about Ijara Sukuk will also increase by thisapproach. Moreover in brochures and advertisements, the distinguishing features of Ijara Sukuk should be emphasized. Lack of awareness and misperceptions about Shariah-compliance of existing products are critical factors constraining the promotion of Islamic finance.   
**B8. Conversion of external debt to Shariah-compllant liabilities under weak balance of payments (BOPs) with low exports and high imports**   
34. When a country's savings are less than its investment requirements, it needs to attract either foreign investment or borrow from abroad. This saving/investment gap is reflected in the country's external current account deficit. A country accumulates external debt when net foreign investment inflows are insufficient and the country borrows from abroad to finance its external current account deficit. In Pakistan, net inflow of foreign investment has usually remained insufficient to finance the external current account deficit and therefore there has almost always been a need to borrow from abroad to meet this gap.   
35. Given that national saving as percent of GDP is very low in Pakistan, obtaining external debt helps in financing investment for a sustainable recovery in economic growth, improving country debt servicing ability, enhancing the foreign exchange reserves and stabilizing foreign exchange market. However, in the long run, solution lies in increasing the exports of the country. Currently the export base is very narrow which needs to be diversified both in terms of products and markets.   
36. Pakistan has been experiencing a persistent deficit in BOP since independence. When analyzing the value of trade of Pakistan starting from 1947-48, we see that there was always a trade deficit except for three specific years during the last 67 years; 1947-48, 1950-51 and 1972-73. The current level of trade deficit is also high (USD 16.6 billion during FY14) see Table 3 in Annexure A. This is 6.7 percent of GDP of FY14.   
37. Being a developing country, the developmental programs of Pakistan requires imports of equipments, refined petroleum and products, machinery etc., and so the burden of interest on foreign capital exerts pressure on BOP. Pakistan's exports mainly depend on agriculture for which the natural conditions and environment in most of the time is not favorable. Pakistan's exports mostly include raw materials, or primary goods, which contain low value addition and being cheaper, fetch less foreign exchange. The gap between country's exports and imports is substantial and increasing over time. Financial inflows which are considered another option for filling this gap is also drying up during last few years, however, worker remittances are providing some support.

38. Given low foreign exchange reserves it is not possible to payoff all the foreign debts. Also, debt has to be paid off at maturity. On the other hand to convert the existing stock of debt to Shariah compliant modes, real challenge is to evaluate the size of real assets held by the government. It is pertinent to mention here that international financial market has large appetite for Shariah complaint financial instruments (as evident from recent international issuances), but the government's supply of Shariah-cornpliant debt instruments is severely limited by ownership of real assets.   
**B9. Speeding up the supply of human resources well-versed in Islamic finance**39. At present the available number of Shariah scholars is small even to cater to the needs of the existing size of IBIs. There is a need to mobilize leading educational institutions to focus on devising courses for preparing Shariah scholars for the purpose of serving in Islamic financial institutions. The majority of bankers are educated and trained in conventional money lending techniques. IBIs need specially trained bankers that are not only aware of the IBIs' products/Shariah injunctions but are also able to assess business modes and profitability. In addition to trained bankers, there is a need of Islamic banking trainings for entire Islamic banking human resource on continuous basis in order to acquaint them with the latest international developments.   
40. According to statistics released by the International Islamic University of Malaysia, a otal of 2 million finance professionals will be required to fill in various positions in Islamic financial institutions worldwide by 2020. This is in stark contrast to the estimated 92,000 finance professionals working in the Islamic finance industry in 2007. Further, in a recent survey conducted by Deloitte, only 4% of Islamic finance leaders in Middle East agreed that the Islamic financial institutions are properly staffed with people who have the necessary depth and experience relevant to the industry, while 61 % of them felt that Islamic finance professionals require more training and skills development[[8]](#footnote-8).

