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تحديات وإمكانيات التمويل الإسلامي على مستوى الاقتصاد: حالة
باكستان

THE CHALLENGES AND POTENTIAL OF ECONOMY-
WIDE ISLAMIC FINANCE: THE CASE OF PAKISTAN¹

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الملخص

بُذلت جهود لتحويل النظام المالي القائم على الفائدة إلى النظام المالي الحالي من الفوائد على المستويات الوطنية في أوائل الثمانينيات في باكستان وإيران والسودان. ففي باكستان توجت خطوة عملاقة لأسلمة الاقتصاد إلى نظام قائم على أساس بيع العينة وبيع وشراء أدوات الدين بشكل عام. وهو النظام الذي أعلنته المحكمة الشرعية في البلاد غير إسلامي واعتباراً من عام 2002 تحولت الحكومة إلى النظام المزدوج للأعمال المصرفية التقليدية والإسلامية، تاركة مجالات التمويل الأخرى مهملة تقريباً. منذ ذلك الحين تطورت الخدمات المصرفية الإسلامية في باكستان من حيث الودائع والأصول والتمويل والربحية في سوق حساسة للعقيدة. بالطبع اقترن هذا النمو بفجوة متزايدة في الهوية حيث قامت البنوك الإسلامية باستنساخ جميع المنتجات التي تستخدمها البنوك التقليدية بموجب

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متطلبات تنظيمية أقل، لا سيما فيما يتعلق بالودائع. على المستوى العالمي أيضاً كان التركيز خلال العقود الثلاثة الماضية على تعزيز العمل المصرفي الإسلامي بالتوازي مع الخدمات المصرفية التقليدية. كما تم إجراء القليل من البحث حول إمكانية وفرص وآثار إدخال التمويل الإسلامي على مستوى الاقتصاد ككل، بما في ذلك خلق النقود والسياسة النقدية. تهدف هذه الورقة النوعية إلى مناقشة إمكانية توسيع نطاق الخدمات المصرفية والتمويل الإسلامي ليشمل العمليات على مستوى الاقتصاد / على المستويات الوطنية في ظل حكم محكمة الشريعة الفيدرالية، باكستان (28 أبريل 2022). ويقدم تقييماً للتقدم المحرز فيما يتعلق بتحقيق أهداف إدخال التمويل الإسلامي في باكستان. ثم يقترح بعض الخطوات والاستراتيجيات السياسية والتنظيمية الرئيسية لتنفيذها إذا كان الهدف من تحويل النظام أن يتحقق. يمكن استخدام الإستراتيجية المقترحة مع الدول الأخرى الأعضاء في منظمة التعاون الإسلامي، مع بعض التغييرات الخاصة بكل اقتصاد، ولا سيما البلدان التي اكتسبت خبرة كافية ولديها حضور واضح للأعمال المصرفية والتمويل الإسلامي.

Abstract

Efforts for transforming the interest-based to interest-free financial system at national levels were made in the early 1980s in Pakistan, Iran and Sudan. In Pakistan, a gigantic move for Islamization of the economy culminating into a system based generally on 'bai'al'inah and the sale and purchase of debt instruments. That system was declared un-Islamic by the country's Shariah Court. As of 2002, the government switched to the dual system of conventional and Islamic banking, leaving other areas of finance, almost unattended. Since then, Islamic banking in Pakistan evolved in the faith-sensitive market in terms of deposits, assets, financing and profitability. Of course, this growth was coupled with an increasing identity gap as Islamic banks replicated almost all products that conventional banks used under lesser regulatory requirements, particularly on the deposits side. At the

global level as well, the focus during the last three decades had been on promoting Islamic banking operating parallel with conventional banking. A little research has been conducted on the possibility, potential and implication of the economy-wide introduction of Islamic finance, also including money creation and monetary policy. This qualitative paper is aimed at discussing the potential of expanding the scope of Islamic banking and finance to economy-wide operations / at national levels in the backdrop of the Judgment of the Federal Shariat Court, Pakistan (April 28, 2022). It presents an evaluation of the progress made in terms of achieving the objectives of introducing Islamic finance, taking Pakistan as a case study. It then suggests some major policy and regulatory steps and strategy to be implemented if the objective of transformation of the system is to be achieved. The suggested strategy can be used for other OIC member countries, with some changes specific to every economy, particularly the countries that have gained sufficient experience and have visible presence of Islamic banking and finance.

