demanded by the bank from its client in advance by way of earnest money against foreign currency agreed to be purchased/sold at a future date.

To conclude, training of banks personnel and creating awareness among the people about the true nature of Islamic banking is an aspect demanding concerted efforts on the level of war footing. The universities and other educational institutions are urged to produce people knowing Shariah as well as principles of finance. Further, Islamic banking and finance is a part of Islamic economic system the very basis of which revolves around justice and morality. Moral dimension, therefore, is *raison d'etre* of Islamic banking and finance. All-out efforts need to be made by the Government, the religious and political leadership and intelligentsia in general for enhancing morality of the populace. For this purpose, fool-proof documentation of transactions, amendment in tax and other relevant laws are essential requirements. Only a well thought out plan with committed and sustained efforts could lead to success and ultimately to transformation of the economy. It would require i) Identification of transformation requirements in terms of laws, rules, regulations, institutional structure, and components of policies fitting into the overall implementation timetable; ii) Laying down a plan comprising phases, their components, and implementation mechanism; and iii) Feed-back or continuous review and evaluation to ensure proper application and to remove any obstacles.



علم وفن میں حضرت امام احمد بن حنبل رحمۃ اللہ علیہ کا کوئی ثانی نہیں : (محدث ابوزرعہ)

levels. Even after creation of SMEDA, these problems persist that need to be removed. Small and micro-enterprises generate more output per unit of capital than large-scale enterprises. According to an estimate, micro-industries in Pakistan's economy account for 81% of industrial labour force and 28.52% of the value-added of manufacturing sector. Suitably planned financing of these units could boost the development process. The value added generated in these industries would favourably affect income distribution.

Islamic banking operations are particularly feasible for short and medium scale business and enterprises. The safeguards and good governance principles and the post investment role of the financier as required in Islamic modes of financing could go a long way in development of SMEs and the economy if a full fledged structure of financial help line is provided through industry-specific and generalist models of investment. The corporate sector and the commercial banks may set up a network of such Funds under the aegis of SEC by establishing institutions under syndicate arrangements or otherwise.

Keeping in view the importance of SMEs the banks may also introduce 'SME Financing Funds' with various geographical locations. The banks may use instruments combining the features of Murabaha and Musharaka for setting up of enterprises and Mudaraba or Salam, etc in subsequent functioning of SMEs.

# Foreign Exchange Financial Facility

Keeping in view the genuine need of Islamic financial institutions and the rules of Shariah, experts in Shariah and finance have recommended that forward foreign currency transactions would be permissible subject to the following conditions.

a) The amount of foreign currency is needed for genuine trade or payment transactions. The need will have to be supported by appropriate documents so as to prevent forward cover for speculative purposes.

b) The forward cover shall be through an agreement to sell or purchase and it shall not be a sale and purchase agreement. It means that sale/purchase shall take place simultaneously at the agreed time in future at the rate agreed upon initially at the time of agreement to sell or purchase.

c) While it will be permissible to fix the price of foreign currency in terms of Rupees according to the agreement, no forward cover fee shall be recovered. However, an amount may be

**Islamic banks can issue Advance Cards (ACs) having all the major benefits of regular credit cards with the difference that the ACs would not have a credit line and instead have a prepaid line. As such, it does not incur any interest. It will have all other benefits like purchase protection, travel safety, etc and can be 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.**

As regards investment banking functions, some of the activities such as trading in derivatives or issue of interest-bearing bonds are not legitimate under the Shariah, but other types of corporate financing activity are permissible, such as fund management, underwriting and advising on and the financing of mergers and acquisitions.

Any mismatch between clients demand for funds and their supply is normally covered through inter-bank transactions, which can be conducted on *Mudaraba* principle as being conducted in Malaysia. Islamic banks can also invest their funds with the conventional banks provided the latter invest them on Shariah compliant basis ensuring segregation of riba free and riba based deposits and financing. The latter will also have to ensure that any Shariah Advisor/Committee has certified such segregation.

In order to provide liquidity to depositors, the banks can be allowed to appropriately securitize the Funds. Securitization of such funds will enable them to issue certificates of deposits in different funds so that these certificates could be traded in the secondary market. Since the certificates will belong to the funds that are based on genuine asset based transactions, they will have a genuine secondary market. These certificates could also become an instrument for Interbank transactions and even for open market operations. It is, however, necessary that the Murabaha component in the assets, of the fund (being securitized) should be less than 50%.