41. The position is not very encouraging m Pakistan also. Low understanding of Islamic finance among existing Islamic banking staff is one of the key impediments in further accelerating the pace of growth of the industry and improving its perception. Similarly the low supply of suitably qualified human resources viz. a viz. high demand has been amongst the key reasons for significant increase in salary inflation in the industry during the last 5 years. The likely doubling of industry size during next five years would further widen the demand and supply gap unless necessary measures to improve supply of qualified and trained human resources are taken. In order to address this challenge State Bank is actively working with stakeholders to establish Center(s) of Excellence in Islamic Finance in various cities of Pakistan.   
**C. Further Challenges: Recent Survey Findings**42. SBP, in collaboration with Department for International Development (DFID), United Kingdom, has recently published a survey on Islamic banking and finance in Pakistan.[[9]](#footnote-9) The survey finds that there is an overwhelming demand for Islamic banking in Pakistan in which a large segment of demand is yet to be met since it largely lies amongst the financially excluded sectors. An important finding of the report is that demand for Islamic banking is higher (95 percent) amongst household (retail) than the businesses (73 percent). This implies that there would be a greater need to convince the business community to consider Islamic banking products and it may take more time to educate and convince them to switch voluntarily to Islamic modes. The study also recommends that the role of Shariah scholars needs to be further enhanced besides designing awareness campaigns for

different areas after the approval of Islamic banking by local religious scholar (like Imam Masjid). The role of the Ulema in promoting Islamic banking and finance cannot be over-exaggerated, as the majority of those who are doing Islamic banking feel that it is a Shariah board that makes a bank Islamic. Currently, only a limited number of Shariah scholars are involved in Islamic banking.

43. The survey highlights that lack. of general awareness about Islamic banking should be a major concern for stakeholders of the Islamic banking .industry. The vast majority of respondents do not understand the Islamic banking model, the nature of deposits, nature of contracts and Shariah compliance mechanism. The knowledge about Islamic contracts and terminology is almost non-existent that makes the task of educating the masses more challenging. So there is a need of educating stakeholders by issuing simple and brief Islamic financial documents instead of issuing complete model illustration. Legal system is also viewed as a challenge for the industry as the same legal principles, statutes and cases are used to adjudicate both conventional and Islamic banking. Almost all respondents stated that a real challenge of being in a dual banking system is the need to continuously educate the public about Islamic banking.

**D. Conclusion**

44. It seems at this stage a very long term and challenging exercise to convert total not practicable to convert the whole financial system at once. The challenges of conversion of domestic debt towards Shariah-compliance and increasing

awareness/education is going to take, a very long period to resolve.

45. All stakeholders especially IBIs and government should work together to create instruments and viable solutions for continuous conversion to Islamic financial and banking system. Awareness of IBIs and their financial products to the masses would play a pivotal role in successfully converting the economy in accordance with Shariah.

46. The role of the government will be very important in providing a plan and milestones for conversion of domestic debt towards Shariah-compliance, removing legal hurdles especially related to property titling, and evaluation. The IBIs and SBP have launched awareness campaign for Islamic banking besides collaborating with academia and religious community for education of Shariah scholars and bankers. The government has established in December 2013 a high powered Steering Committee to suggest practical steps needed to be taken to implement Shariah-based financial system. The Committee has submitted its interim report and some of its recommendations have already been implemented by State Bank and SECP.

**Prayer:**

In view of the foregoing it is respectfully prayed that the titled petition and all connected matters may kindly be disposed off and the State Bank of Pakistan as well as the Federal Government and the State generally be permitted to give effect to the Injunctions of Islam in the economy at large and the banking sector in particular in a gradual manner.

RESPONDENT  
State Bank of Pakistan   
(Mahmood Shafqat)  
Additional Director, Islamic Banking Department

Through:-

BABUR SUHAIL SALMAN AKRAM RAJA  
LL.M. (UC. BERKELEY) M. A. Cambridge L.L.M. (London) (Legal Counsel) L.L. M. (Harvard) Advocate Supreme Court PLH No. 3960

SAYEDUZAIR MALIK GHULAM SABIR  
LL.M. (London) Advocate High Court   
Advocate High Court

Annexure A

Billions of PKR

Table 1 – Islamic Banking Industry Progress and Market Share

Dece03 Dec04 Dec05 Dec06 Dec07 Dec08 Dec09 Dec10 Dec11 Dec12 Dec13 Dec14

Assets of Islamic Banks 13 44 72 119 206 276 366 477 641 837 1014 1259 Share (%) 0.5 1.4 2.1 2.8 4.3 4.9 5.6 6.7 7.8 8.6 9.6 10.4  
CAGR (%) . 238.5 135.3 109.2 99.5 84.2 74.4 67.3 62.8 58.8 54.6 51.5