الكلمات الدالة: أسلمة الاقتصاد، الصيرفة والتمويل الإسلامي، باكستان، موافقة الشريعة، التوزيع العادل للثروة، صندوق أسهم الشركات

Keywords: Islamization of economy, Islamic banking and finance, Pakistan, Shariah legitimacy, equitable wealth distribution, Corporate Equity Fund.

1.0 Introduction

Ribā is prohibited in all Abrahamic religions—Judaism, Christianity and Islam (Hanif and Ayub, 2021). This also is the requirement of the natural law and ethics (Ayub, 2020, JIBM, 10 (01), 1-11). The modern capitalistic system is based on interest, necessarily a form of ribā, in addition to other proscribed elements like uncertainty about the subject matter, price or delivery of the contracted item (gharar) or creating and dealing in risk, short selling, or other means of exploiting others. Such ethical proscriptions that serve as built-in discipline tools have a significant bearing on economic and commercial activities and financial transactions.

The search for an Islamic system of economics and finance was basically the result of the notable reform movements in Muslim societies, including Pakistan, Iran, Sudan, Turkey, Egypt, and Algeria. Credit for national level movements for Islamisation of economy goes to such movements to an extent for overwhelming acceptance and positivity in sentiments about Islamic financial system among Muslim customers. (Hanif and Ayub, 2021).

Islamic finance is poised to promote shared prosperity by promoting financial and social inclusion, the concept which is not only central to the teachings of Islam but also a part of the lately emerging concepts of CSR and SDGs. Its core principles, namely, risk-sharing and asset-backed nature, prevent an economy from becoming over-financialized and leveraged.

As per Islamic economics and law of contracts, profit or return on cash capital can be earned if capital is linked to any liability, risk or responsibility. It is possible in all contracts like that of partnership based, sale based, lease based, or service contracts. The capital owner is required to be involved in any real economic activity or business to get return.

These constructive elements of Islamic economics and finance have the potential of meeting the challenges facing mankind, provided the systems in vogue are transformed to the ethical basis as prescribed by the divine authority for human beings. Risk & reward-sharing, the

hallmark of Islamic finance, not only offers the foundation for a more stable financial system but also more equitable growth because the proceeds of returns to growth are shared by agents in line with the risk they bear (Maghrebi and Mirakhor, 2015).

However, the system as evolved over the years could not be helpful in realizing the objectives. Hanif and Ayub (2021) have identified the dichotomy in theory and practice and thus failure in achieving the objectives in respect of trade modes like murabaha and tawarruq; use of tawarruq on deposits side, and even in case of the shirkah based contracts like the running musharaka, and other wa'ad based contracts for Forex markets. They have raised certain questions on the current PLS based practices. "Lack of true PLS application has added to the confusion among masses as far claims versus realities of modern Islamic finance industry are concerned", they added.

1.1 The Objective and Plan of the Paper

For Muslims and Islamic countries, evolving economic and finance systems free from ribā and other unethical/exploitative forms of business is also a religious obligation. Additionally, it is an indispensable socio-economic requirement to get rid of the serious problems created by the current capitalistic system, and to achieve broad based welfare of the public.

This study is aimed at discussing the potential of expanding the scope of Islamic banking and finance from the parallel functioning to the economy-wide operations at national levels. It is an effort to initiate deliberations and encourage the researchers to fill the gap for undertaking theoretical and operational studies to facilitate the policy makers, regulators and the practitioners to adopt Islamic system of finance in its totality. The challenges and the potential in this regard have been discussed in detail.

Next, the objective is to suggest a possible strategy for transformation of the entire economy as instructed by the Federal Shariat Court (FSC, 2022). Section 2 discusses the objectives of Islamic banking and finance and possibility of their realization.