## SMEs – A Vital Area for Islamic Banks

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 also mitigate the serious problems of unemployment and stagnant exports. This potential has not been exploited so far due to a number of problems at policy and operational

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expected to be the lowest. Keeping in view relatively larger inflow of foreign exchange these days, banks may also set up International/Foreign Currency Trade Funds which could finance imports/exports of clients, firms and industries. Pakistanis resident abroad may also undertake direct investment, project financing and portfolio investment through Islamic banks. For clients of high net worth and the big investors, banks may offer Individual Investment Portfolios (IPPs) and investment funds on fixed return (Mark-up based) and on variable return (PLS based) modes according to advice of the fund owners. In case of such funds, bank may serve as Mudarib (on two-tier Mudaraba basis) or as an agent. As Mudarib, banks will get share in the profit on pre-determined ratio while as agent they would get fee and the rest of the profits/losses would go to the fund owners.

One practical example of leasing may be that a bank purchases an aeroplane identified by PIA and then gives it on leasing to the PIA thus covering its cost and return in the form of rentals. The other option for financing on the basis of leasing is that PIA, after consultation with a bank may acquire an aeroplane according to its requirements and priorities and sell it to the bank at the same price. Thereafter, the bank would give the plane to the PIA on leasing with payment of rental covering cost plus its profit margin.

Housing finance can be provided on the basis of both *Murabaha* and Diminishing *Musharaka.* In case of *Murabaha* for purchase of houses/flats, it is the client who would agree the purchase price with the vendor, but the bank would buy the property on the client's behalf, and then resell it to the client at a mark-up. The client may be required to pay 25 percent of the purchase price in cash and the remaining 75 percent can be deferred over 5, 10, or 15 years, with repayments made monthly by direct debit from their current accounts into which their salaries and other incomes are paid. Those who might be in genuine financial crisis could be treated sympathetically by debit of the amount to the charity fund or recourse to Zakat or social security funds established with NGOs or in the public sector.

**Consumer finance should be more a matter of facilitating purchases rather than encouraging consumerism and materialist aspirations. Banks can run car-financing schemes with referrals both from car retailers and as a result of direct demand from its own customers. Banks can also finance the purchase of equipments by professionals like doctors/dentists/hospitals, publishers, etc.**

changes can be made in the relevant regulatory set-up, if so required. 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. Dedicated branches, as allowed to be set up by the State Bank, can also provide these services offering a range of Shariah compatible products on the line National Commercial Bank is doing in Saudi Arabia. Broadly, following may be the categories of Funds:

Funds yielding return with minimum possible variability: These funds can be based on short-term *Murabaha* and leasing operations of the banks and hence can be made to offer minimal risk to the depositors in such funds. Such low-risk funds that would be earmarked for purchase of goods and their resale on mark-up and short to medium-term leasing operations giving fixed earning to the banks would be best suited for risk-averse savers who cannot afford possible loses, in PLS based investments. Such funds may facilitate transactions in both local as well as foreign currencies.

The other category may be the Funds yielding high return based on *Musharakah* or long term leasing operations for those who are willing to take some risk for higher returns. While *Musharaka* carries the element of risk per se, long-term leases may also involve some risk as Shariah compliant leases give all risks and rewards of the leased assets to the lessor.

There may be many types of equity based investments – the other major category of Funds based on partnership principle. Banks may 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 existing account-holder to subscribe. Instead of sharing in the bank's profit, the investors would share the profits of the enterprise in which the 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. Investors would be fully or partially allowed to redeem funds at any time on a weekly basis.

Specifically, banks may introduce 'Rupee Trade Fund' for those who want to invest their savings with minimal risk. The amount thus mobilised can be invested both in domestic and international trade. Experiences of Grameen Bank of Bangladesh and the Bangladesh Islamic Bank reveal that banks may invest such funds mainly for small and medium level trading activities wherein default level/ratio is

*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. Since the seller in *Salam* has to repay the *Salam* principal in terms of goods and if he is the producer of such goods, he will 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 also 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.