Deposits 8 30 50 84 147 202 283 390 521 706 868 1070  
Share (%) 0.4 1.2 1.9 2.6 4.1 4.8 5.9 7.2 8.4 9.7 10.4 11.6  
CAGR (%) . 275.0 150.0 119.0 107.0 90.7 81.2 74.2 68.5 64.5 59.8 56.1

Full Fledge Islamic Banks 1 2 2 4 6 6 6 5 5 5 5 5  
Conventional Banks with   
Islamic Banking Branches 3 7 9 12 12 12 13 13 12 13 14 17   
No. of Branches 17 48 70 150 289 514 651 751 886 1097 1304 1574

Memorandum Items  
Assets of Commercial Banks 2,542 3,043 3,660 4,282 5,172 5,628 6,516 7,117 8,171 9,720 10,487 12,106  
CAGR (%) . 19.7 20.0 19.0 19.4 17.2 17.0 15.8 15.7 16.1 15.2 15.2  
  
Deposits of Commercial Banks 1,964 2,393 2,832 3,202 3,854 4,218 4,786 5,451 6,244 7,291 8,311 9,230  
CAGR (%) . 21.8 20.1 17.7 18.4 16.5 16.0 15.7 15.5 15.7 15.5 15.1  
Source: Islamic Banking Bulletin, State Bank of Pakistan (various issues) and statistics of the Banking System, State Bank of Pakistan (Various issues).

Table 2: Mode-wise Financing Share (in percent)  
  
 Dece03 Dec04 Dec05 Dec06 Dec07 Dec08 Dec09 Dec10 Dec11 Dec12 Dec13 Dec14

Murabaha 79.4 57.1 48.4 40.3 45.3 40.6 42.3 44.9 43.8 39.7 40.6 30.1  
Ijarah 16.5 24.8 31.8 29.9 26 20.5 14.2 12.7 10.4 9.2 7.7 7.7  
Diminishing Musharaka 1.2 5.9 9 16.1 23.9 30.5 30.4 29.5 32 35.7 30.8 32.6  
Musharaka 0 1 1.3 0.8 1.2 1.7 1.8 2.9 2.4 0.8 6.7 11.0  
Mudaraba 0 0 0 0 0.3 0.2 0.4 0.2 0.1 0.2 0.2 0.1  
Salam 1.6 1 0.6 0.7 1.2 1.8 1.2 1.4 2.4 3 4 4.5  
Qarz/Qarz-e-Hasna 0 0 0 0 0 0 0 0 0 0 0 0  
Others 1.3 9.8 6 10.8 1.2 1.8 3.6 2.6 4.4 4.3 4.4 5.6  
Total Financing 100 100 100 100 100 100 100 100 100 100 100 100.0

Table 3 – External Accounts Summary (billion US$)

FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10 FY11 FY12 FY13 FY14 FY15

Exports - SBP 10.9 12.4 14.4 16.6 17.3 20.4 19.1 19.7 25.4 24.7 24.8 25.2 20.2  
Imports – SBP 11.3 13.6 18.8 25.0 27.0 35.4 31.7 31.2 35.9 40.5 40.2 41.7 34.0  
Trade Balance -0.4 -1.2 -4.4 -8.4 -9.7 -15.0 -12.6 -11.5 -10.5 -15.8 -15.4 -16.6 -13.9  
Remittances 4.2 3.9 4.2 4.6 5.5 6.5 7.8 8.9 11.2 13.2 13.9 15.8 15.0  
Current A/C Bal 4.1 1.8 -1.5 -5.0 -6.9 -13.9 -9.3 -3.9 0.2 -4.7 -2.5 -3.0 -1.4  
   
  
*Memorandum Item   
Liquid Foreign Exchange   
reserves over all*  10.0 11.1 12.6 13.2 16.6 11.6 12.8 16.7 18.2 15.3 11.1 14.2 17.7

Table 4 – Fiscal Balance (Billion Rupees)

