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Islamization of Financial System in Pakistan

Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed by the principles and rules laid down by Islamic Shariah. Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Shariah, but also to participate actively in achieving the goals and objectives of an Islamic economy.

Establishment of a small saving bank in a rural area of Egypt in 1963 was the first formal attempt for putting the principles of Islamic finance into practice. Islamic banking and finance is now an established sector and an important segment of the international financial market arena (see **Box 10.1**).

Steps for Islamization of banking and financial system of Pakistan were started in 1977-78. Pakistan was among the three countries in the world that had been trying to implement interest free banking at comprehensive/national level. But as it was a mammoth task, the switchover plan was implemented in phases.¹ An Ordinance was promulgated to allow the establishment of Mudaraba companies and floatation of Mudaraba certificates for raising risk capital. Amendments were also made in the Banking Companies Ordinance (BCO), 1962 to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase.

Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman) on January 1, 1981 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.

As from April 1, 1985 all finances to all entities including individuals began to be made in one of the specified interest-free modes. From July 1, 1985, all commercial banking in Pak Rupees was made 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. 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. An explanation of some of the important modes of financing under Islamic Sharia is provided in **Box 10.2**.

¹ The Islamization measures included the elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT in July 1979 and that of the commercial banks during January 1981 to June 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).

Box 10.1: Islamic Banking: Global Scenario

Over the last three decades Islamic banking and finance has developed into a full-fledged system and discipline reportedly growing at the rate of 15 percent per annum². Today, Islamic financial institutions, in one form or the other, are working in about 75 countries of the world. Besides individual financial institutions operating in many countries, efforts have been underway to implement Islamic banking on a country wide and comprehensive basis in a number of countries. The instruments used by them, both on assets and liabilities sides, have developed significantly and therefore, they are also participating in the money and capital market transactions. In Malaysia, Bahrain and a few other countries of the Gulf Islamic banks and financial institutions are working parallel with the conventional system.

Bahrain with the largest concentration of Islamic financial institutions in the Middle East region, is hosting 26 Islamic financial institutions dealing in diversified activities including commercial banking, investment banking, offshore banking and funds management. It pursues a dual banking system, where Islamic banks operate in the environment in which Bahrain Monetary Agency (BMA) affords equal opportunities and treatment for Islamic banks as for conventional banks. Bahrain also hosts the newly created Liquidity Management Centre (LMC) and the International Islamic Financial Market (IIFM) to coordinate the operations of Islamic banks in the world³. To provide appropriate regulatory set up, the BMA has introduced a comprehensive prudential and reporting framework that is industry-specific to the concept of Islamic banking and finance. Further, the BMA has pioneered a range of innovations designed to broaden the depth of Islamic financial markets and to provide Islamic institutions with wider opportunities to manage their liquidity.

Another country that has a visible existence of Islamic banking at comprehensive level is Malaysia where both conventional and Islamic banking systems are working in a competitive environment. The share of Islamic banking operations in Malaysia has grown from a nil in 1983 to above 8 percent of total financial system in 2001. They have a plan to enhance this share to 20 percent by the year 2010. However, there are some conceptual differences in interpretation and Shariah position of various contracts like sale and purchase of debt instruments and grant of gifts on savings and financial papers.

In Sudan, a system of Islamic banking and finance is in operation at national level. Like other Islamic banks around the world the banks in Sudan have been relying in the past on Murabaha financing. However, the share of Musharaka and Mudaraba operations is on increase and presently constitutes about 40 percent of total bank financing. Although the Islamic financial system has taken a good start in Sudan, significant problems still remain to be addressed.

Like Sudan, Iran also switched over to Usury Free Banking at national level in March 1984. However, as in case of Malaysia, there are also some conceptual differences between Islamic banking in Iran and the mainstream movement of Islamic banking and finance.

