5. *Report of the Council of Islamic Ideology on Elimination of Interest from the Economy* (Islamabad: C.I.I., 1980)
6. *Annual Report of the State Bank of Pakistan,* 1984. (Karachi: State Bank of Pakistan, 1985).
7. State Bank of Pakistan (SBP) circular no. BCD-13, 20 June 1984.
8. Text reproduced in *Islamic Studies*, Islamabad, Spring 1985, PP. 86-114.
9. SBP Circular BCD-13.
10. Qur'an (2:275-79).
11. SBP Circular No. BCD 26, November, 1984.
12. SBP Circular No. BCD 13, 20 June, 1984.
13. Siddiqi, M.N., *Partnership and Profit-sharing in Islamic Law* (Leicester, 1985), pp. 24-29
14. SBP Circular No. BCD 33, 26 November, 1984.
15. SBP Circular No. BCD 39, 10 December, 1984.
16. Ibid. and Circular No. BCD 40, 10 December, 1984.
17. *Report of the High Level Working Group on Housing Finance on Income Sharing Basis, unpublished,* (Karachi, HBFC, 1980).
18. HBFC Act, 1952 (as amended), Sec. 24 (8).
19. An exception to this has been made by banks (perhaps without approval from the State Bank) in case of markup on export finance. If a person takes finance for export but fails to export the goods, he is charged a markup on the principal and then a markup on the total for another 210 days.
20. "But if you repent, you shall keep your principal. Oppress none and no one will oppress you" (Qur'an 2 : 279).
21. Siddiqi, M. N., *Issues in Islamic Banking*, (Leicester: Islamic Foundation, 1983), p. 81ff.
22. SBP Circular No. BCD 39, 10 December, 1984.
23. SBP Circular No. BCD 34, 10 December, 1984.
24. Meenai, S. A., *Money and Banking in Pakistan,* (Karachi, 1984) pp. 136-139.
25. Explained below.
26. Ahmad, Sh. Mahmud, "Banking in Islam,"*Muslim News International*, (Karachi, June 1969), pp. 5-11.

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trade, the audit would also examine the performance of businesses carried out by the banks. The audit criteria would be derived from the above mentioned guidelines for management. The auditors would report on whether the banks carried out their business economically, efficiently, and effectively and whether the banks had suitable internal controls in place to safeguard the public funds being handled by them. This would, of course, require a basic change in the concept, scope, approach, and procedures of audits. Training of auditors in the expanded scope of auditing would be another requirement of the proposed system.

Concluding Remarks

The above proposals transcend the existing framework of banking. They visualize an expanded role for banks and consider complete restructuring of the system. We think the present literature on the subject shows the patchwork in the existing system. Consequently it has resulted in a number of compromises. These have kept the institution of interest intact.

The proposed approach needs to be developed into a model. Interest is so deeply interwoven into the economy these days that only a major departure from current thinking can find a way to eliminate it. Elimination of interest is not merely a legal problem. It has wide social and economic dimensions. Those who think that we can do away with interest by a simple switchover to profit sharing have not understood the problem in all its complexity.

FOOTNOTES

1. See, for example, Fazalur Rehman, "*Riba* and interest," *Islamic Studies*, Karachi, March 1964, pp. 1-43 and Shah, S.Y. "Islam and productive credit," *Islamic Review*, London, March 1959, pp. 34-37.
2. See, for example, Mawdudi, A.A., *Sud* (Interest), (Lahore, 1961); Shafi.
3. *Report on Istifsarat* 1962-1984 (Report on Questions Asked). (Urdu). (Islamabad, 1984).
4. *Report of the Panel of Economists and Bankers on Elimination of Interest from the Economy*, (Islamabad: The Council of Islamic Ideology, 1980).

continue opening with the banks, as at present, those people who want to receive a return on their money could invest their money in specific banks. Their decisions to open investment accounts in a particular bank would be an indication of their preference for that particular business. They would be making a conscious decision to share the risk and profit of the particular trade. In this way, they would take an interest in that particular trade as well. Different banks could compete for desposits for investment on the basis of their performance and prospects. This would help in keeping the banks efficient in running their businesses.