Primary Revenue Fiscal Fiscal Balance as % of GDP  
FY03 22.4 -61.2 -177.4 -3.5  
FY04 46.0 -5.1 -150.3 -2.6  
FY05 -27.6 -63.8 -237.8 -3.5   
FY06 -88.1 -66.7 -347.5 -4.2  
FY07 -8.7 -77.4 -377.5 -4.1  
 FY08 -287.5 -358.2 -777.2 -7.3  
FY09 -42.6 -190.7 -680.4 -5.2  
FY10 -286.8 -307.9 -929.1 -6.2  
FY11 -498.4 -350.0 -1196.5 -6.5  
FY12 -480.7 -556.0 -1369.7 -6.8   
FY13 -842.9 -678.0 -1833.9 -8.2  
FY14 -240.9 -367.3 -1388.7 -5.5  
FY15 -64.7 -516.4 -1048.9 -3.8

Table 5 – Pakistan’s Debt and Liabilities - Summary (Billion Rupees)   
 Jan13 Dec13 Mar 14 Jun 14 Sept 14 Dec14 Mar15

1. Government Domestic Debt 9,612.5 10,338.6 10,936.0 11,028.3 11,219.5 11,631.5 12,044.8
2. Government External Debt 4,311.1 4,637.9 4,373.4 4,791.3 4,828.2 4,700.2 4,633.8
3. Debt from IMF 434.8 379.4 356.6 298.4 300.1 358.4 378.2
4. External Liabilities[[10]](#footnote-10) 307.8 395.4 332.1 324.2 331.5 320.4 319.0
5. Private Sector External Debt 465.5 521.2 537.2 497.6 538.6 534.1 536.3
6. PSEs External Debt 208.5 210.7 199.6 211.1 225.5 243.6 247.1
7. PSEs Domestic Debt 312.2 366.5 386.5 366.2 365.8 431.3 432.3
8. Commodity Operations[[11]](#footnote-11) 469.7 381.2 366.0 492.4 468.7 466.8 436.8
9. Intercompany External Debt from Direct  
   Investor abroad 308.2 325.3 270.6 335.9 385.3 306.7 270.9
10. Total Debt and Liabilities (Sum 1 to 9) 16,439.3 17,520.0 17,728.1 18,345.5 18,663.2 18,992.9 19,299.2
11. The Total Public Debt (Sum 1 to 4) 14,675.3 15,715.2 15,998.2 16,442.3 16,679.3 17,010.5 17,375.9
12. Total Public Debt (Sum 1 to 3) MOF Definitions [[12]](#footnote-12) 14,367.4 15,355.8 15,666.1 16,118.0 16,347.8 16,690.1 17,056.8
13. Total External Debt & Liabilities (Sum 2 to 6+9) 6,036.0 6,433.8 6,069.6 6,458.6 6,609.2 6,463.3 6,385.3
14. Commodity Operation and PSEs (Sum 6 to 8) 990.3 958.4 922.0 1,069.7 1,060.1 1,141.7 1,116.2

Guaranteed Debt & Liabilities 554.3 443.5 375.2 540.5 526.8 564.6 545.4

Non- Guaranteed Debt & Liabilities 436.1 515.0 546.8 529.2 533.2 577.1 570.8

**As percent of GDP**

Total Debt and Liabilities 73.1 69.0 69.8 72.2 64.2 65.3 66.4  
Total Public Debt 65.3 61.9 63.0 64.7 57.4 58.5 59.8  
Total Public Debt – MOF Definition 63.9 60.5 61.7 63.5 56.2 57.4 58.7  
Total external Debt & Liabilities 26.8 25.3 23.9 25.9 22.7 22.2 22.0  
PSEs Debt & Liabilities 4.4 3.8 3.6 4.2 3.6 3.9 3.8

Guaranteed Debt & Liabilities 2.5 1.7 1.5 2.1 1.8 1.9 1.9

Non-guaranteed Debt & Liabilities 1.9 2.0 2.2 2.1 1.8 2.0 2.2

Government Domestic Debt 42.8 40.7 43.1 43.4 38.6 40.0 41.4

Memorandum Items FY13 FY14 FY14 FY14 FY15[[13]](#footnote-13) FY15 FY15

GDP (Current Market Price) 22,489.1 25,401.9 25,401.9 25,401.9 29,078.0 29,078.0 29,078.0  
US Dollar, last day average exchange rates 99.1141 105.6782 98.2198 98.8088 102.6506 100.4586 101.9223