The procedure adopted by banks in Pakistan since July 1, 1985 was, however, declared un-Islamic by the Federal Shariat Court (FSC) in November 1991. The system was based largely on 'mark-up' technique with or without 'buy-back arrangement'. The FSC declared that various provisions of the laws held repugnant to the injunctions of Islam in its Judgment dated November 14, 1991 would cease to have effect as from July 1, 1992. However, the Government and some banks/DFIs preferred appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan. 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 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.

² Bahrain Monetary Agency: Islamic Banking and Finance in the Kingdom of Bahrain, 2002.

³ The LMC is designed to manage the asset liquidity mismatch, to create a pool of quality assets for Islamic financial institutions (IFIs) and an Islamic interbank money market collaterally with enhancing Shariah credibility and achieving higher returns for investors and shareholders. It also facilitates the pooling of assets acquired from the government, financial institutions and corporates to be securitized through the issuance of tradable instruments (sukuk), where IFIs will invest their surplus liquidity.

Box 10.2: Islamic Modes of Financing***Ijarah / Ijarah-wal-Iqtina'*** (Hire-purchase)

A contract under which an Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rental as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit, which is usually determined in advance.

Murabaha

Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. Islamic banks have adopted this as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost, which is settled in advance.

Bai' Muajjal

Literally it means a credit sale. Technically, a financing technique adopted by Islamic banks takes the form of *Murabaha Muajjal*. It is a contract in which the seller earns a profit margin on his purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. He has to expressly mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

Bai' Salam

Salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver or currencies. Barring this, *Bai' Salam* covers almost everything, which is capable of being definitely described as to quantity, quality and workmanship.

Istisna'a

It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. *Istisna'a* can be used for providing the facility of financing the manufacture or construction of houses, plants, projects, building of bridges, roads and highways.

Mudarabah

A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the *Mudarib*. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider of the capital.

Musharakah

Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds, which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.

Diminishing Musharaka

In a *Diminishing Musharaka* contract, two parties enter into a partnership to jointly own an asset. One of the parties agrees to sell its part of ownership (divided into units) to the other party periodically and at the end of the contract, complete ownership is transferred from one party to the other. The rental payments decrease with periodical purchase of units of ownership in the asset by the other party.

10.1 Post Judgment Measures ⁴

The Commission for Transformation of Financial System (CTFS) was constituted in January 2000 in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor State Bank of Pakistan. A Task Force was set up in the Ministry of Finance to suggest the ways to eliminate interest from Government financial transactions. Another Task Force was set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CTFS constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system.

The first Interim Report of the CTFS submitted in October 2000 identified a number of prior actions, which were needed to be taken to prepare the ground for transformation of the financial system. The second Interim Report submitted in May, 2001 identified major Shariah compliant modes of financing, their essentials, draft seminal law captioned 'Islamization of Financial Transactions Ordinance, 2001', model agreements for major modes of financing, and guidelines for conversion of products and services of banks and financial institutions. 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 works 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.

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.

10.1.1 Follow up Measures

The Finance Minister in his budget speech for the FY02 declared the following:

"Government is committed to eliminate Riba and promote Islamic banking in the country. For this purpose a number of steps are under way, which are:

⁴ Supreme Court's judgment dated December 23, 1999

1. A legal framework is designed to encourage practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations;
2. Consultations and exchanges are undertaken with brother Islamic countries and renowned institutions of Islamic learning such as Middle Eastern countries and Al-Azhar University of Egypt, to learn more about their experiences and practices;
3. Amendments in HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC would be fully Shariah compliant institution, which will play an effective role both in promotion of Islamic financing method but also in the development of the important housing sector;
4. Sharia compliant modes of financing like Musharaka and Mudaraba will be encouraged so that familiarity and use of such products is enhanced and their adoption at a wider scale made possible.
5. The transformation commission established in the State Bank of Pakistan will continue to function and its recommendations whenever finalized will be considered by the government for appropriate action.

It is government's intention to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors".

