

FAQs

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Q1. What is Islamic Banking?

Ans. Islamic banking has been defined as banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles 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 avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy.

Q2. What is the philosophy of Islamic banking and finance?

Ans. Islamic Shariah prohibits 'interest' but it does not prohibit all gains on capital. It is only the increase stipulated or sought over the principal of a loan or debt that is prohibited. Islamic principles simply require that performance of capital should also be considered while rewarding the capital. The prohibition of a risk free return and permission of trading, as enshrined in the Verse 2:275 of the Holy Quran, makes the financial activities in an Islamic set-up real asset-backed with ability to cause 'value addition'.

Islamic banking system is based on risk-sharing, owning and handling of physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of finance. As such, Islamic banks deal with asset management for the purpose of income generation. They will have to prudently handle the unique risks involved in management of assets by adherence to best practices of corporate governance. Once the banks have stable stream of Halal income, depositors will also receive stable and Halal income.

The forms of businesses allowed by Islam at the time the Holy Quran was revealed included joint ventures based on sharing of risks & profits and provision of services through trading, both cash and credit, and leasing activities. In the Verse II:275, Allah the Almighty did not deny the apparent similarity between trade profit in credit sale and Riba in loaning, but resolutely informed that Allah has permitted trade and prohibited Riba.

Profit has been recognized as 'reward' for (use of) capital and Islam permits gainful deployment of surplus resources for enhancement of their value. However, alongwith the entitlement of profit, the liability of risk of loss on capital rests with the capital itself; no other factor can be made to bear the burden of the risk of loss. Financial transactions, in order to be permissible, should be associated with goods, services or

benefits. At macro level, this feature of Islamic finance can be helpful in creating better discipline in conduct of fiscal and monetary policies.

Besides trading, Islam allows leasing of assets and getting rentals against the usufruct taken by the lessee. All such things/assets corpus of which is not consumed with their use can be leased out against fixed rentals. The ownership in leased assets remains with the lessor who assumes risks and gets rewards of his ownership.

Q3. What is the history of Islamic Banking in Pakistan?

Ans. 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. 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). An Ordinance was promulgated to allow the establishment of Mudaraba companies and floatation of Mudaraba certificates for raising risk based capital. Amendments were also made in the Banking Companies Ordinance, 1962 (The BCO, 1962) and related laws 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.

The procedure adopted by banks in Pakistan since July 1 1985, based largely on 'mark-up' technique with or without 'buy-back arrangement', was, however, declared un-Islamic by the Federal Shariat Court (FSC) in November 1991. However, appeals were made in 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 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 CTFS in its Report identified a number of prior actions, which were needed to be taken to prepare the ground for transformation of the financial system. It also 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 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 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 Finance Minister of Pakistan 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:

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. Shariah 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. 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 launched in 2001 Asaan Ghar Scheme in the light of amended Ordinance based on the Diminishing Musharakah concept. A Committee was constituted in the Institute of Chartered Accountants, Pakistan (ICAP), wherein the SBP was 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 Organisation for Islamic Financial Institutions (AAOIFI) with a view to adapt them to our circumstances and if considered necessary, to propose new accounting standards.

It was decided in September 2001 that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions. It was also agreed that State Bank of Pakistan would consider for:

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 new full-fledged commercial banks 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. Al Meezan Investment Bank received the first Islamic commercial banking license from SBP in January 2002 and the Meezan 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 now maintains a long term rating of A+ and short term rating of A1+, assessed by JCR VIS Credit Rating Co Ltd, signifying a consistent satisfactory performance.

The Government as also the State Bank are mainly concerned with stability and efficiency of the banking system and safeguarding the interests, particularly, of small depositors. With this concern in mind it has been decided to operate Islamic banking side by side with traditional banking. The approach is to institute best practice legal, regulatory and accounting frameworks to support Islamic banks and investors alike. The year 2002-2003 witnessed strengthening measures taken in the areas of banking, non-bank financial companies and the capital markets.

