

Appendix-D

Summary of Reports of various Commissions and Committees formed for Development of Islamic Financial System in Pakistan.

A number of Commissions, Committees, Task Forces, Working groups, etc. were formed over the years, which have contributed in thrashing out various issues at conceptual and operational level.

In this regard following is the list of some important reports/judgments

1. Report of the Panel of Economists and Bankers - 1979
2. Report of the Council of Islamic Ideology (CII) on Elimination of Interest from the Economy (1980)
3. Judgment of Federal Shariat Court (1991)
4. Commission for Islamization of Economy Report - 1992 (Hanfi Commission)
5. Commission for Islamization of Economy Report - 1997 (Raja Zafarul Haq Commission)
6. Judgment of Shariah Appellate Bench of the Supreme Court (1999)
7. Bankers Committee Report – 2000
8. Report of the Commission for Transformation of Financial System (CTFS) - 2001
9. Report of Task Force of the Ministry of Law – 2002
10. Report of Task Force of the Ministry of Finance – 2002
11. Report of Committee on Development of Financial Instruments & Standardized Documents – 2001.

Report of Council of Islamic Ideology *clearly* expressed that the elimination of interest is but a part of the overall value system of Islam. It also mentioned that the true Islamic techniques to replace interest in the banking are profit-loss sharing and Qard 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. The Council, therefore, allowed certain other methods like leasing, hire purchase, Bai-Muajjal, investment auctioning and financing on the basis of normal rate of return with a clear provision for adjustment on the basis of actual operating results. In order to ensure that these modes are not used as a back door for interest, the Report emphasized that their use should be kept to a minimum and that their use as a general techniques of financing must never be allowed. It further observed that lack of proper accounting practice due to

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illiteracy and tendency to conceal profits on the part of the business concerns would act as a hindrance in widespread adoption of the system of profit sharing by the banks.

The Federal Shariah Court in November 14, 1991 declared that a number of financial laws and practices were repugnant to the injunctions of Islam and called upon the government and other concerned agencies to take appropriate measures to bring them in conformity with the Islamic tenets by the end of 1992. The FSC declared that various provisions of the laws held repugnant to the injunctions of Islam would cease to have effect from July 1, 1992.

Hanfi Commission Report recommended Musharaka and Modaraba to be the basic forms of Islamic financing to be used in the domestic financial sector and that steps should be taken to remove obstacles in the application of these modes. The general recommendations of the Report include i) Introducing a Law to prohibit interest, ii) Taking steps to create mass awareness about the new system, iii) Providing adequate training to the bank's staff to apply these modes of financing in their operations, iv) Reinforcing the system of corporate audit v) A thorough re-appraisal of tax system and treating dividend paid on equity as at par, for tax purposes, with profit paid on other interest-free finance, vi) Recovery laws to be made more effective and stringent. The Report also recommended the establishment of a permanent Committee consisting of Shariah experts and bankers to advise on various aspects of Islamization of banking and financial system.

Raja Zafar ul Haq Commission Report recommended that a phased approach may be adopted for three different types of transactions, namely private domestic, Government and foreign transactions, in that order, without effective dates specified in the Act. The Act will provide the ancillary details toward the adjustment and smooth transition to the new system; specifically it will provide for the manner in which the existing arrangements will be converted to the new system, suggested alternative modes of financing, method of settlement of Government liabilities etc., including mobilization of resources for retiring government's debt and constraints on its future fiscal operations. The report also recommended that State Bank of Pakistan be accorded a special role in ensuring the effective administration of the proposed change to the new system.

Supreme Court Judgment:

The Government and some banks/DFIs preferred appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan against the Federal Shariat Court's Judgment. The SAB delivered its judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. In the judgment, the Court concluded that the present financial system had to be subjected to radical

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changes to bring it into conformity with the Shariah. It also directed the Government to set up, within specified time frame, a Commission for Transformation of the Financial System and two Task Forces to plan and implement the process of the transformation. The Court indicated some measures, which needed to be taken, and the infrastructure and legal framework to be provided in order to have an economy conforming to the injunctions of Islam.

In June 2002, the reconstituted Shariah Appellate Bench (SAB) of the Supreme Court noted that some material issues were discussed in the earlier judgments but a final verdict was not given. Therefore, SAB set aside the riba judgments of 1991 and 1999 and remanded the case to the federal Shariah Court for fresh hearing, where it is still pending.