The House Building Finance Corporation had shifted its rent sharing operations to interest based system in 1989. The Task Force of the M/O Law proposed amendments in the HBFC Act to make it Shariah Compliant. Having vetted by the CTFS, the amended law has been promulgated by the Government. Accordingly, the HBFC has launched "Ghar Aasan Scheme" in the light of amended Ordinance based on the Diminishing Musharakah concept. A Committee has been constituted in the Institute of Chartered Accountants, Pakistan (ICAP), wherein the SBP is also represented, for development of accounting and auditing standards for Islamic modes of financing. The Committee is reviewing the standards prepared by the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) with a view to adapt them to our circumstances and if considered necessary, to propose new accounting standards. The State Bank has also reviewed its forms of financial statements for banks in the light of AAOIFI standards. A new Islamic Banking Division has been established in Banking Policy Department of SBP for regulation and promotion of Islamic banking. Existing Prudential Regulations for banks have been reviewed by SBP for their application on Islamic banks.

10.2 Policy Decision

It was decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions⁵. It was also agreed that State Bank of Pakistan would consider:

1. Setting up subsidiaries by the commercial banks for the purpose of conducting Shariah compliant transactions;
2. Specifying branches by the commercial banks exclusively dealing in Islamic products, and
3. Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.

Accordingly, the State Bank issued detailed criteria in December 2001 for establishment of full-fledged Islamic commercial banks in the private sector (see Annexure). Al Meezan Investment Bank received the first Islamic commercial banking license from SBP in January 2002 and the Meezan

⁵ This decision was made in a meeting held on September 4, 2001 under the Chairmanship of the President of Pakistan, attended by officials of the Ministries of Finance and Law, Governor State Bank of Pakistan, Chairman and some members of the Council of Islamic Ideology and the Chairmen of the CTFS and the two Task Forces.

Bank Limited (MBL) commenced full-fledged commercial banking operation from March 20, 2002. Further, all formalities relating to the acquisition of Societe Generale, Pakistan by the MBL were completed, and by June, 2002 it had a network of 5 branches all over the country, three in Karachi, one in Islamabad and one in Lahore. The MBL maintains a long term rating of AA and short term rating of A1+, assessed by JCR VIS Credit Rating Co Ltd, signifying a consistent satisfactory performance.

Meanwhile, the Shariat Appellate Bench (SAB) of the Supreme Court, in its short judgment dated June 24, 2002 set aside the previous verdicts on Riba, i.e. judgment by the Federal Shariat Court dated November 14, 1991 and the verdict by the SAB dated December 23, 1999 and referred the issue back to the Federal Shariat Court for rehearing.

While discussion on Riba may go on in the Court, the Government/State Bank shall proceed ahead with Islamic Banking practices in parallel with the conventional banking. Some extracts from the 'Affidavit' filed by Deputy Governor of the State Bank in the Supreme Court of Pakistan during recent hearing of the Riba case are given below which also reflect the future policy of the Bank for the time being.

"The SBP is itself committed to promoting Islamic banking in Pakistan on a parallel basis. The SBP strategy provides for three institutional options: an independent and dedicated Islamic bank; an Islamic banking subsidiary of a conventional bank; or a dedicated Islamic banking branch of a conventional bank with all safeguards to ensure integrity and purity of Islamic banking operations. In this respect, SBP has taken a number of initiatives since the judgment:

1. A detailed set of criteria for establishment of Islamic commercial banks in the private sector was issued in December 2001.
2. A new fully dedicated Islamic bank, Meezan Bank Limited, has been issued a license and the bank has started its business.
3. In order to allow existing banks to set up subsidiaries for Islamic banking, draft amendments in Section 23 of Banking Companies Ordinance, 1962 have been submitted to Government for approval.
4. A new Islamic Banking Division has been established in the Banking Policy Department for regulation and promotion of Islamic banking.
5. Existing Prudential Regulations have been reviewed by SBP for their application on Islamic banks, and revised regulations are being prepared.
6. Export Finance Scheme of SBP is being revised to conform to Musharaka basis.
7. Courses on Islamic economics, banking and finance have been included in the curricula of the Institute of Bankers in Pakistan.
8. International Islamic University, Islamabad, has conducted a training course for trainers on Islamic Financial System in April 2002. SBP staff along with staff of other banks attended the course.
9. SBP has reviewed its Forms of Financial Statements for banks in the light of newly developed accounting standards."