Islamic Banking Subsidiaries

A new clause (aa) was inserted in sub-section (1) of Section 23 of the Banking Companies Ordinance 1962 by an amendment notified in the Gazette of Pakistan on November 4 2002, which provided that banks could form subsidiaries for "carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah." In January, 2003 the State Bank issued BPD Circular No. 01

outlining detailed instructions on the remaining two parts of the strategy, viz. setting up of subsidiaries and Stand-alone branches for Islamic Banking by existing commercial banks. The criteria for subsidiaries are almost similar to the criteria for setting up scheduled Islamic commercial bank with emphasis on complete segregation of accounts of Islamic banking subsidiaries and the parent banks doing conventional banking. The subsidiaries shall have minimum paid up capital of Rs 1,000 million that is equal to the capital requirement for full-fledged commercial banks.

Islamic Banking through Stand-alone Branches

For Part-III of the strategy, guidelines for opening of stand-alone branches for Islamic banking by existing commercial banks, enlisting eligibility criteria, licensing requirements and other operational details on the subject were issued on January 1 2003. The criteria pertain to financial strength of the applicant bank as evident from its capital base (net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services and the convenience and the needs of the population of the area to be served by the proposed branches. Further, banks seeking permission should have CAMELS rating of 1, 2 and 3 in the last ON-SITE inspection and there should not be major adverse inspection findings against the bank. The applying bank is required to submit proposal to the State Bank, outlining the following details:

- Number of branches along with name of city where the Islamic Banking Branch (IBB) is to be offered within the next financial year.
- Products and services to be offered by the IBB including deposits, financing, investment, etc.
- Method of segregating the funds of IBB from the funds of commercial banking of the applying bank.
- Infrastructure and logistic requirements, including manpower and training programs.
- The name, qualification and experience of Shariah Adviser (s), and
- Accounting aspects, such as accounting policies to be followed, profit and loss sharing mechanism, manuals, etc.

The bank will also be required to set up Islamic Banking Division (IBD) at the Head Office/Country Office in Pakistan. The responsibilities of this Division have been depicted in detail. The bank would also appoint a Shariah adviser/Shariah Supervisory Committee consisting of Shariah scholar(s) of repute to advise the IBD on matters pertaining to Shariah. Moreover, the bank shall ensure that proper systems and controls are in place in order to ensure segregation of funds and to protect the interest of depositors. The banks shall ensure proper maintenance of records for all transactions for disclosure of assets, liabilities, expenses and income of IBD/IBB(s). The IBD will also comply with statutory liquidity and cash reserve requirements determined by SBP.

As regards the status of Islamic banking industry in the country (End June 2004), Meezan Bank is operating with 10 branches in 5 cities as a full fledged Islamic bank. In addition to it, 5 banks (MCB, Bank of Khyber, Bank Alfalah, Habib Bank AG Zurich and Standard Chartered Bank) have been issued licenses for 12 dedicated Islamic Banking Branches (IBB) of which 10 branches are operating in Karachi, Islamabad, Peshawar, Lahore, Faisalabad and Multan. These banks are planning to offer Islamic banking products in Quetta, Hyderabad, Gujranwala and other major cities during the year 2004. SBP has also given in principle approval for opening 10 more Islamic banking branches during 2004 by MCB and Bank Alfalah.

Habib Bank Limited and Bank Al Habib Limited have been granted in principle approval to open two Islamic banking branches. They are expected to start these branches during the year 2004. At least five more banks are expected to open Islamic banking branches during the year ending December, 2004. Applications for two new full-fledged Islamic banks are also under scrutiny while the license of a foreign Islamic bank is being converted to Islamic banking. Some of the banks who are operating Islamic banking branches are also offering Islamic banking products through their existing conventional branches by using hub & spoke arrangement. It will increase the outreach of Islamic banking products in other cities as well.