It should be made clear at this point that entitlement to a return on investment account deposits would accrue only if funds were deployed for a long period. Financial instruments for investment for a short period could also be developed on the pattern of National Investment Trust Units. These units are marketable, and the price reflects the dividend absorbed by each at a particular time. We do not visualize a return on short term deposits with the banks because that brings in the problem of calculating profit, which in turn, opens a window for the re-entry of interest into the system.

Guidelines for Management: It is clear from the above that banks would be using the funds of their clients obtained as counter loans or on long-term investment accounts. There remains, therefore, a possibility that the banks would squander these funds through inefficient management. Efficiency in business is a complex phenomenon. It depends on a number of factors, and no shortcuts can be suggested to achieve it. Banks' struggle to be profitable would keep them efficient. However, we think that the central bank should develop guidelines for the management of businesses by the banks. These guidelines would consist of generally accepted practices in business management.

Expanded Scope of Audit: We also visualize that the present audit practices in banking are inadequate. In the proposed setup when t e banks would come into direct

for meeting their day-to-day working needs. The present scheme has adopted a cumbersome and arbitrary method of calculating products of the finance provided by the bank and deployed by the businessman. Thereafter, profit-sharing is done on the basis of these products. Besides being cumbersome, the share of the bank cannot be known until the clients of the banks close their accounts.

An alternative proposed by Shaikh Mahmud Ahmad, is the method of time-multiple counter loans.[26] The banks should extend finance to the clients for a specified period. In return, the client should extend a counter loan for a small amount but for a multiple of the time period for which the bank has given the loan. For example, if a person needs $1,000 for one month, the banks should extend it. But in return the client should lend to the banks a sum, say $100, for 10 months. On due dates both loans would be repaid without interest. The funds thus acquired would be invested by the banks in direct trade. The concept of time-multiple counter loans has the inherent flexibility of adjusting the amounts and time periods. Moreover, this can work for financing all activities, including public welfare programs.

We are aware that the religious scholars have refused to accept the above proposal, since it conceives conditioned loans which, strictly speaking, are not covered by Islamic law. But we think that the religious scholars should reconsider their opinion. On the one hand, we are faced with an insurmountable problem of eliminating interest and on the other hand we can achieve our goal if we are willing to accept in concept of conditioned loans proposed above. The above relaxation in the rule is a matter of far less significance than the acceptance of interest in disguised forms.

New Classification of Deposits: The depositors who decided to join the banks in a particular business would be able to do so if they opened investment accounts with the banks. Besides current accounts which people would

functions will increase manifold. Therefore, specialized banks for different kinds of trade can come into being, or large banks can create separate divisions to handle trade in different fields. For example, there can be banks (or divisions of large banks) dealing with the importation of machinery and leasing it on rent. Others could engage in export, manufacture, construction, lease-purchase and other types of business. But if large banks create separate divisions for each trade, their accounts should be prepared separately as independent banks. These banks should get into trade directly. For example, if a bank chooses to be in the leasing business, it should acquire assets for hiring and should let out these assets for rent. In doing so, the bank would undertake all the risks which any other business in this fields would undertake. Similarly, a bank specializing in export should buy merchandise from the local market and export it. It could establish branches abroad, which could work as counterpart organizations for importing goods from here. Anyhow, this would expose the bank to all the risks and opportunities which an exporter comes across. Those banks which like to specialize in wholesale or retail trade should do so by opening their business outlets. Banks can come into manufacturing business by floating subsidiaries. The banks would require the services of efficient and trained managers to run their business.