In case of financing through leasing and *Musharaka* the financiers have to assume ownership responsibilities. Thus, Islamic banks are exposed to greater liability as compared with the conventional financial institutions. This includes damage to asset being funded, the risk of loss and liabilities arising out of the use of assets. Consideration must be given to legal issues such as owner's liability, the consequences of default and what happens in the event of loss or destruction of the assets. If the asset leased by the bank, for example, causes death or injury during its use, then the Islamic financier could be held legally responsible. If the asset being financed is an oil tanker that is involved in an accident, causing oil spillage that results in serious pollution, then the Islamic financier may also be liable for claims relating to the environmental damage. Therefore, Islamic bank will have to be more cautious and apply risk mitigating techniques so as to protect the interest of the stakeholders particularly that of the savers/depositors. In order to counter the 'default culture' prevalent in our society, banks may get post-dated Cheques from their clients. As bounce of the Cheques has been declared by the Government as a criminal act, it would help in curtailing the non-performing portfolio of banks.

## How to Proceed Ahead

Banks may engage in 'Fund Management' and establish variety of Mutual Funds and companies like Trade Finance / Lease Finance Companies, Shirkah/Investment Companies or Islamic Funds for different operations. All these entities can exist in the economy on their own or can be integral parts of some big companies or subsidiaries as is the case of Universal Banking in Europe. As such entities emerge, engineering firm/contractor will express its willingness to take up the work and the terms and conditions on which it can complete the job. After both the parties agree to the terms and conditions, the firm/contractor will start the work. After completion of an agreed portion of the job, the financial institution will start releasing its funds as agreed in the partnership contract. An agent of the government will monitor the quality of work while an agent of the financial institution will monitor the use of the funds. In case the job is too big to be accomplished by a single contractor/firm and involves huge sums of money, the contractor may form a consortium of engineering firms to carry on the work. The financial institution, on its part, may either form a consortium or may issue bonds to the public for subscription.

## Non-PLS Techniques

The non-PLS techniques, as acceptable in the Islamic Shariah, have their own uses and applications both at micro and macro levels. They 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 and may not be as fruitful in reducing income inequalities and generation of capital goods as participatory techniques, yet they can be helpful in employment generation and alleviation of poverty. Such techniques, in addition to other benefits for the real economy, activate the commodity markets. Ijarah related financing that will 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. Any leasing contract that absolves the bank from these activities will fall into the category of financial leasing which is not permitted according to *Shariah* principles. Leasing can be very much conducive to the formation of fixed assets and medium and long-term investments. This helps in capital accumulation in the economy and the Development Finance Institutions may resort to this mode for financing of development activities. *Murabaha* financing technique has several advantages over lease financing. The risk bearing period in trade financing is less than in lease financing. The bank knows its profit as soon as the purchase/sale transaction is completed. Like leasing, it also provides a link between financial transactions and the real economic activities.

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efforts are needed on the pattern of Bahrain, Sudan and Malaysia.

## Role, Various Modes can Play

In the initial stage of evolution of Islamic banking it was considered that mainly the profit loss sharing (PLS) modes would be the alternative to interest to rectify the socio-economic injustice caused by the institution of interest in the world. The literature on Islamic finance, even now, generallv favours the use of the *Musharakah* and *Mudarabah* being the most suitable instruments. However, there has been gradual change in the approach and it is being increasingly felt that all Islamic modes of financing can have positive role in the development process. Islamic banks, while functioning on a basis other than interest, have to perform a crucial task of resource mobilization, their efficient allocation on the basis of both categories of modes and strengthening the payments systems to contribute significantly to economic growth and development. It is generally felt even now that profit/risk sharing techniques not only make the capital risk bearing, a badly needed factor of production even in the developed countries, but also encourage entrepreneurship. As regards the non-sharing modes, a just and economically viable set of criteria govern transactions based on deferred payment or mark-up pricing and operational leasing.

### PLS Techniques – Sharing Modes

In order to ensure maximum role of Islamic finance in development of the economy it would be necessary to create a conducive environment which could induce financiers to channelize more funds for *Musharakah/Mudarabah* based financing of productive units, particularly of small enterprises. Amendments are needed in the legal framework to plug the possible loopholes for cheating, fraud, and concealment, application of co-operative framework, scrapping of discriminatory rules and development of a fair business culture. The implementation of these conditions will bring about a right kind of environment which, in turn, will promote financing for development in all sectors in Pakistan.

Even the socio-economic projects can be developed on the principle of profit sharing. The engineering firm or the contractor will, before bidding for any contract, convince any financial institution for entering into partnership with it on the condition of sharing in the benefits of the project. The financial institution on becoming convinced of the feasibility and profitability of the project, would make a firm commitment to finance the project on the basis of Shirkah. Then the undertake business on the basis of both sharing and non sharing modes. Some amendments might be needed in the relevant regulations issued by the both regulatory authorities.