Section 3 indicates the steps taken for evolving Islamic Finance in modern age with focus on Pakistan. Section 4 identifies the difficulties and challenges in transforming the whole System in the perspective of the judgment (2022). Section 5 identifies the possible strategy for planning and implementing the process of transformation of the entire economy with focus on the financial system. Chalking out the strategy involves identification of gaps, measures to be taken for filling the gaps at legal, institutional and policy-making and implementing levels, scope of the process covering central banking and commercial banking operations, domestic and foreign funding issues. This section also discusses the concern for the end-results (ma'alat or the higher purposes of Shariah), capacity building of the management and the operational officials of the banks and other financial institutions, and the need for strengthening the regulatory environment for Islamic banking and finance.

1.2 The Research Gap

Islamic finance emerged as a movement in the 1970s with establishment of Islamic Development Bank (IsDB) Jeddah, and Dubai Islamic bank in 1975; the first Int'l Conference on Islamic Economics, held in Makkah in 1976; and publication of the Report of the Council of Islamic Ideology (C.I.I), Pakistan (1980). Governors of central banks and monetary authorities of OIC States resolved to jointly strengthen regulation and supervision of Islamic financial system at the Muslim Ummah level (Janjua, 2002).

At the level of application of the desired system, there emerged two approaches: i) developing an entirely different structure and framework than the existing financial system; and ii) to work within the existing system to achieve the dual objective of Shari'ah compliance and profitability comparable to the existing businesses (Hanif and Ayub, 2021). As the latter approach was easy and suited more for business and profitability, it was adopted across the world. Having seen the success of this dual system in terms of getting increasing business without much change in substance, even the

countries like Pakistan shifted their focus to parallel functioning of Islamic and interest-based systems.

The new approach to promoting Islamic finance changed the whole scenario. The focus moved to tapping the financial market to attract funds from the faith-sensitive population without giving much attention to realizing the objectives for which Islamic finance was to be evolved amidst the already developed conventional finance.

Over last three decades, focus on global level had been at promoting Islamic banking operating parallel with the conventional interesting banking. A little research has been conducted on the possibility, potential and implication of economy-wide introduction of Islamic finance. Hence, there is a gap in the literature on the need for moving to economy-wide application of Islamic banking and finance if the objectives of Islamic finance are to be achieved.

1.3 The Methodology

This paper adopts the qualitative/conceptual methodology to achieve the objectives as listed above. It discusses the existing phenomenon of Islamic finance working parallel to the conventional finance. It draws specific lessons and recommends future course of actions for moving to economy-based finance. Taking Pakistan as a case study in this context, it suggests strategy and steps the future course of action. Based on the growth and development so far, it identifies the potential, challenges and the possible way-out for transforming the present capitalistic system to ethics and value-based system for shared and sustainable growth and welfare-oriented economies.

2.0 Objectives of Islamic Banking and Finance and their Realization

The objectives behind the move for introducing Islamic banking and finance included poverty alleviation, ethical investing, promotion of social values, corporate social responsibility; environmental protection, financial stability, risk-reward sharing, and access to finance (Obaidullah, 2005, Sairally, 2007, Asutay, 2012, Saged et al., 2017 and Hanif and Ayub, 2021. Hanif and Ayub (2021) have

discussed in detail the following objective of Islamic finance: i) Shariah compliance in form as also substance; ii) Financial stability; iii) Equitable distribution of wealth; iv) Financial inclusion leading to social inclusion, and v) Social responsibilities.

The objectives of Islamic finance can be realized by properly and equitably linking the business and economy with finance while avoiding *ribā*, *gharar*, and other forms of exploitation. For this, two approaches have been recommended in the literature i) by promoting risk-sharing contracts - providing a viable alternative to conventional debt-based financing; and ii) by using specific wealth redistribution instruments (WB, 2016, Ch.1, pp.23-33).

Islamic finance scholars and practitioners must ensure linking finance with the real business and avoid all means of earning money from money. As part of the CSR, IBFIs are expected to provide finance to the so-far unbanked groups from their equity or philanthropists through the institutions like *waqf*, *zakah*, and *sadaqāt*.