The banks would accept deposits from savers on the basis of time-multiple counter loans.[25] Thus the limitations of profit-loss sharing could be overcome. However, we do not overrule the theoretical possibility of private capital joining banks' capital in floating subsidiaries and running businesses on a long-term basis. In that case, banks as managing partners could devise universal standards for determining profit and thus could overcome the limitations of profit-loss sharing to some extent.

Time-Multiple Counter Loans: Profit-loss sharing cannot help where people need money for a short term or

savers and provide the same funds to businessmen for investment, and while doing so, earn a profit through interest rate differentials. Banks do not undertake any trade directly, nor is trade considered a legitimate banking function.

In the recent past, when need for Islamization of banks was felt, Muslim scholars started presenting theoretical models of interest-free banking. The entire literature on Islamic banking is based on the assumption that banks would continue doing financial intermediation as their principal business. Within this general framework a number of models were developed to carry out this function on the basis of profit-loss sharing. Since profit-loss sharing cannot be practised universally, other modes of finance were presented. In suggesting these modes of finance the bankers were not insincere but the inherent limitations of profit-loss sharing led them to think of other modes of finance.

In our opinion, a meaningful effort to Islamize banks requires us to transcend the existing framework which visualizes financial intermediation as the primary function of banks. Instead, we shall have to accept that the actual role of banks is direct trade. Of course, banks will be entering into a field which has been traditionally considered outside their pail. But until they take this bold step, they will never be anywhere near the goal of eliminating interest from their operations. Financial intermediation by its very nature is averse to risk and demands a fixed pre-determined return. On the other hand, trade involves business risks and probability of loss. Therefore, trade cannot be practised as an alternative to interest. So far, financial intermediation remains the principal role of banks.

The detailed model based on the above concept would be developed by banks. But we shall present below, briefly, the manner in which this can be done.

If banks have to enter into direct trade, their present

total profit in the form of a management fee (over and above the recovery of full administrative expenses) from the share of profit accruing to depositors. This is also unfair. After charging all administrative expenses to the depositors' share of profit, why are they charging another 10% of total profit as a management fee?

Reserves: The banks are required to keep 5% of their deposits as a cash reserve and 30% as a legal reserve with the State Bank of Pakistan in the form of securities and bills.[24] But interest-free securities have not been developed so far. Therefore, the banks have been allowed to treat financing on markup for commodity purchases to the government as deductible from the 30% reserve requirement.

This is only an interim solution of the problem. At present the reserve ratio is 35%, which means the banks can create credit to the extent of 2.85 times their deposits. The matter needs to be considered to lower the reserve ratio, say, to 10%. This would enable the banks to create credit up to 10 times the amount of their deposits. It would increase the supply of credit and bring down the effective rate of interest considerably. In fact, this seems to be the direction for effective abolition of interest. However, in the meantime non-monetary measures to control inflation would have to be devised. This also suggests that we need not rely entirely on the traditional tools for controlling inflation.

Suggestions for a New Approach: We shall present a few suggestions to develop a new approach towards Islamic banking. These suggestions do not outline a model of Islamic banking which requires a separate effort by the bankers. But in our opinion the following suggestions indicate a need for a major departure from the present thinking on the subject.

From financial intermediation to direct trade: Present-day banking all over the world is based on the concept of financial intermediation by banks. They accept deposits from

shorter period is entitled to profit at a lower rate as compared to a person who deposits the money for a longer period. The rates are arrived at by multiplying the deposits with different weights. The concept of weight *per se* is not un-Islamic but the way it has been used here has made it difficult to distinguish between deposits on fixed interest and deposits on a profit-sharing basis. We do not disagree with the arguments that deposits for longer periods can be deployed for more profitable investment. Therefore, they deserve a higher return. But a judicious system would require account-keeping and determining of profit for each category of profit separately. If this is done, the method of assigning weights according to length of the deposit, which anyhow is tentative, could be dispensed with. This would also remove an apparent similarity to interest-bearing deposits.