Table 6: Illustrative exercise showing how long it could take for Islamic banking to increase the size its assets to 50% of total conventional banking interest-based and Shariah-Complaint assets.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Assets of Commercial banks  (Last eleven years  Year CAGR 15.2%) | | Assets of Islamic banks (20% growth) | | Assets of Islamic banks (25% growth) | | Assets of Islamic banks (30% growth) | |
|  | Assets Share | | Assets | Share | Assets | Share |
|  | Dec-14 | 12,106 | `1,259 | 10.4 | 1,259 | 10.4 | 1,259 | 10.4 |
|  | Dec-15 | 13,946 | 1,511 | 10.8 | 1,574 | 11.3 | 1,637 | 11.7 |
|  | Dec-16 | 16,066 | 1,813 | 11.3 | 1,967 | 12.2 | 2,128 | 13.2 |
|  | Dec-17 | 18,508 | 2,176 | 11.8 | 2,459 | 13.3 | 2,766 | 14.9 |
|  | Dec-18 | 21,321 | 2,611 | 12.2 | 3,074 | 14.4 | 3,596 | 16.9 |
|  | Dec-19 | 24,562 | 3,133 | 12.8 | 3,842 | 15.6 | 4,675 | 19.0 |
|  | Dec-20 | 28,295 | 3,759 | 13.3 | 4,803 | 17.0 | 6,077 | 21.5 |
|  | Dec-21 | 32,596 | 4,511 | 13.8 | 6,003 | 18.4 | 7,900 | 24.2 |
|  | Dec-22 | 37,551 | 5,413 | 14.4 | 7,504 | 20.0 | 10,270 | 27.3 |
|  | Dec-23 | 43,259 | 6,496 | 15.0 | 9,380 | 21.7 | 13,351 | 30.9 |
|  | Dec-24 | 49,834 | 7,795 | 15.6 | 11,725 | 23.5 | 17,356 | 34.8 |
|  | Dec-25 | 57,409 | 9,354 | 16.3 | 14,657 | 25.5 | 22,563 | 39.3 |
|  | Dec-26 | 66,135 | 11,225 | 17.0 | 18,321 | 27.7 | 29,332 | 44.4 |
|  | Dec-27 | 76,187 | 13,470 | 17.7 | 22,901 | 30.1 | 38,132 | 50.1 |
|  | Dec-28 | 87,768 | 16,165 | 18.4 | 28,626 | 32.6 |  |  |
|  | Dec-29 | 101,109 | 19,397 | 19.2 | 35,783 | 35.4 |  |  |
|  | Dec-30 | 116,477 | 23,277 | 20.0 | 44,729 | 38.4 |  |  |
|  | Dec-31 | 134,182 | 27,932 | 20.8 | 55,911 | 41.7 |  |  |
|  | Dec-32 | 154,577 | 33,519 | 21.7 | 69,889 | 45.2 |  |  |
|  | Dec-33 | 178,073 | 40,223 | 22.6 | 87,361 | 49.1 |  |  |
|  | Dec-34 | 205,140 | 48,267 | 23.5 | 109,201 | 53.2 |  |  |
|  | Dec-35 | 236,321 | 57,920 | 24.5 |  |  |  |  |
|  | Dec-36 | 272,242 | 69,505 | 25.5 |  |  |  |  |
|  | Dec-37 | 313,623 | 83,405 | 26.6 |  |  |  |  |
|  | Dec-38 | 361,294 | 100,087 | 27.7 |  |  |  |  |
|  | Dec-39 | 416,210 | 120,104 | 28.9 |  |  |  |  |
|  | Dec-40 | 479,474 | 144,125 | 30.1 |  |  |  |  |
|  | Dec-41 | 552,354 | 172,950 | 31.3 |  |  |  |  |
|  | Dec-42 | 636,312 | 207,539 | 32.6 |  |  |  |  |
|  | Dec-43 | 733,031 | 249,057 | 34.0 |  |  |  |  |
|  | Dec-44 | 844,452 | 298,857 | 35.4 |  |  |  |  |
|  | Dec-45 | 972,809 | 358,628 | 36.9 |  |  |  |  |
|  | Dec-46 | 1,120,676 | 430,354 | 38.4 |  |  |  |  |
|  | Dec-47 | 1,291,019 | 516,425 | 40.0 |  |  |  |  |
|  | Dec-48 | 1,487,253 | 619,709 | 41.7 |  |  |  |  |
|  | Dec-49 | 1,713,316 | 743,651 | 43.4 |  |  |  |  |
|  | Dec-50 | 1,937,740 | 892,382 | 45.2 |  |  |  |  |
|  | Dec-51 | 2,273,748 | 1,070,858 | 47.1 |  |  |  |  |
|  | Dec-52 | 2,619,358 | 1,285,029 | 49.1 |  |  |  |  |
|  | Dec-53 | 3,017,501 | 1,542,035 | 51.1 |  |  |  |  |