All participatory and exchange contracts and even agency-based Islamic modes can serve the purpose of developing a real economy. Of course, the IBFIs need to use modes while observing their *Sharī'ah* essentials in letter and spirit. *Tawarruq*, for example, could be used only in extreme cases strictly in line with the AAOIFI's *Sharī'ah* Standards. The relative stability of the Islamic banks and financial institutions even during the GFC-2008 was because they were not exposed, by that time, to financial derivatives, and the use of organized *tawarruq* was on a much-limited scale. But they have been increasingly compromising on fundamental principles and strong ethical values for mere profit motives.

The continuing crises in the global economy and finance must inspire the IBFIs to follow a different paradigm. To properly relate finance to the real sector, Islamic banks need to explore such modes and instruments that could play role in promoting the real economy. They must avoid all games of chance and such engineered financial products that could be tools of extraordinary benefit to innovators of complicated synthetic products but are harmful to the masses and the global economy and finance. Forward sale and creating financial assets based on the future potential of growth in goods and services is valid only when it is subjected to the conditions imposed for the valid

salam and istisnā transactions. It refers to the need for controlling money and credit in national economies and global finance. Inflation targeting, monetary policy, and its management must be geared to ensure that financial flows are just sufficient to facilitate the growth of the real sector. It could be accomplished by the IsDB or any apex forum like the COMCEC of the OIC.

3.0 Practical Steps for Evolving Islamic Finance in Modern Age

Nationwide efforts for Islamizing the economy were made by Pakistan, Iran and Sudan. In Pakistan, start of Islamic banking at separate interest-free counters in all banks (January 1981), and then transforming the whole financial system as from July 1985 after enormous changes in the legal structures was a huge step towards making Islamic finance a full-fledged system in the modern world.

Some impactful steps taken at global level included establishment of Jeddah based Islamic Fiqh Academy (IFA), Islamic Development Bank and its research and training arm, IRTI; the Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI), and Kuala Lumpur-based Islamic Financial Services Board (IFSB). While AAOIFI issues around 120 Shariah Standards, Accounting and Auditing Standards, and Corporate Governance standards for Islamic finance industry, the IFSB so far issued (30) Standards on capital adequacy, risk management and Shariah governance of Islamic finance institutions. The International Islamic Financial Market (IIFM) established in Bahrain in 2002 also has issued (12) standards on different aspects of Islamic finance market practices. A Liquidity Management Center and some rating agencies are also operating in their specific ambits (Hanif and Ayub, 2021).

Starting from the late 1970s, the Government of Pakistan took measures to Islamize the financial system of the country. These measures included the introduction of Zakat (June 1980) and Ushr (tithe on land produce) (March, 1983) and the elimination of interest from the operations of Specialized Financial Institutions (July 1979 to July 1985) and the commercial banks (January, 1981 to July, 1985). Financial instruments like Participation Term Certificates (PTC) (June 1980) and Term Financing Certificate (TFC) (1984-85) were also

introduced to replace interest-based corporate financing while Mudarabah Certificates (June 1980) were introduced to provide capital on profit/loss sharing basis.

The Islamic financial system being evolved in Pakistan was supposed to be based on the report of the Council of Islamic Ideology (CII) Pakistan (1980). While structuring the new system, the then Pakistan Banking Council (PBC), a parallel institution for managing the affairs of commercial banks working in the then-nationalized commercial banking sector, and the State Bank of Pakistan (SBP) created innovations in ‘murabaha’ to allow sale and purchase of receivables and debt instruments, and ‘bai al-inah’ (sale and buy-back strategy).

As the whole system developed based on ‘sale and buy-back’ and the sale of receivables/debts, there was much criticism by the scholars, academia and the CII itself. The Non-Interest based (NIB) system was, therefore, declared un-Islamic by the FSC, Pakistan in November 1991. Appeal was preferred by the government and some banks and ribā remained on trial for over three decades till 28th April 2022 when the FSC reiterated that interest as ribā and instructed to transform the whole system in five years, by the end of 2027.