The Affidavit further says:

"That having taken a series of steps to promote Islamic banking, and considering all other practical problems associated with the complete transformation of the financial system, discussed herein, it is State Bank of Pakistan's considered judgment that a parallel approach will be in the best interest of the country. This means that Islamic banking is introduced as a parallel system, of which a beginning has already been made; it is provided a level playing field vis-à-vis the existing conventional banks, and its further growth and development is supported by Government and State

Bank of Pakistan through appropriate actions. This approach will eliminate the risk of any major cost/damage to the economy, give a fair chance to Islamic banks to develop alongside the conventional banks, and will provide a choice to the people of Pakistan, and the foreigners doing businesses in/with Pakistan, to use either of the two systems”.

10.3 Regulation of Islamic Banks

Granting permission for Islamic banking operations in the country necessarily entails an appropriate framework for regulating and supervising Islamic banks applying the principles of sound banking business. The State Bank of Pakistan is working to evolve such a framework. It would require an innovative approach keeping in view the Shariah essentials of Islamic modes, accounting and auditing standards recommended by AAOIFI (Bahrain) and the international best practices. In this context recourse could be made to the experience of Bahrain Monetary Agency (BMA) that in addition to the application of rigorous regulatory and transparency standards, has pioneered a range of innovations designed to broaden the depth of Islamic financial markets and to provide Islamic institutions with wider opportunities to manage their liquidity and risk spectrum.

A number of factors relating to institutional arrangements, supervisory/regulatory and legal framework, and human resource development in the central bank, the treasury and the banks need to be taken care of. The State Bank will also have to strengthen the set-up for preparation and evaluation of feasibility reports and follow-up on project implementation.

The problem of alternative liquidity management by banks and monetary management by the State Bank needs to be resolved. For this purpose, development of financial instruments on the basis of Musharaka, Mudaraba, Leasing and Salam – related to a wide spectrum of maturities, projects and issuing entities, whether governmental or private, to cover needs of the financial market would require resolute and common efforts by the State Bank, Islamic banks and the concerned research institutions.

The State Bank would like to ensure that Islamic banks, subsidiaries, windows or the branches operating parallel with the conventional banking practices are prototype of commercial banks, i.e. doing all functions that a commercial bank normally does. Taxation laws also require some amendments in order to save the banks from extra burden due to their involvement in trading and leasing activities. These and other related issues are under consideration.

The State Bank is also managing to benefit from the global Islamic banking experience. As a part of international collaboration, the IMF provided technical assistance to the Ministry of Finance and the Commission for Transformation of Financial System. A Technical Assistance Mission comprising the Fund’s experts, on Islamic banking namely Dr. Ghiath Shubsigh and Mr. Michael Taylor provided guidelines on Islamic financial system. The Commission had detailed discussion with them on the practical aspects of transforming the system. Specific issues discussed with them included:

1. Viability of the new system
2. Effects on Resource Mobilization
3. Tools for Monetary Management
4. Supervisory and Regulatory Needs of the new system

The IMF experts believed that there was no priori reason to believe that the system *per se* would generate adverse effects on savings and resource mobilization. They also made presentation on how the tools for monetary management could be developed within the interest free framework. They however, emphasized the need to review and revamp the supervisory and monetary mechanism to provide adequate supervision and regulation of the new system.