Fines: Replacement of a fixed rate of interest by other modes of financing gave birth to another problem: what should be done to those who default on this obligation to return money when it comes due or do not utilize the finance for which it was intended? The State Bank of Pakistan has introduced the concept of fines to tackle such situations. Fines as a concept are not un-Islamic, but the manner in which they have been implemented carries the spirit of interest. For example, if a person takes funds from a bank to export machinery within a specified period and then does not do so, he is liable to a fine of 75 paisas per Rs 1000 per day.[22] Thus making the fine grow with time has brought back the concept of interest. In the above example the fine is the equivalent of a 27.38% rate of interest. The implementation of the concept needs to be reconsidered.

Administrative Expenses: While sharing profit with the depositors, the banks deduct all administrative expenses from the share of profit accruing to the depositors.[23] This means that the shareholders of the bank do not bear any charge on account of administrative expenses. This obviously is inequitable. Moreover, the banks charge another 10% of

concept, one comes across difficulties in its determination. "Profit" as a concept is a subjective measure. A number of subjective elements enter in its determination. For example, depreciation of assets is a subjective decision of the management. A higher rate of depreciation would lead to lower profit and a lower rate of depreciation to higher profit. Similarly, decisions on such matters as the basis of valuation of stocks, amortization of assets, or creation or dissolution of intangible assets can create major changes in the ultimate profit declared by a bank's clients. Thus a scheme of Islamic banking which is based on profit-loss sharing gets involved in a difficult situation.

Thirdly, the literacy rate in Pakistan is about 20%. Even those people who are educated are not convinced of the utility of proper bookkeeping. In such a society, asking a client to share profit with the bank is expecting too much from him.

Fourthly, it is common knowledge that the level of honesty and integrity of the people in Muslim countries is far from satisfactory. Profit-loss sharing presumes complete honesty in record-keeping. The assumption has no empirical basis. That is, perhaps, the reason why banks have contrived new methods of markup, leasing, and projected profit rather than relying on the profits declared by their clients.

Fifthly, the profit-loss sharing cannot satisfy the enormous capital needs of governments for social, cultural and welfare programs. Profit-loss sharing is, simply, not possible in this area.

Sixthly, profit-loss sharing cannot be applied judiciously to short term loans for day-to-day needs since profit cannot be worked out for such short periods.

Weights in Profit-sharing: The present system visualizes that the depositors will "share" in the profit of the bank at rates which increase in proportion to the length of time of a deposit. Thus a person who deposits money for a

cost. The present concept of Islamic banking has made the availability of credit slightly more difficult. Thus in fact the ultimate goal of abolishing interest has shifted farther away. In such a system the effective rate of interest only goes up and cannot come down.

The present concept of Islamic banking does not give any guidelines or criteria to the banks for evaluating credit-worthiness. Thus the question of making finance available to poor people has not received due attention. Similarly, the scheme does not visualize any mechanism for providing finance for social needs. The legal provisions on interest-free loans (*qard hasan*) are only a theoretical possibility. The banks have not been given [illegible] delines or incentives for providing interest-free loans. In sum, it is difficult to distinguish Islamic banking from interest-based banking so far as the objective of socio-economic justice is concerned. We do not see that the present concept of Islamic banking can meet the ultimate objective of the prohibition of interest. We agree that this is an uphill task and that no shortcuts would help, but the present system does not move even a step towards the ultimate goal.

Limitations of Profit-Loss Sharing: The present scheme of Islamic banking is based on the concept of profit-loss sharing as a substitute for interest. The main reason for this is that most of the theoretical work in this field has presented profit-loss sharing as an alternative to interest. Such is the case, but thinking on this subject has missed an obvious, vital point. Profit-loss sharing is possible in trade, but present-day banks, as they have evolved over centuries, do not engage in intermediation in which profit-loss sharing does not fit in well. The result is that despite all the theoretical support for profit-loss sharing the banks do not find it possible to get out of the concept of a fixed return for their service as financial intermediators. Thus the concept of profit-loss sharing is like a round plug in a square hole.