Q4. What is the Islamic Banking Global Scenario?

Ans. Over the last three decades Islamic banking and finance has developed into a full-fledged system and discipline reportedly growing at the rate of 15percent per annum. 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 world. 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 2003. 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, there are some conceptual differences between Islamic banking in Iran and the mainstream movement of Islamic banking and finance.

Owing to the growing amount of capital availability with Islamic banks, the refining of Islamic financing techniques and the huge requirement of infrastructure development in Muslim countries there has been a large number of project finance deals particularly in the Middle East region. Islamic banks now participate in a wide financing domain stretching from simple Shariah-compliant retail products to highly complex structured finance and large-scale project lending. These projects, inter alia, include power stations, water plants, roads, bridges and other infrastructure projects. Bahrain is the leading centre for Islamic finance in the Middle East region. The establishment of the Prudential Information and Regulatory Framework for Islamic Banks (PIRI) by the BMA in conjunction with AAOIFI has gone a long way towards establishing a legal and regulatory framework to meet the specific risks inherent in Islamic financing structures.

The BMA has quite recently signed MoU with the London Metal Exchange (LME) to pool assets to develop and promote Shariah compliant tradable instruments for Islamic banking industry. The arrangement is seen as a major boost for industry's integration in the global financial system and should set the pace for commodity-trading environment in Bahrain. BMA has also finalized draft guidelines for issuance of Islamic bonds and securities from Bahrain. In May 03, the Liquidity Management Centre (LMC) launched its debut US\$ 250 million Sukuk on behalf of the Government of Bahrain.

National Commercial Bank (NCB) of Saudi Arabia has introduced an Advance Card that has all the benefits of a regular credit card. The card does not have a credit line and instead has a prepaid line. As such, it does not incur any interest. Added benefits are purchase protection, travel accident insurance, etc and no interest, no extra fees with no conditions, the card is fully Shariah compliant. It is more secure than cash, easy to load up and has worldwide acceptance. This prepaid card facility is especially attractive to women, youth, self employed and small establishment employees who sometimes do not meet the strict requirements of a regular credit card facility. Saudi Government has also endorsed an Islamic-based law to regulate the kingdom's lucrative Takaful sector and opened it for foreign investors.

Islamic banks have also built a strong presence in Malaysia, where Standard & Poor's assigned a BBB+ rating to the \$600 million Sharia-compliant trust certificates (called sukuk) issued by Malaysia Global Sukuk Inc. Bank Negara Malaysia (BNM) has announced to issue new Islamic Bank licences to foreign players. The Financial Sector Master plan maps out the liberalisation of Malaysia's banking and insurance industry in three phases during the next decade. It lists incentives to develop the Islamic financial sector and enlarge its market share to 20 percent, from under 10 percent now. A dedicated high court has been set up to handle Islamic banking and finance cases.

In United Kingdom, the Financial Services Authority is in final stages of issuing its first ever Islamic banking license to the proposed Islamic Bank of Britain, which has been sponsored by Gulf and UK investors. The United States of America has appointed Dr. Mahmoud El Gamal, an eminent economist/expert on Islamic banking to advise the US Treasury and Government departments on Islamic finance in June 2004.

Q5. What are the Major modes of Islamic banking and finance?

Ans. Following are the main modes of Islamic banking and finance:

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 certain goods for him. The bank does that for a definite profit over the cost, which is stipulated in advance.

IJARAH

Ijarah is a contract of a known and proposed usufruct against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, Ijarah or leasing is the transfer of usufruct for a consideration which is rent in case of hiring of assets or things and wage in case of hiring of persons.

IJARAH-WAL-IQTINA

A contract under which an Islamic bank provides equipment, building or other assets to 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 rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum alongwith with profit over the period of lease.

MUSAWAMAH

Musawamah is a general and regular kind of sale in which price of the commodity to be traded is bargained between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus, it is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawamah is not obliged to reveal his cost. Both the parties negotiate on the price. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be used where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

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 and building of bridges, roads and highways.