Islamic finance is being evolved in almost all parts of the world. The FSC (2022, para. 93) has quoted the SBP saying, “In terms of jurisdictions, Islamic finance is present in almost 90 countries across the globe, with about 50 Muslim countries. In a majority of Muslim countries, Islamic banking system is operating in parallel to the conventional banking system. The Islamic financing industry comprised of a total of 1,526 Islamic financial institutions offering Shariah-compliant products & services in different sectors like banking, capital market, takaful, etc.” (ICD-Refinitiv, 2020).

Pakistan, however, despite playing an active role in initiating the process of Islamization of the economic and financial system during the 1970s–1980s, lagged many other countries in the movement of promoting Islamic banking and finance as it is not included now even in the 10 evolving markets of Islamic finance.

4.0 The Issues and Challenges in Transforming the System

Mainly two types of challenges are faced in Islamisation of entire economy and the financial system, particularly in Pakistan. One, the huge amounts of public debt already incurred that are difficult to be converted into Shariah-compliant instruments. A large part of investment portfolio of banks comprises the public debt. Secondly, the products, instruments and the contracts used by Islamic banks, both on deposits/liabilities and assets/financing sides, represent generally the replicas of the interest-based products that they innovated to survive in competitive environment while operating within the conventional finance paradigm. The second challenge is equally serious as the system once evolved as 'shariah compliant' cannot be reformed so easily; and this poses the major hurdle in realizing the objectives of introducing Islamic banking and finance as an alternative to the conventional finance. We discuss below the challenges:

4.1 The Issue of Domestic and Foreign Debt

The main issue behind the stance of the and the government is transforming the domestic and foreign public debt and replacing the interest-based tools of investment used by various investors in the economy. These are required to be changed to Islamic principles by 2027 (FSC 2022, paras, 132 & 158, pp.248, 287). The transformation issue is serious on the face of it as the huge debt taken by the government and public sector entities, both from the banks as also National Savings Schemes (NSSs) that might be up to 15 years is difficult to be changed to any of the Islamic bases.

Pakistan's total debt and liabilities as of the end of June 2021 stood at Rs. 47. 8 trillion (100.3 % of GDP). Total public debt from external resources amounted to US \$ 95.2 billion which also included debt taken from IMF (USD 7.4 billion). Public foreign debt also including that of PSEs amounted to \$ 102.2 billion (SBP, Sept. 2021).

Regarding the domestic public debt, banks are holding instruments of around PKR 12-15 trillion out of the public debt of PKR 31 trillion. It constitutes around 53 % of the total investment portfolio of banks, although legally they are required to hold only 17-23 % of their time and demand liabilities (TDLs). This debt is held in the form of 3- and 6-months T. Bills, FIBs, PIBS and other debt instruments.

Due to high debt-related obligations, Pakistan's net revenue receipts could meet mainly the debt servicing requirements during 2021-22 (85%). So, the country's defence, development, and running of civil government including salaries and pensions of the federal government have to be paid out through "borrowed" money (The News, 27 Nov. 2021). It highlights the recipe for an unsustainable debt profile and increasingly severe problems for the low-income and salaried class of the country, around 40% according to World Bank's data of June 2021.

An issue of further concern is that the rate of borrowing from the banks, benchmarked with the SBP's policy rate is extraordinarily high. In July 2022, the 3 months T-bill rate was 15.6%, carrying a premium of 60bps above SBP's policy rate of 15%. Another issue is that the debt given by the SBP in the past on lower rates is being reprofiled under the instruction of the IMF by transferring it to commercial banks. By 2019, SBP was holding Rs 7.8 trillion of the domestic debt. Due to reprofiling of public debt - retiring the debt held by SBP to be taken by commercial banks by 2029, the SBP was holding around Rs. 6 trillion public debts by July 2022. This shift at abnormally high rate is also leading to increasing debt burden on the public. It enriches the banks at the cost of public who are made to pay in the form of higher taxes. Further, in terms of SBP Amendment Act 2021, a ban has been imposed on the direct borrowing of government from the central bank; and in case of liquidity crunch in the market, SBP lends to banks for onward lending to the government.