The Governor, State Bank of Pakistan has been participating in various meetings arranged for establishment of the Islamic Financial Services Board (IFSB) with the active participation of

International Monetary Fund. Based in Malaysia, the IFSB will be a coordinating body among regulators/supervisors of Islamic banks in various parts of the world (see **Box 10.3**). State Bank has also been sending its officials to international seminars and conferences on Islamic banking held in Iran, Sudan, Bahrain, Lebanon, Egypt, etc.

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, Dr. Riazul Hasan Gilani was sent by the Finance Minister to Malaysia, Egypt and Saudi Arabia in October-November, 2001 which met with experts in Islamic banking and finance, religious scholars, central bankers and relevant Government officials.

The delegation discussed relevant issues with senior officials of regulatory agencies, Islamic banks, training institutes and Shariah scholars of these countries as well as the officials of Islamic Development Bank, Jeddah. These issues included conceptual, legal, regulatory, operational, products and services, training, etc. Overall, the visit gave the delegation an opportunity of getting first hand knowledge of Islamic banking practices in these countries and discussing with experts matters of common interest.

Box 10.3: The Islamic Financial Services Board (IFSB)

The decision to establish an institution to support the design and adaptation of uniform prudential supervision standards for Islamic financial products was made in a Conference of Central Banks Governors held in February 2000 in Bahrain on regulation of Islamic banking industry.

Consequently, and at the request of many of the central bank governors, the IMF staff convened a meeting of the Governors and senior officials of 18 countries and organizations on September 23, 2000 in Prague, on the occasion of the IMF-World Bank Annual meetings. The Central Bank Governors of Pakistan, Bahrain, Egypt, Iran, and Sudan, senior officials from Jordan, Malaysia, Indonesia, the IDB, AAOIFI, and a number of senior officials from the IMF attended the meeting. The meeting discussed the need to adapt and, where necessary, develop new standards to control the unique risks associated with Islamic financial products. The setting and harmonization of such standards, it was agreed, would not only promote a level playing field and foster industry development, but would also enhance the basis for more effective supervision of institutions offering such products and improve the prospects for better risk management.

The delegations unanimously supported the proposal to establish an Islamic Financial Services Board (IFSB) that would, amongst other roles, develop and disseminate uniform prudential, disclosure and regulatory standards to govern risks incurred in Islamic financial products. It was also decided that the Organization would be structured around a General Assembly, an Islamic Financial Services Board (IFSB), a Technical Committee (TC) and a permanent Secretariat.

Accordingly, it was decided in a meeting held in April 2002 at the IMF headquarters, to facilitate the establishment of an Islamic Financial Services Board (IFSB) to harmonize Shariah based banking system in the world. They also agreed to establish a Steering Committee headed by Dr. Zeti Akhtar Aziz, Governor, Bank Negara Malaysia, to undertake the necessary steps for the establishment and inauguration of the IFSB in Kuala Lumpur. With its headquarter at Kuala Lumpur, the IFSB will consist of the General Assembly, a Board, a Technical Committee and the Secretariat.

The IFSB will serve as an association of institutions that have responsibility for the regulation and supervision of the Islamic financial services industry and will perform the following functions:

- i. Set and disseminate standards and core principles-as well as adapt existing international standards-for supervision and regulation, consistent with the Shariah principles governing the industry, and for voluntary adoption by member countries;
- ii. Cooperate with other standard-setters in the areas of monetary and financial stability; and
- iii. Promote good practices in risk management in the industry through research, training, and technical assistance.

According to the report submitted by the delegation, Egypt and Saudi Arabia have no separate laws but have allowed Islamic banking to operate under their existing laws for conventional banks. None of these two countries has any constitutional, judicial or administrative policy or plan for a complete transformation of their economic and financial system. Malaysia has developed a parallel Islamic banking system in a systematic and planned manner. Of the three countries, only Malaysia has opted for a separate legal framework for Islamic Banking. The Bank Negara Malaysia issues license to conventional banks to open branches and windows for Islamic banking operations. In order to ensure segregation of funds of these operations, it has established a separate cheque clearing system.