Secondly, even if profit-sharing is accepted as a valid

capital is sunk then the bank would bear the loss.

These modifications have introduced an element of fixed pre-determined return for banks. The banks bear minimal risk on their financing. The entire risk is borne by the clients. The banks take risk only when the clients' capital is fully sunk. It is very difficult to distinguish between this mode of financing and interest-bearing loans.

Social Justice: There are certain social aspects of Islamic banking. The present setup of Islamic banking has not taken into account these social aspects. The Qur'an explains the reason for prohibition of interest as eradication of injustice from the society.[20] This is often quoted as the rationale for Islamic banking.[21] But if the objective of social justice is not met by the present vision of Islamic banking, then we need to reconsider the very basis of our vision. In our opinion, Islamic banking in Pakistan has not taken into account the objective of socio-economic justice. Banks provide finance to the economically well-to-do people on the basis of purely "economic" analysis, as do interest-based banks. The poor and needy continue to be deprived of finance, as in the previous system. The criteria to judge credit-worthiness have perhaps become more strict in the new setup as compared to traditional banking. In brief, the availability of finance has not been eased. It has, perhaps, become more difficult. The situation sheds light on the basic thinking of the authors of the new system. They think, perhaps, that the elimination of interest is a legal and organizational problem. If we pass a suitable law and reorganize the banks the interest will be eliminated effectively. But, in fact, interest is an economic problem. So far, needy people exist in the society, and since the credit they need is in short supply they have to pay a price for it. The price in most cases is interest, though it may come under different guises. Therefore, interest cannot be abolished effectively until such structural changes are introduced which make the needed credit available at no

Profit-Loss Sharing (*Musharakah*): Banks are allowed to provide equity finance on the basis of profit-loss sharing. This is based on the Islamic concept of (*musharakah*) partnership. As a concept, *musharakah* is permissible in the Islamic framework, but the banks are practising it in a doubtful manner.

Banks carry out a feasibility study or appraisal of the clients' present or proposed business before providing finance. They prepare forecasts for the future profitability of the business. The banks do not agree to provide finance if the projected profit is less than the prevalent rate of interest. Thus interest is used as a point of reference for making decisions about investments. Anyhow, if the banks agree to provide finance, they start charging provisional profit each quarter at the projected rate of profit (or at a lesser rate if the market rate of interest is lower than the projected profit). It is laid down in the agreement that a profit and loss account shall be prepared annually and that if the provisional profit received by the bank is higher than the actual profit, the bank will repay the excess so received. And if the actual profit is higher than the provisional profit, the bank has the option to receive the difference or to transfer the excess to a reserve fund. In case of loss, it is agreed that the bank and the client will share it in proportion to their respective amounts of capital. These provisions are entirely according to the spirit of the *shari'ah*. But the banks have introduced certain innovations which have nullified the spirit of profit-loss sharing and re-introduced the concept of interest. For example, the banks claim their share of the profit at the rate of projected profit on a priority basis. If anything is left after that, it is treated as the client's share. Similarly, if the actual profit is less than the bank's expected share at the rate of projected profit, the entire actual profit is taken by the bank, and the client gets nothing for his share of capital. In some banks the practice is to charge the entire loss first to the capital of the client, and if the client's entire

this from lending with interest.

Development of Property: The banks provide finance to develop property on similar grounds. The banks "buy" for cash the developed property and then immediately "sell" it to the client for a higher sum on a deferred payment basis.

In all of the above modes of financing, the basic principle remains the same: the banks provide finance to receive funds back with a pre-determined markup after a definite period. The bank does not assume any business risk. The bank's finance continues growing with the passage of time. All of these characteristics are distinctive features of lending with interest.