4.2 The Issue of Capital Inflow from Abroad

The inflow of foreign resources in any economy depends upon many factors necessarily including, inter alia, stability and continuity of policies, consistency of investment, tax, trade and exchange rate policies, availability and cost of energy, enforcement of the property rights and business laws/law and order situation, availability of raw material and that of the skilled labour.

Various options for inflow of capital in terms of priority are:

- a) Foreign Direct Investment (FDI) – the best for the recipient country

- b) Portfolio investments through purchase and sale of stocks and debt instrument
- c) Project based inflow of capital under commercial, bilateral, or multilateral arrangements
- d) Loans – private banks, bilateral and multilateral loans and grants also including finance by international finance institutions like the World Bank, IMF, ADB, IsDB and other consortia for international lending like Paris Club.

IMF is the most strategic source of foreign funding for Pakistan. While all other lenders base their funding on IMF's review of Pakistan's economy, its conditionalities have created serious imbalances for the economy.

A visible move by Islamic finance institutions towards the value-based and ethical procedures and practices may be useful in attracting global cooperation needed for the purpose of developing finance for the service of human beings, as a whole. Banking and finance have to do something solid for the benefit of the poorer and less powerful who have, at least, to be provided with their 'generic rights' and 'basic goods' as required in most of the SDGs 2030. It would require maqāsid based model instead of 'financial engineering' model. In this perspective, Islamic banks need to become models for global finance. (Issue of foreign funding also discussed in Section 5.1.2).

4.3 Transformation of the Whole System – the 'Do or Die' choice for Pakistan

Amidst the issues and difficulties listed above, it is to be reiterated that serious efforts must be initiated without further delay as the task as required by Pakistan's Constitution is becoming increasingly difficult. The present trend is not sustainable and has to be changed with proper planning. It would have been much easier if some effective steps were initiated in the early 1990s (external debt = USD20 billion), and 2001 (external debt = USD37 billion) respectively, when the appeals were preferred against the FSC judgment (1991), and then SAB judgment (1999); and the case ultimately remanded back to the FSC. The reasons and the bases given by SBP in the current appeal (25 June 2022) are

almost like the arguments given by it and the government during the review hearing by the SAB in 2002.

“Abruptness in implementation will create uncertainty in the banking sector, which may create instability to the whole economy”, avoiding any adverse effect to the economy ... (SAB, 2002, p.4).

The current level of indebtedness certainly poses problems and hurdles but measured steps must be taken to get rid of the vicious circle of poverty, indebtedness, and exclusion of an increasing number of people from the financial and social wealth of society. SBP should have initiated the process by transforming the banking system in phases along with other efforts as suggested by various Commissions and Committees time to time (brief about report of all such Commissions can be seen in SBP History compiled by M. Ashraf Janjua, Vols 2 and 3 (Janjua, 1977-2003). Then a review application could be filed before the FSC for getting more time, if needed in case of longer-term liabilities.

Scope of transformation process must also involve reforms in Islamic banking system in vogue. Islamic banking is facing a crisis of identity. The banks need to ensure shariah compliance of their business in substance if they wish to expand their outreach to the whole population of the country that is predominantly Muslim. Although the FSC (2022) has dispelled the impression that Islamic banking in vogue is based on any kinds of heelas (Para 80), there are many issues arising from the use of some grey area modes like organized tawarruq, currency salam, running musharaka and sale of near-to-maturity GOP ijarah sukuk to SBP. Currently, As indicated by the FSC (2022), Islamic banks must consider the end result (ma’alat) of the financing activities for realizing shariah compliance in spirit, and for desired socio-economic impacts.

Although the SBP and some commercial banks went into an appeal to the SAB of the Supreme Court of Pakistan, the Prime Minister of Pakistan has constituted a Task Force under Chairmanship of the Minister of Finance with some members from various ministries and three Shariah scholars covering different religious sects in Pakistan. Governor, State Bank of Pakistan is also a member. The TOR

of the taskforce speaks of some trickery as it has been asked to review whether the FSC (2022) has suitably addressed the questions raised by the SAB in its Review Order of 2002? The thrust of the TOR should have been transforming the economy to Islamic principles.