Illustration of Table 6  
  
1. If assets of Islamic banks continue to grow at the assumed rate of 20 percent per annum, it will take about 39 years for Islamic banks to have a share of 50% in total banking (Islamic + conventional) assets.

2. If assets of Islamic banks continue to grow at the assumed rate of 25 percent per annum, it will take about 20 years for Islamic banks to have a share of 50% in total banking (Islamic + conventional) assets.

3. If assets of Islamic banks continue to grow at the assumed rate of 30 percent per annum, it will take about 13 years for Islamic banks to have a share of 50% in total banking (Islamic + conventional) assets.

Appendix-A

STEPS TAKEN TO ELIMINATE RIBA IN 1980s

Numerous measures were taken to introduce non-interest based banking in Pakistan. Banking and other relevant laws viz. SBP Act, BCO, Companies Ordinance, recovery laws, Negotiable Instruments Act, etc. were amended to facilitate non-interest based banking system and the industry was given a specific timeline to convert to the Islamic banking system.

State Bank Pakistan also gave the industry the products which it was allowed to use without any change or exception. Non-interest based banking was rolled out country-wide. New regulations were prepared prescribing the modes of financing, profit distribution mechanism for deposits, financing facilities by SBP, etc. which constituted ground work for Islamization of financial system.

The Islamization measures among others entailed

* Elimination of interest from the operations of specialized financial institutions in 1979 and from commercial banks during 1981 to 1985.
* The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980 to permit issuance of a new interest free instrument of corporate financing named Participation Term Certificate (PTC).
* An Ordinance was promulgated to allow the establishment of Modaraba companies and floatation of Mudaraba certificates for raising risk capital. Amendments were also made in the Banking Companies Ordinance, 1962 (The BCO, 1962) to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase.
* On January 1, 1981 Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman) to mobilize deposits on profit and loss sharing basis. Regarding investment of these funds, bankers were instructed to provide financial accommodation for Government commodity operations on the basis of sale on deferred payment with a mark-up on purchase price. Export bills were to be accommodated on exchange rate differential basis.
* In March, 1981 financing of import and inland bills and that of the then Rice Export Corporation of Pakistan, Cotton Export Corporation and the Trading Corporation of Pakistan were shifted to mark-up basis. Simultaneously, necessary amendments were made in the related laws permitting the State Bank to provide finance against Participation Term Certificates and also extend advances against promissory notes supported by PTCs and Mudaraba Certificates.
* From July 1, 1982 banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the technique of Musharaka.
* The State Bank of Pakistan had specified 12 modes of non-interest financing classified in three broad categories. However, in any particular case, the mode of financing to be adopted was left to the mutual option of the banks and their clients.
* As from April 1, 1985 all finances to all entities including individuals began to be made in one of the specified non-interest based modes.
* With effect from July 1, 1985, the Federal Government notified that all commercial banking in Pak Rupees has become interest-free. From that date, no bank in Pakistan was allowed to accept any interest-bearing deposits and all existing deposits in a bank were treated to be on the basis of profit and loss sharing.
* Deposits in current accounts continued to be accepted but no interest or share in profit or loss was allowed to these accounts. However, foreign currency deposits in Pakistan and on-lending of foreign loans continued as before.
* At that time two important areas were kept outside the purview of interest free banking system mainly due to lack of research in these fields, viz. Government borrowings (both local and foreign) and foreign exchange.