- The subsidiaries can be created for specific sectors/operations, which would enter into genuine trade and leasing transactions. However, some relaxation might be needed in the rules for establishing subsidiaries so that at least big banks could be persuaded to enter into this business.
- Single transactions relating to imports, exports or day-to-day needs of traders/business community can be financed through *Musharakah* or *Mudarabah* modes. Similarly, working capital and project financing can be offered through participatory modes.
- Provisioning for bad debts can be replaced by sharing in possible losses.
- Credit system would need to be reformed to decrease credit creation capacity of commercial banks.
- Takaful system needs to be introduced to cater for insurance needs of Islamic banks.. The task of introducing *Takaful* in the country is relatively easier than that of Islamic banking.
- Some kind of risk cover based on the principle of *Takaful* will be needed in respect of both assets and liabilities sides of the banking system.
- Forward market would be working but strictly regulated to ensure that it leads to a real economic activity fully integrated with spot/cash market and that speculative activities are avoided.
- Reforming and redesigning the stock market, documentation of the economy, discontinuing or formalizing all bearer financial instruments like Rupee Traveler Cheques, etc and substituting Income Tax with a mix of payment value tax and consumption tax would be a prerequisite. Exploring the possibilities of introducing monetary units of big denomination through banks' Accounts can also be fruitful.
- A massive debt retirement program would occupy a central place in such an exercise. For effective planning, to achieve the end, budgetary practices may be divided into commercially viable projects, non-commercial but infrastructure projects with durable long life assets, welfare budget and the general budget.
- Progress on development of instruments for liquidity management, SLR and OMOs is overdue. So far, we have made an adhoc arrangement to accommodate banks like Al-Meezan. Serious

# Creating Demand for Islamic Banking

**The foremost pre-requisite in this regard is mass awareness about the concept of Islamic banking among the general public and the education of bankers and the business community. Efforts are needed at changing the general perception about return on financial savings/assets and creating genuine demand for Islamic banking. Through a comprehensive campaign, people must be made to understand that Islamic banking does not mean free loaning to the business and industry and that the savers can justifiably take return on the basis of results of the business activity undertaken with the help of their funds. Similarly, industrialist and the business community need to be persuaded to raise more and more equity based funds instead of loans.**

The savers who have been avoiding the banking channel so far due to involvement of Riba would approach Islamic Banks only when they are assured that their funds would be invested in Shariah compliant activities. Therefore, credibility of Islamic banks is the most important aspects and the key to success and development of the emerging discipline. The clients would need to be assured of Shariah compliance and that funds are kept separate from their conventional deposits and financing is provided purely on the basis of Islamic modes. Islamic banks would also need to ensure that their funds are not invested in Haram and indecent activities. Companies with excessive reliance on debt financing will also be excluded, and hence gearing ratios will need to be monitored. This also highlights the need for education and training of all the stakeholders

## Strategy for Promotion of Islamic Banking in Brief

- All banks may provide training to their employees in the field of Islamic banking and finance.
- Banks, subsidiaries or the stand-alone branches may engage in fund and portfolio management through Assets Management Companies regulated by the State Bank or SECP, as the case may be. Presently similar activities are covered by the Asset Management Rules, 1995, Asset Backed Securities Rules, 1999, BPD Circular No. 31 of November 14, 2002 dealing with assets securitisation through special purpose vehicles, relevant NBFI Rules and Prudential Regulations particularly PR No. XXI. Various Funds like Equity Funds, Mutual Funds, Trade Funds, Investment Funds, Unit Trusts, etc may largely replace the interest based fund mobilization schemes to

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of Islamic countries, in particular, more than half of which are presently classified as the Least Developed Countries. The main objective in presenting this paper is to deliberate upon the ways and means by which Islamic banking could not only be promoted in Pakistan, but also used as a vehicle for fostering socio-economic development of the country.

## Promoting Islamic Banking in Pakistan: A Challenge

Efforts made during 1980 for Islamisation of Pakistan's economy at comprehensive and nation wide level failed and the current 'non interest based' (NIB) system was declared un-Islamic by the superior courts in the country. Keeping in view that experience, the authorities during the last one year or so, have made some important policy decisions.* As a part of 3- pronged strategy, private sector has been allowed to establish Islamic banks and the conventional commercial banks have been allowed to set up subsidiaries and stand-alone branches for conducting pure Islamic banking business. Amendment has also been made in Section 23 of BCO (1962) for establishing subsidiaries by commercial banks to conduct exclusive Shariah compliant banking business.