4.4 Benefiting from the experiences gained, and the work already done

In the light of the experience already gained regarding Islamic banking, the government, the regulators and the banks will have to learn the lesson. It would need a new paradigm, firm resolve and commitment of the government functionaries, financial sector regulators (SBP and the SECP), Shariah scholars involved in Islamic banking, economists and the researchers in Islamic economics and finance. There must be a pro-active interaction between the Finance Ministry, SBP, the CII, and the Pakistan Banks Association representing the banks in the country. The policymakers and the regulators may get insights from a lot of work already done and reports given, by different institutions, committees, and commissions, some of which are:

- a) The Panel of Bankers and Economists and six (6) Working Groups in the SBP with their detailed working and Report of the Panel (1979-80)
- b) Report of the Council of Islamic Ideology on Elimination of interest from the economy, June 1980. The Report (June 1980) was based on the deliberations of the Working Groups and the Panel of Economists and Bankers.
- c) Hanfi Commission Report (1992). Constituted as per Enforcement of Shariat Act, 1991.
- d) The Commission for Transformation of the Financial System (CTFS) established in SBP as per Directives of the SAB Judgment (1999).
- e) Task Force (headed by Mr. Javed Ahmed Noel) in the Finance Ministry to plan for transforming government debt to an interest-free system (2000).
- f) Task Force (headed by Dr. Mahmood Ahmad Ghazi) in the Ministry of Law for suggesting the main law for the prohibition

of ribā and ancillary laws on foreclosure and fair trade and business practices (2000)

Providing alternative law and legal framework for Islamic financial system is a crucial area that may take much time. Work on this aspect has to be done in the ministry of law, SBP, SECP and the Parliament. All stakeholders need to be on board for preparing a suitable legal framework for the proper functioning of the new system. Regarding the legal framework, while the CTFS (2001) proposed one comprehensive seminal law namely, ‘Islamization of Financial Transactions Ordinance’ the Task Force of Ministry of Law proposed two separate ordinances namely ‘Prohibition of Ribā Ordinance’ and the ‘Financial Transactions Ordinance’. However, the Task Force corresponded to the proposal by the CTFS that in the case of two separate laws, the same may be promulgated simultaneously to avoid any gap or dislocation.

Two IMF experts with expertise in financial sector regulations, and control and supervision mechanisms, met the CTFS on latter’s invitation in July 2000. The team was led by Dr. Ghiath Shabsigh who contended that there was no a priori reason to believe that Islamic system of finance per se would generate adverse effects on savings and resource mobilization. He also made presentation to the CTFS on how the tools for monetary management could be developed. He, however, emphasized the need to review and revamp the supervisory and monetary mechanism to provide adequate supervision and regulation of the new system. The team suggested gradualism and submitted a detailed report about their observations and gave recommendations regarding the work of the CTFS. The report suggested that a campaign to educate the public about various Islamic finance instruments and eliminate any misconceptions about the new system should be launched prior to the conversion. Important points covered in the IMF team’s report included, inter alia:

- i) The Islamic financing instruments should be able to meet the funding needs of the government, replace the various instruments that exist at present (i.e., treasury bills, bonds, and National Saving Schemes (NSS), and flexible

- and liquid enough to meet the SBP and financial market requirements.
- ii) It is essential to issue at least one tranche of the new Shariah compliant instruments securities [at the earliest], to test the market and build confidence in the new instruments.
 - iii) A gradual process should be considered where maturing debt is replaced by the new instruments with the possibility of accelerating the process through buybacks of existing debt if the new instruments are received well by the financial markets.
 - iv) While acknowledging that the instruments like Murabaha, Ijarah, and Musharakah form the backbone of new system and would most likely be used by the market, it is important that other instruments (e.g., Mudarabah, Salam, etc.) are documented as well. It is also highly preferable to use the new law as the legal basis for these documents rather than issuing them under separate laws. In addition, the documents should only provide the elements that are necessary for the financial institutions to draft their own contracts that reflect the market needs rather than enforcing specific detailed contracts. This would preserve the needed flexibility to accommodate dynamism and developing financial markets.
 - v) Some types of Islamic financial contracts involve Islamic financial institutions taking on the risks normally associated with a commodity traders and venture capitalist. An important issue for the CTFS will be to determine whether the core payments system needs to be insulated from these risks and, if so, how this might be accomplished, for example by requiring banks to conduct certain types of business only in separately incorporated subsidiary companies. Whether or not this route is adopted, a comprehensive framework of effective consolidated supervision in any case needs to be developed.