The State Bank of Pakistan has, however, specified that the banks cannot charge a markup on markup.[19] This means that if a client defaults the banks cannot continue adding interest on the principal. Thus an upper limit has been placed on the interest accumulation. But the banks have devised a method to "neutralize" this rule. While determining markup for any specified period the banks add an additional markup for 210 days and determine the amount to be recovered from the client. If the client repays the amount by the due date, the banks give him a "rebate" for the additional markup. If the client repays after the due date but within 210 days, then the "rebate" is reduced for the period by the amount remaining overdue. If the client defaults even after 210 days, the bank can go to the Banking Tribunal and seek redress.

Practically, the provisions of limiting the interest calculations to 210 days would not make much difference. Banks are overly careful not to extend finance to people of doubtful credibility. Moreover, the banks always keep a margin for doubtful and non-performing debts. Thus they would prefer to forego the claims rather than go to the Tribunal wherever they can afford to do so.

The banks distinguish between an operating-lease and a financing-lease. The operating-lease means that the lessor hires out an asset which he owns for rent. The ownership, risk, and depreciation of the asset pertain to the lessor. In a financing-lease the lessor provides finances to purchase the asset. The title of ownership remains with the lessor. The lessor is responsible to arrange its acquisition, bear the risk of transit loss, operate it, maintain it, and bear all other unforeseen losses (such as obsolescence). In return, the lessee pays rent to the lessor. The rent is so calculated that the lessor gets back his principal sum along with fixed return on it over a predetermined period.

The banks have adopted the concept of financing-lease. Under this arrangement, the banks extend a sum of money to buy an asset and continue receiving back "rent" so that over a period of time they get back their principal sum plus a pre-determined return. The ownersnip title remains with the bank by way of mortgage, so that if the "lesser" defaults the bank's interest is safeguarded. The banks do not undertake any risk or effort. Thus the concept of operating-lease, which is lawful in the *shari'ah*, has been stretched to include the financing-lease, which in essence is nothing but lending money with interest.

Lease-Purchase: This is quite similar to leasing, as discussed above. The banks provide finance to purchase or construct property on behalf of the bank and start receiving "rent". At the time of financing the banks agree to "sell" the property after certain period for a certain price (settled in advance). The price is determined in such a manner that the banks receive back their principal sum, plus a pre-determined return over a definite period. The responsibility of construction or purchase of the asset lies with the lessee. Similarly, the banks do not assume any responsibility for operation, maintenance and other risks to the property. In sum, banks extend a sum of money and get back a higher sum determined in advance. It is very dificult to distinguish

the promise to pay back a higher sum later. If we get out of the quagmire of terms, it becomes difficult to distinguish this mode of financing from an interest-bearing loan.

Purchase and Sale of Trade Bills: Banks buy and sell trade bills of different kinds, which include inland promissory notes, trust property receipts, and foreign bills. Under the permissible mode, the banks buy these bills at face value and pay cash to the client. After the due date, the banks present the bill before the drawer and claim the face value plus markup. Alternatively, the banks deduct an amount known as markdown while cashing the bill. After the due date they claim the face value from the drawer. In case of default the drawer remains liable to repay the amount taken from the bank plus markup for the days it remained in the use of the drawee. The rates of markup and markdown are different for each kind of bill.

The above description illustrates that if we replace the term markup with a markdown by interest rate no substantial difference would take place. Thus interest has been retained intact in the sale and purchase of trade bills.

Purchase of Property: If a person needs financing for the purchase of movable or immovable property, he approaches the bank with a concrete proposal. The bank agrees to buy the property from the client on cash payment, which the client buys back from the bank at the same price plus a markup on deferred payment basis. Both these transactions are carried out "immediately" and on paper. The real transaction would take place later, when the client takes out the money. The above mechanism explains that in essence the bank gives out a sum of money to the client with agreement to receive later a fixed sum over the above principal. It is difficult to distinguish this type of financing from lending on interest.