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. Detailed criteria for setting up of Islamic banking subsidiaries and the strategy, guidelines and criteria for opening of stand-alone branches for Islamic banking by existing commercial banks, have also been issued. Thus, those interested in establishing scheduled Islamic commercial banks, subsidiaries or stand-alone branches for Islamic banking may apply to the State Bank of Pakistan, in fulfillment of the determined criteria.

* Initially, this decision was made in a meeting on September 4, 2001 chaired by the President of Pakistan and attended by all concerned officials also including the Chairmen of the Council of Islamic Ideology and the Commission for Transformation of Financial System.

some issues. A significant development in this field since late 1980s has been that conventional commercial banks, both within and outside the Islamic world, started offering Islamic banking services side by side with their normal operations. Now, relatively larger part of the Islamic banking and Takaful business is undertaken by conventional institutions that offer Islamic financing facilities to their clients as alternative to Riba-based dealings. For example, in Malaysia there are only two full-fledged Islamic banks while over 35 commercial banks, merchant banks, finance companies, discount houses, etc are operating Islamic banking schemes through their relatively wider networks. Similarly, in the Kingdom of Bahrain, which is hosting about 30 Islamic banks and financial institution working in parallel with the Riba-based banks, many institutions are originally conventional banks that are benefiting profitable opportunities in diversifying their services to Islamic banking. In Kingdom of Saudi Arabia, where a few years back only Al-Rajhi was doing Islamic banking, a number of commercial banks like National Commercial Bank (NCB), Riyadh Bank, Saudi British Bank, etc are offering Islamic banking and finance services at wider scales.

The NCB is particularly committed to Islamic finance, with a specialist network of over 35 dedicated branches throughout Saudi Arabia offering a range of the Shariah compatible products particularly including NCB International Trade Fund, Saudi Riyal Trade Fund, Personal Investment Portfolio (PIP) and Global Trading Equity Fund. In Egypt, the National Bank and the Banque du Caire, leading state-owned banks, now offer Islamic services. Similarly, United Bank of Kuwait, Arab Banking Corporation, Citibank, ABN AMRO, Kleinwort Benson, the Australia and the New Zealand Bank Group are offering Islamic financing services in various parts of the world. The main areas covered by these institutions are trade operations for a range of merchandise and commodities, including, inter alia, oil and gas, but excluding gold, silver, currencies and other commodities prohibited under Shariah, investment in equity markets, housing finance/ mortgages, fund management and portfolio investments.

The above progress should certainly be regarded as an excellent reflection on the success and viability of the concept of Islamic banking as the achievement so far in laying a solid foundation is no small matter. However, the Islamic banks' performance in achieving various socio-economic objectives is rather modest relatively to the hopes attached to them in Islamic economic thought. They are facing a number of challenges to ultimately play a decisive role in development monetary units, edible items, petrol, etc cannot be leased out; such items can be loaned and exactly their similar has to be repaid. Therefore, money has time value but that can be manifested in sale/leasing contracts only wherein earning profit is permissible by dint of involvement in real economic activities and the process of 'value addition'.

*Gharar*, the other main prohibition, refers to uncertainty about the ultimate of a contract and the nature and/or quality and specifications of the subject matter of the contract or the rights and obligations of the parties.

Following are the main forms of Islamic financing and investments: Trade finance (*Murabaha-Muajjal*) that involves acquiring goods upon customer's demand or otherwise and their sale at profit margin. It results in a debt instrument covering the cost plus a profit margin; leasing an asset and receiving rentals, so long as the asset is on lease the lessor owns risk and reward of ownership and after the lease period, the lessee can own the asset (*Ijarah*); providing funds against purchase of precisely defined goods with pre-payments (*Salam*); engaging a financing agent to supply an item at some future date for an explicit sum on periodic payment (*Istisna'a*). The agent contracts with a manufacturer to produce the good, and the customers make payments to cover the production price and profit margin. Besides, profit/loss (PLS) arrangement, in which the bank provides capital to the partnership while the other party provides entrepreneurial skills (*Mudaraba*); Any loss is borne by the financier; any profit is shared by the partners according to a predetermined arrangement. Musharaka, another PLS arrangement, may take the form of permanent equity investment, partnership in a specific project having a fixed duration or that of the Diminishing Partnership (bank's share is reimbursed over time by the Company acquiring funds) especially for housing finance.