Work done by Commission for Transformation of Financial System:

The Commission for Transformation of Financial System (CTFS), constituted in January 2000 in State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor State Bank of Pakistan, submitted two Interim Reports to the Government: First in October, 2000 and the Second in May, 2001.

a) The First Interim Report

The Report gave key features of Islamic Financial System

It recommended some prior actions for preparation of ground for introduction of Shariah compliant financial system, which include:

- Creating legal infrastructure conducive for working of Islamic Financial System
- Launching a massive education and training program for bankers and their clients about features of the Islamic Financial System
- An effective campaign through media for the general public to create awareness about the new system and to gain their confidence
- Urgency of work to be done by the Task Force of Ministry of Finance – development of Shariah compliant securities.

b) The Second Interim Report

The Second Interim Report includes Shariah compliant modes of financing, their Essentials, Model Agreements for various modes to be used by the banks, guidelines for adoption of these modes for various services being offered by the banks and the proposed legal framework for Prohibition of Riba and introduction of Shariah compliant modes

c) Final Report

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The Commission submitted its final report, by joining together the above two reports, to the Government in August 2001. The Commission also dealt with major products of banks and financial institutions, both for assets and liabilities side, like letters of credit or guarantee, bills of exchange, term finance certificates (TFCs), State Bank's Refinance Schemes, Credit Cards, Interbank transactions, underwriting, foreign currency forward cover and various kinds of bank accounts. The Commission observed that all deposits, except current accounts, would be accepted on Mudaraba principle. Current accounts would not carry any return and the banks would be at liberty to levy service charge as fee for their handling. The Commission also approved the concept of Daily Product and Weightage System for distribution of profit among various kinds of liabilities/deposits. The CTFS suggested that its recommendations concerning the modes of financing, their essentials and guidelines for conversion of banks' services and products be circulated among banks, financial institutions, trade bodies, etc. to help them prepare for the adoption of the new system when the proposed law is promulgated. The Report also contained recommendation for forestalling willful default and safeguarding interest of the banks, depositors and the clients. According to the Commission, prior/preparatory work for introduction of Shariah compliant financial system briefly included creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and training program for bankers and their clients and an effective campaign through media for the general public to create awareness about the Islamic financial system.

Task Force of the Ministry of Law

The Report of the Task Force of the Ministry of Law comprises the Case History of the movement for eliminating Riba from the economy, proposed ordinances and draft amendments in various laws or provisions of laws and the record of discussions held during meetings of the Task Force. While the CTFS had proposed one comprehensive seminal law namely, 'Islamization of Financial Transactions Ordinance' the Task Force proposed two separate draft ordinances namely 'Prohibition of Riba Ordinance' and the 'Financial Transactions Ordinance'. However, it corresponds to the proposal by the CTFS that in case of two separate laws, the same may be promulgated simultaneously to avoid any gap or dislocation.

Report of Special Delegation Sent by the Finance Minister

In order to gather experience on Islamic banking in some Islamic countries a delegation comprising representatives of Ministry of Finance, State Bank and a renowned lawyer, was sent by the Finance Minister to Malaysia, Egypt and Saudi Arabia in October-November,

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2001 which met with experts in Islamic banking and finance, religious scholars, central bankers and relevant Government officials.

According to the report, only Malaysia has a separate legal framework for Islamic Banking. An important conclusion made by the Delegation was that the introduction of Islamic Banking System is a long process requiring development of legal and regulatory framework, institutions, markets, and efficient and appropriate practices. The Delegation suggested that Pakistan should follow the example of Malaysia, Egypt and Saudi Arabia and adopt a dual/parallel banking system. The Delegation also observed that the Government should be mindful of the following factors, which have so far impeded the development of Islamic banking in Pakistan:

- Inadequate legal framework for Islamic banks
- Inadequate regulatory and accounting framework for Islamic banking
- Ineffective enforcement of contracts and inefficient system for early recovery
- Ineffective code of conduct for professionals
- Absence of Shariah audit in financial institutions
- Absence of Shariah Supervisory Boards in banks
- Non-availability of Shariah compliant government securities
- Lack of research and development in the field of Islamic finance and economics
- Inadequate training to the staff of SBP and banks
- Disoriented education system devoid of Islamic principles
- Lack of public awareness about Islamic economic system
- Adoption of free market economic (capitalistic) policies
- Social and Cultural factors
- Weak Political resolve of successive governments for Islamization of Economy

Report prepared by Task Force of the Ministry of Finance

The Task Force of the Ministry of Finance in its Report concluded the following:

"The Task Force, after carefully considering a series of financial data of the Government, the available assets and their remunerative capacity has come to the conclusion that the outstanding government debt cannot be securitized against the pool of the existing assets and a Mutual Fund based there on. The privatization program, which is one of the possible ways of reducing the debt burden, is another complication in the process. It further complicates the possibility of converting GOP borrowing into Islamic modes of financing".