Leasing: Leasing as a concept is permissible in the *shari'ah*, but the banks have rendered its legality doubtful.

banks have adopted markup as the most convenient replacement for interest. Other less common modes of financing adopted by the banks are leasing and profit-loss sharing (*musharakah*). The areas from where interest has been eliminated effectively are not a major proportion of the total business carried out by commercial banks. Therefore, our general conclusion is that, by and large, the present measures have not been successful in eliminating interest from the banking system. We shall show later that effective elimination of interest would require a fundamental change in the banking structure. Mere patchwork would not succeed.

Now we shall explain the mechanism by which interest has been retained in the system in disguised forms.

Markup: Banks provide finance on the basis of markup for the following purposes:

* Purchase and sale of goods
* Purchase and sale of trade bills
* Purchase and sale of property
* Leasing
* Lease-purchase
* Development of property

Purchase and Sale of Goods on Markup: Financing on the basis of markup for the purchase of raw materials or semi-manufactured or manufactured goods is carried out in the following manner: The bank's client approaches the bank for finance to purchase goods. Since lending on interest is not permissible, the bank "purchases" those goods from the client (or asks the client to purchase them from the market for the bank) for the amount which the client needs. Then immediately the bank "sells" those goods to the client at a price for which it is bought, plus a markup on a deferred payment basis. The banks have termed this arrangement a "buy-back agreement." The net result of these presumptive transactions is that the client gets the money he needs, with

above.

(e) Penal interest has been replaced by a concept of fines on defaulters.[16] A "fine" is lawful, but in its application the spirit of interest has been brought back in disguise. We shall revert to this point later.

(f) Financing on the basis of rent-sharing by the House Building Finance Corporation (HBFC) is generally in accordance with the provisions of Islamic law. The HBFC finances construction and purchase of houses as a partner. On the basis of a survey of the entire country they have identified categories of houses and localities for imputing rent. This imputed rent is shared by the HBFC and the owner-builder or a purchaser of the house in proportion to their investments. Since the HBFC does not share the future maintenance cost and taxes of the house it gives a reasonable credit to the other party while determining respective shares of rent. Similarly, since the other party does not share the administrative cost of the Corporation, a small percentage is added to the HBFC's share of rent to recover this cost.[17] In our opinion the above mechanism is in conformity with the law of Islam. In fact, so far as Islamic banking is concerned this is, perhaps, the only scheme where interest has been eliminated effectively.

(g) While financing on the basis of rent-sharing, the HBFC cannot provide finance to an individual for building more than one house or to build a house larger than a specified size.[18] These conditions are in conformity with the broad socioeconomic goals of Islam which visualize greater distribution of wealth.

Permissible Modes of Financing and Disguised Interest

Now we shall discuss the mechanism which has frustrated the effort to eliminate interest effectively. The

Our general conclusion is that under new modes of financing there are a few peripheral areas where interest has been eliminated. We shall enumerate those areas below. To the extent of these areas the Islamization of banks has evolved in the right direction:

(a) Financing on the basis of a service charge or *qard hasan* on compassionate grounds (with payment of the service charge deferred to the distant future) are Islamic provisions in the new system.* Islamic law does not allow lending on interest. Besides, it persuades the lender to give an extension to the indigent borrower on compassionate grounds.[10] The determination of service charge has been regulated carefully to prevent interest from getting back into the system in disguise. The banks cannot add anything to the service charge as cost of funds. The State Bank of Pakistan has devised an effective system of control to watch against this.[11]

(b) In trade-related or investment types of financing, where banks finance on the basis of profit and loss sharing, the profit can be shared in any proportion while the loss must be shared in proportion to the amount of capital.[12] This provision is in accordance with the *shari'ah.*[13]

(c) While sharing profit and loss with banks for refinance, the State Bank of Pakistan receives a provisional profit in advance. It has been provided that the State Bank will refund any profit which it receives in excess of the actual profit determined at the end of the year.[14] This provision is also in line with the *shari'ah*.