BAI MUAJJAL

Literally it means a credit sale. Technically, it is a financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal. It is a contract in which the bank 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. It 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.

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 only 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.

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.

Q6. Can Islamic banks play any role in economic development of the Country?

Ans. Islamic banks, while functioning within the framework of Shariah, can perform a crucial task of resource mobilization, their efficient allocation on the basis of both PLS (Musharaka and Mudaraba) and non-PLS (trading & leasing) based categories of modes and strengthening the payments systems to contribute significantly to economic growth and development. Sharing modes can be used for short, medium and long-term project financing, import financing, pre-shipment export financing, working capital financing and financing of all single transactions. In order to ensure maximum role of Islamic finance in development of the economy it would be necessary to create an environment that could induce financiers to earmark more funds for Musharakah/Mudarabah based financing of productive units, particularly of small enterprises.

The non-PLS techniques, as acceptable in the Islamic Shariah, not only complement the PLS modes, but also provide flexibility of choice to meet the needs of different sectors and economic agents in the society.

Trade-based techniques like Murabaha with lesser risk and better liquidity options have several advantages vis-à-vis other techniques but may not be as fruitful in reducing income inequalities and generation of capital goods as participatory techniques. Ijarah related financing that would require Islamic banks to purchase and maintain the assets and afterwards dispose of them according to Shariah rules, require the banks to engage in activities beyond financial intermediation and can be very much conducive to the formation of fixed assets and medium and long-term investments.

On the basis of the above it can be said that supply and demand of capital would continue in an interest-free scenario with additional benefit of greater supply of risk-based capital alongwith more efficient allocation of resources and active role of banks and financial institutions as required in asset based Islamic theory of finance. Islamic banks can not only survive without interest but also could be helpful in achieving the objective of development with distributive justice by increasing the supply of risk capital in the economy, facilitating capital formation, and growth of fixed assets and real sector business activities.

Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It also provides incentive to enhance production as the seller would spare no effort in producing, at least the quantity needed for settlement of the loan taken by him as advance price of the goods. Salam can also lead to creating a stable commodities market especially the seasonal commodities and therefore to stability of their prices. It would enable savers to direct their savings to investment outlets without waiting, for instance, until the harvesting time of agricultural products or the time when they actually need industrial goods and without being forced to spend their savings on consumption.

Banks might engage in fund and portfolio management through a number of asset management and leasing & trading companies. Such companies/entities can exist in the economy on their own or can be an integral part of some big companies or subsidiaries, as in the case of Universal Banking in Europe. They would manage Investors Schemes to mobilize resources on Mudarabah basis and to some extent on agency basis, and use the funds so collected on Murabaha, leasing or equity participation basis. Subsidiaries can be created for specific sectors/operations, which would enter into genuine trade and leasing transactions. Low-risk Funds based on short-term Murabaha and leasing operations of the banks in both local as well as foreign currencies would be best suited for risk-averse savers who cannot afford possible losses, in PLS based investments. Under equity based Funds, banks can offer a type of equity exposure through specified investment accounts where they may identify possible investment opportunities from existing or new business clients and invite account-holder to subscribe. Instead of sharing in the bank's profit, the investors would share the profits of the enterprise in which funds are placed with the bank taking a management fee for its work. Banks can also offer open-ended Multiple Equity Funds to be invested in stocks.

Small and medium enterprises (SME) sector has a great potential for expanding production capacity and self-employment opportunities in the country. Enhancing the role of financial sector in development of SME sub-sector could mitigate the serious problems of unemployment and low level of exports. The banks may introduce 'SME Financing Funds' with various geographical locations. The corporate sector and the commercial banks may set up a network of such Funds under the aegis of SECP by establishing institutions under syndicate arrangements or otherwise.

Q7. What are the features of State Bank's Islamic Export Refinance Scheme?