12 MODES INTRODUCED DURING 1984:

(Circulated vide BCD Circular No. 13 of 1984)

A. Financing by Lending

i. Loans not carrying any interest

ii. Oard-e-Hasna

B. Trade Related Modes of Financing

i. Purchase of goods by banks and sale to customers on deferred payment with mark-up

ii. Purchase of Trade Bills

iii. Purchase of property by banks and sale to customers with or without buy back

iv. Leasing

v. Hire Purchase

vi. Financing on Development Charge basis

C. Investment Type Modes of Financing

i. Musharaka

ii. Equity Participation and purchase of shares

iii. Purchase of PTCs and Modaraba certificates

iv. Rent Sharing

ISLAMIC MODES WHICH CAN BE CURRENTLY USED BY ISLAMIC BANIkIING INSTITUTIONS

(Notified vide IBD Circular No.2 of 2008)

Participatory Modes:

i. Mudaraba

ii. Musharaka

iii. Diminishing Musharaka

iv. Equity Participation in the form of shares

Trading Modes:

i. Ijarah or Ijarah wa Iqtina

ii. Murabaha

iii . Musawamah

iv. Salam

v. Istisna

vi. Tawarruq (in exceptional cases with prior approval of IBD/SBP).

Debt Based Modes:

i. Qard

Other Modes:

i. Wakalah

ii. Assignment of Debt (Hawalah)

iii. Kafalah

1. BPD Circular No. 01 dated January 1, 2003 amended vide IBD Circular No.2 of 2004, State Bank of Pakistan. State Bank of Pakistan in 2001 issued detailed criteria for setting up of Scheduled Islamic Commercial banks based on Shariah Principles in the Private Sector in the form of a Press Release which was reproduced as Annexure-I to these circulars. [↑](#footnote-ref-1)
2. Islamic modes notified under section 7(1) (o) of the Banking Companies Ordinance, 1962 vide IBD Circular No.2 of 2008 [↑](#footnote-ref-2)
3. Malaysia, one of the leading countries in Islamic finance, reached above 20 percent share in overall banking industry in around 30 years. [↑](#footnote-ref-3)
4. The IBI's growth was substantially higher in initial years (2003-07) because of low base thus the average growth was pushed up by exceptionally high growth numbers in these years. The annual average growth for the period 2008-14 moderated to around 30 percent. [↑](#footnote-ref-4)
5. Ayub, Muhammad (2007), Understanding Islamic Finance, Wiley, Page 460 [↑](#footnote-ref-5)
6. Arby, M. Farooq (2008). Some Issues in the National Income Accounts of Pakistan (Rebasing Quarterly and Provincial Accounts and Growth Accounting). PhD Dissertation. Islamabad: Pakistan Institute of Development Economics. [↑](#footnote-ref-6)
7. Riazuddin, Riaz (2011), "Challenges of Transforming Riba-based Government Debt to Shariah-Complaint Instruments in Pakistan", 1'' International Conference on Islamic Business and Finance, Riphah Centre of Islamic Business, Riphah International University, Islamabad. [↑](#footnote-ref-7)
8. Islam, Accounting and Finance: Challenges and Opportunities in the new Decade, International Islamic University, Malaysia (2011) [↑](#footnote-ref-8)
9. KAP Study: Knowledge, Attitude and Practices of Islamic Banking in Pakistan; Karachi: State Bank of Pakistan (September 2014) [↑](#footnote-ref-9)
10. External Liabilities include Central Bank Deposits, SWPS, Allocation of SDR and Nonresident LCY deposits with central bank [↑](#footnote-ref-10)
11. Includes borrowings from banks by provisional governments and PSEs for commodity operations. [↑](#footnote-ref-11)
12. MOF defines public debt as “The portion of total debt which has a direct charge on government revenues as well as debt obtained from IMF”. [↑](#footnote-ref-12)
13. Annual Development Plan GDP (current market price) Target for FY15.

    P: Provisional [↑](#footnote-ref-13)