(d) For providing refinance to the commercial banks against their financing for the purchase of locally manufactured machinery the State Bank will share 75% of the profit, while loss would be borne in proportion to the amount of capital.[15] This is a specific application of the general provision stated

(ii) Interest-free loan (*qard hasan*) on compassionate grounds, with permission to defer the service charge to the time when the borrower can pay it.

B. Trade-related modes

(i) Purchase of goods by banks and their sale to clients with an appropriate markup in price on a deferred payment basis. In case of default, there should be no additional markup.
(ii) Purchase of trade bills on a markup or markdown basis.
(iii) Purchase of moveable or immoveable property by banks from their clients with buy-back agreements or otherwise.
(iv) Leasing.
(v) Hire-purchase.
(vi) Financing for development of property on the basis of a development charge.

Investment-type modes

(i) *Musharakah* or profit-loss sharing
(ii) Equity participation and purchase of shares
(iii) Purchase of participation term certificates or *mudarabah* certificates
(iv) Rent-sharing

We shall explain these modes of financing below while evaluating them for effective elimination of interest. We shall point out those areas where interest has been eliminated and the banking system has been synchronized with the *shari'ah*. Later, we shall bring to limelight those areas where interest has not been eliminated but has been disguised behind the new nomenclature.

Evaluation of the Permissible Modes of Financing

was set up to study the whole question. The panel gave a report on "Elimination of Interest from the Economy" in 1980,[4] which was submitted to the Council of Islamic Ideology. The Council examined the report and submitted its own report (1980), making substantial changes.[5]

The government prepared a plan to Islamize the banking system in three years, starting in January 1981, but subsequently extended the plan by another one and a half years.[6] In January 1981 all the scheduled banks were authorized to open Profit-Loss-sharing (PLS) counters to accept deposits. The funds thus mobilized were to be invested on an interest-free basis. Since January 1, 1985 the scheduled banks have been unable to finance the federal and provincial governments and public enterprises on the basis of interest. Instead, the banks must adopt one of the twelve approved modes of "interest-free" finance. From April 1, 1985 the same condition has been made obligatory for financing private sector enterprises. Since July 1, 1985 the banks have not been allowed to accept deposits on the basis of interest. All interest-free deposits in the banks on June 30, 1985 have been converted into PLS deposits.[7]

To provide legal cover to the above scheme the government has promulgated the following ordinances:

a) The banking and financial services (amendment of laws) ordinance of 1984.
b) The banking tribunal ordinance of 1984.[8]

Permissible Modes of Financing

The State Bank of Pakistan has allowed financing by commercial banks in any one of the following modes after prohibiting lending on interest:[9]

A. Financing by lending

(i) Interest-free loans for a service charge not including cost of funds.

ISLAMIC BANKING IN PAKISTAN

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The main objective of this paper is to review the basic framework, strategy and various regulations regarding Islamic banking in Pakistan. The paper will attempt to evaluate the efforts made in Pakistan during the last five year for eliminating interest from the banking system. We shall try to determine the extent to which interest has been effectively eliminated and also point out areas where it has been retained *intact* in disguised forms. At the end, we shall give some suggestions for tackling the problem.

The history of Islamic banking in Pakistan is not very long. With the birth of the state in 1947 the religious activists started campaigns for the Islamization of law. In the economic sector Islamization always meant elimination of interest from the banking system. Despite the short-term controversy raised by modernists about the meaning of *riba*[1] (usury) in an effort to make commercial interest acceptable, the religious scholars could persuade the masses of the ban on interest in Islamic law (*shari'ah*).[2] Therefore, the successive governments, while paying lip-service to Islam, always showed mere academic interest in the elimination of interest from the economy on a top-priority basis. This was indicated in frequent questions which the government asked of the Council of Islamic Ideology (formerly the Islamic Advisory Council) about the legality of various forms of interest and the means of its elimination.[3]

It was in 1979 that the Zia regime showed a real earnestness about Islamization of all laws, including elimination of interest. A panel of bankers and economists

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