Ans. State Bank of Pakistan has introduced a Musharakah-based Islamic Export Refinance Scheme (IERS) to meet the export financing requirements of banks conducting operations under Islamic Modes. IBIs can avail this facility under both parts of SBP's Export Finance Scheme (EFS). The framework of the IERS is based on the concept of Profit & Loss Sharing. The State Bank shares the actual profit of the Musharakah pool of the Islamic Bank. However, in case the actual profit of the pool is more than ongoing rates under conventional EFS, the excess profit so received by SBP would be credited to the Takaful fund, a reserve fund to be maintained by SBP under Islamic modes for risk mitigation that would be used to meet future losses arising on implementation of IERS. Salient features of the Scheme are as under:

1. The facility is allowed only against transactions, designed on the basis of Islamic Modes of financing approved by the Shariah Advisor/Board of the concerned bank.
2. Each Islamic bank shall be under obligation to create a Musharakah pool (having a minimum of 10 companies - to be achieved in first year of operations) consisting of financing to blue chip companies on Islamic modes. The blue chip companies shall mean such companies involved in the export business or other business or both, or a manufacturing concern marketing their products in Pakistan or abroad, who have i) good track record on the stock exchange or ii) have a rating of minimum B + or equivalent by the rating agencies approved by the State Bank for rating banks in Pakistan, such rating should be acceptable to the bank as per its own lending policies, for advancing loans, or iii) companies having Return on Equity (ROE) during last three years which should be at least higher than the rates of finance prescribed by the State Bank during those years on its conventional EFS. In case of a company which is in operation for less than three years, the ROE of the available number of years shall be considered. The Islamic Bank shall ensure that companies selected for Musharakah Pool under the above criteria does not have adverse Credit Information Bureau report as also export overdues of more than one year.

3. The State Bank will share in the overall profit (gross income less any provision created under Prudential Regulations during the period plus amount recovered against prior periods' losses and reversal of provision) earned by the Islamic bank on the Musharaka pool under the provisions of the IERS calculated on daily product basis.

4. If, on the basis of the annual audited accounts of the Islamic Bank, the profit accruing to the SBP is more than the profit paid to the SBP on quarterly basis as per un-audited accounts of earnings of the pool, the difference shall be deposited by the Islamic bank, within 7 days of its determination, in a special non remunerative reserve fund viz. "Takaful Fund" to be maintained at the office of the SBP BSC (Bank), where the head office/country office of the concerned bank is situated. This arrangement shall remain effective for all intents and purposes for the duration of the agreement.

5. If, on the basis of the annual audited accounts of the pool, the share of the State Bank in the profit works out to be less than the amount, which has already been paid to the State Bank on provisional basis, the State Bank will refund the excess amount involved out of balance held in the Takaful Fund, if any.

6. In the event of loss suffered on the Musharakah pool on the basis of annual audited accounts, the Islamic bank and the State Bank shall share the loss in the proportion of their share of investment in the Musharakah Pool expressed on daily product basis. The share of loss to State Bank will first be met out of credit balance in the Takaful Fund, if any. The loss not met from the Takaful Fund shall be borne by the State Bank.

7. In case of loss, the Islamic bank shall be entitled to claim refund on account of share of profit paid by it to SBP on provisional basis, alongwith SBP's share in the loss of principal amount extended to the Musharakah pool.

Q8. Is it permissible for an Islamic bank to impose penalty for late payment?

Ans. In Islamic law it is permissible to penalize a debtor who is financially sound but delays payment of debt without any genuine reason. Such act of the debtor is unjust as the Prophet (PBUH) has said, "A rich debtor who delays payment of debt commits Zulm".