## Islamic Banking as of Now

Over the last three decades the Islamic banking and finance industry has developed into a notable segment of the global financial market. Growing at the annual average rate of about 15 percent, the industry now has a market size estimated at US $ 200-230 billion. The whole financial system of Sudan has been transformed to the Shariah compatible basis in strict sense. Iran also has adopted Islamic banking system at national level, of course with some difference of opinion on transactions and eliminates speculative transactions from normal business and economic activities. Some conditions have been put in place to ensure that the contracts would not contain the elements of Riba and Gharar – the main prohibitions as discussed in the Islamic law. In addition to these prohibitions, Islam has prescribed a moral/behavioral standard that is almost common in all civilized societies of the world.

Lending in Islam is a charitable act since the lender according to Shariah tenets has to give away the lent goods/money to the borrower for the period of the loan without seeking any worldly compensation. Therefore, in loan contracts, any increase over the principal of a loan is Riba. However, all gains to the principal are not prohibited. Profit has been recognized as 'reward' of capital and Islam permits gainful deployment of surplus resources for enhancement of their value. Alongwith the entitlement of profit, the liability of risk of loss rests with the capital itself; No other factor can be made to bear the burden of the loss risk on capital. Important *Shariah* maxim: "*Al Kharaj bid Daman*" or "*Al Ghunm bil Ghurm*" is the criterion of legality of any return on capital meaning thereby that assumption of business risk is a pre-condition for acquisition of any profit over the principal. Further, financial transactions, in order to be permissible, should be associated with tangible real assets. It refers to the fact that the productive role of invested fund that justifies return on it in a real activity is the willingness and ability to cause 'value addition' and bear the risk of a potential loss in a genuine business. Reward should depend on the productive behaviour implying that interest, lotteries, gambling, etc are prohibited.

In the context of Islamic economics a loan will be considered a monetary or financial transaction where funds exchange hands with a guarantee for repayment in full and in the same coins. On the other hand, investment in Islamic context is not merely a financial or monetary transaction in which transfer of funds is the only activity. Investment will be considered only if it is a part of real activity or is itself a real activity. Money has potential for growth when it joins hands with the entrepreneurship. In itself, it is not recognized as capital and, therefore, it cannot earn a return. A person can sell any commodity, not including money, for one price on a cash-and-carry basis and for a higher price on deferred payment basis. However, this is subject to certain conditions the fulfillment of which is necessary to differentiate between interest and the legitimate profit. All such things/assets corpus of which is not consumed with their use can be leased out against fixed rentals. Thus, money/goods representing

# Islamic Banking for Development: Meeting the Challenge

By Muhammad Ayub*

There is complete unanimity among scholars that *Riba* has been prohibited not only by Islam but also by all revealed religions. Although some people still differ, yet there is no real room for difference in interpretation that commercial interest is included in the term '*Riba*'. It is obvious from the explicit *Nass* for the principle of prohibition laid down in the Verses 11:278, 279 of the Holy Quran. A consensus definition of '*Riba*' is that wherever there is money from the one part and there is only grace period or deferment of the repayment of loan on the other, and for that a return is stipulated, it is *Riba*. After detailed discussion and taking into account all relevant texts of the Holy Quran and Sunnah and the arguments given so far from time to time, the Supreme Court of Pakistan in its Judgment of December, 1999 held that any amount, big or small, over the principal, in a contract of loan or debt is "*Riba*" prohibited by the Holy Qur'ān, regardless of whether the loan is taken for the purpose of consumption or for some production activity.

In the light of all relevant principles of Islamic law, the main rationale for prohibition of Riba that appears convincing is that of distributive justice because Riba inflicts injustice and creates imbalances in the society. Islam tended to stop injustice by declaring that any excess taken by the creditor over his principal was unjust, hence declared forbidden. Those who protested and argued that lending on interest was like an act of trade were admonished through revelation in the Quran that while 'trade' was permitted, 'riba' was forbidden and in loan transactions they were entitled to their principal sums only.

## Principles of Islamic Finance

The principle of prohibition of Riba and permission of trading, in essence, drives the financial activities towards asset-backed

* The writer is Senior Research Economist in the State Bank of Pakistan. Contents of the paper reflect personal views of the author and not necessarily of the State Bank. The paper is a draft and would be finalized later on in the light of comments received, if any.