An important conclusion made by the Delegation is 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. This process requires constant monitoring and fine-tuning. The Delegation has 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

Box 10.4: Musharaka Based Term Finance Certificates

Sitara Chemical Industries Ltd, a public limited company, made a public issue of profit & loss sharing based Term Finance Certificates (TFCs) worth Rs 360 million which were subscribed on June 19 and 20, 2002. The Issue, rated 'AA' by JCR-VIS was under written by Saudi Pak Industrial and Agricultural Investment Company (Pvt) Ltd, Meezan Bank Ltd, Faysal Bank Ltd and Pakistan Kuwait Investment Company (Pvt) Ltd. Out of total, TFCs worth Rs. 255 million were made available for private placement by institutions while Rs. 105 million was offered to the general public. The Sitara clearly indicated, "These TFCs are based on profit and loss sharing, subscribers are, therefore, advised to carefully read the features of profit and loss sharing of TFCs as mentioned in the Prospectus". The public gave enthusiastic response and Rs 224 million were subscribed against the offer of Rs 105 million.

The TFCs for the period of 5 years are based on the mechanism of profit and loss sharing. The payment of profit to or sharing of loss with the TFC holders are linked to the operating profit or loss of the Chemical Division of the Company. Therefore, the investors assume the risk of sustaining losses proportionate to their principal amount in case of operating losses incurred by their Chemical Division. The exact rate of profit on investment in the TFCs will not be possible to determine for each year in advance. Changes in any government regulations may affect the profitability of the Company. By investing in the TFCs, the investor assumes the risk of not being able to sell the TFC without adversely affecting the price.

10.4 Training and Education

The importance of training and education of the bankers, their clients and the public at large for the purpose of promotion of the new system cannot be overemphasized. Some efforts have been made in this regard as well. National Institute of Banking and Finance (NIBAF), training wing of the State Bank, has included a Module on Islamic banking and finance in its training courses designed for State Bank's Officers Training Scheme (SBOTS) and other fresh inductees. Planning is also underway for imparting training on the subject to State Bank's existing officials. Courses of the Institute of Bankers, Pakistan have been revised to include topics on Islamic economics, banking and finance. Some other institutions like International Institute of Islamic Economics, International Islamic University Islamabad, Centre for Islamic Economics, Karachi, etc are also organizing seminars and training courses on Islamic banking and finance.

10.5 The Main Challenge

The experience in Islamic banking operations around the world reveals that transformation of retail banking is not a big problem. The financial sector in Pakistan is already familiar, at least to some extent, with the concepts of Islamic banking and finance. Some of the Investment Banks, Mudaraba Companies and other financial institutions are already practicing not only Murabaha and leasing but also profit/loss sharing based financing operations. The experience of an Investment Bank shows that they had been earning very lucrative profit of over 100 per cent per annum in export financing on the basis of Musharaka/Mudaraba.

However, there are problems in development of instruments for liquidity management by banks and monetary management by the State Bank and this is the main challenge. Government financial transactions constitute a large part of the financial system of the country. Banks and financial institutions have sizable investment in Government securities. The monetary management is also primarily linked to transactions of government securities. Therefore, the process of Islamization of financial system will crucially depend on development of instruments for Shariah compliant government financial transactions. Accordingly, the development of instruments of Government financing and restructuring the national/public debt on the Shariah compliant basis is the main challenge facing the country for making its financial system Shariah compliant. Internal and external debt as a whole is equivalent to about 100 per cent of the GDP by end-FY02. While the instruments for raising resources by the Government should be real assets based, borrowing needs of the Government are so large that the real assets are quite insufficient to cover them.

The Task Force of the Ministry of Finance in its Report that was submitted to the Court during recent hearing has come to the following conclusion:

"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".