A heavy non-performing portfolio and default on part of the clients is a serious problem confronting the financial institutions all over the world including Pakistan. This problem could be a threat to success of Islamic banking system. If clients do not honor their commitment in respect of timely payment of a debt created in installment sale, Murabaha, leasing or do not pay banks' share of profit in participatory modes or do not deliver goods at stipulated time in Salam and Istisna'a, it could cause irreparable loss to the system, the banks and financial institutions and ultimately to savers and the economy. The jurists allow punishment (T'azir) to such borrower in the form of fine. In the opinion of some Maliki jurists a delaying borrower would be obliged to pay for charitable activities. In view of the severity of the problem, all Shariah bodies like Islamic Fiqh Academy of the OIC, Shariat Appellate Bench of the Supreme Court of Pakistan, etc. have approved the provision of penalty clause in the contractual agreements that keeps a balance between the requirement in view of severity of the problem and that of the Shariah conditions/principles to keep the fine difference between interest and Murabaha profit intact. However, the penalty proceeds would be used for charity because penalty on default in repayment cannot become an automatic source of income for the creditor.

Q9. Can Islamic banks claim solatium or liquidated damages on account of late payment/default by the clients?

Ans. The contemporary Shariah scholars have evolved a consensus that banks are authorized to impose late fees on the delinquent. But proceeds of such penalty are to be used for charity purposes. Only the court or any independent body can allocate any part of the penalty as liquidated damages / solatium for the banks.

Liquidated damages can be given to banks in case of default on the part of banks' clients provided it is based on actual financial loss. The court may reasonably adjust the amount of compensation. The 'actual financial loss' cannot be the loss in terms of conventional 'opportunity cost'. It has to be proved by the bankers themselves to the satisfaction of the court or any arbitrator. However, some Shariah Boards allow Islamic banks to charge from the defaulter the rate realized by them on their Murabaha portfolio during a specific period. They also recommend that the financial condition of the client be taken into account.

Q10. There is a perception in the West and the USA that Islamic banks finance terrorists. What is the true situation?

Ans. In the post -9/11 global scenario anti money laundering measures by regulatory authorities of banking and finance have gained extraordinary importance. It is pertinent to indicate in this regard that Islamic banks, by their nature, are less likely to engage in money laundering and other illegal activities. They cannot undertake activities which are detrimental to society and its moral values and have to go

through an exhaustive test of Shariah compliance. They are not allowed to invest in narcotics, casinos, nightclubs, breweries etc. This requires that the clients of Islamic banking must have business which should be socially beneficial for the society, creating real wealth and adding value to the economy rather than making paper transactions. Therefore, a stringent 'Know Your Customer' (KYC) policy is an inbuilt requirement for an Islamic bank.

The Governor, State Bank of Pakistan while addressing an international seminar on "The Financial War on Terrorism and the Role of Islamic Banking" held in London on April 7, 8 2003, observed that Islamic modes of financing and deposit-taking discourage questionable/undisclosed means of wealth which form the basis of money-laundering operations. The Islamic banks disclosure standards are stringent because they require the customers to divulge the origins of their funds in order to ensure that they are not derived from un-Islamic means. Islamic financing modes are used to finance specific physical assets like machinery, inventory, and equipment.

Further, the role of Islamic banks is not limited to a passive financier concerned only with timely interest payments and loan recovery. Islamic bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. To avoid the loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele. As such, Islamic banks are less likely to engage in illegal activities such as money laundering and financing of terrorism than conventional banks.

However, the existence of rogue elements cannot be ruled out in any type of organization. Keeping this in view, Pakistan has adopted a strategy by adopting uniform international standards to ensure fair play by all kinds of banks and financial institutions also including Islamic banks. After reviewing its existing systems and procedures, it has developed a multiple-track strategy in its financial war on terrorism and money laundering. It has also put in place stringent regulations in order to effectively curb money laundering. The 'Know Your Customer' (KYC) regulation has been sharpened to provide more detailed guidelines to banks/DFI's for due diligence in respect of customers. All banks are required to properly investigate transactions which are out of character with the normal operation of the account involving heavy deposits/withdrawals/transfers.