- vi) The draft Basic Law, documents and contracts would form the basis for developing a training program. It is important to have such a program in place at least 6 months prior to conversion date to provide adequate training in the new mode of finance for reasonably large number of financial market participants. The training manuals should be composed primarily of the new basic law, the legal documents on individual instruments, and sample contracts. The training program should be launched as early as possible after the finalization of the Basic Law to allow for the time needed to train sufficiently large number of officers by the target date.

Other points of the report of IMF experts can be detailed in the History of the State Bank of Pakistan (Janjua, 1977-2003).

5.0 Suggested Strategy for the Transformation Process

As advised by the Shariat Court (FSC, 2022), the state institutions and the regulators are duty bound to transform the whole system to the Islamic principles. That is the only way to do justice with all, and for welfare of the masses at broader scale, as required in the Article 38 (a) and (e), along with application of other tenets of Islam. Of course, the gigantic work of transforming the whole economy would require a purposefully prepared strategy. Some institutional parts of the strategy are suggested here:

A. The government may constitute a high-powered Committee or Task Force [Task Force for Strategy & Planning (TFSP)] comprising experts in finance, economics, accounting, legal and Shariah matters; the TFSP must take benefit of the work already done by various commissions and committees also including report of the IMF experts as indicated above. TOR of the TFSP should be, inter alia, to:

- i) Proper gap and impediments Identification in terms of:
 - Legal reforms – main laws and subsidiary legislation
 - Regulatory reforms for an effective governance for realization of the objectives and implementing the stakeholders' approach

- ii) Prepare a Blueprint or Model of all business, banking, investment and finance transaction with practical illustrations and implementation guidelines. It may also share success stories of banks and companies that transformed to Islamic principles.
- iii) Suggest gradual process for conversion of the existing debt.
- iv) Overseeing the implementation of the strategy and the procedures as per the agreed gradual process and resolving the issues arising during implementation. Hence, the task force may continue even after giving its strategy related report, though its membership could be reduced, if warranted.

B. There could be a Coordination & Implementation Committee for Transformation (CICT). The CICT may have representation in CESP in the State Bank (that would be working only for the banking and finance system). As implementation is the most strategic part of the process, some members of the Task Force must also be in the CESP of the State Bank.

C. Transformation of entire economy to Islamic principles of socio-economic justice would also require new fiscal policy vision for budgetary finance and managing required level of liquidity in the economy by the central bank.

The strategy must involve reforms in the current Islamic banking policies and practices. Providing finance by replicating conventional instruments may only add to the problems and miseries of the poor and the developing economies. Organized tawarruq is the main grey area product being used excessively to circumvent the prohibition of interest (Khan, 2010; Siddiqi, 2007). Along with w'aad (promise) it has become a major part of the 'Islamic financial derivatives' like credit default and profit rate swaps. It leads to creation of money and credit or the 'financial engineering' model. This is why, an IMF Working Paper (WP/15/120, 2015, P. 12) contended, "Islamic banks are not different from conventional banks". distribution of income and wealth and uphold the concept of justice, they have to contribute to the community by financing genuine entrepreneurs requiring capital to grow.

The key issue in *Ijarah*-based financing was the unjust terms of ownership transformation, maintenance responsibility, default penalty, and the issue of legal treatment. However, the issue of ownership transformation was considered one of the major issues in *Ijarah*-based financing contracts, whereby the transfer of asset title to the lessees once the asset has depreciated present is riskier, as well as transfer the responsibilities to the lessees before asset title transformation is another injustice and hazard moral. Thus, to solve the problem, Islamic banks, as the lessor, must fully recognise the ownership of the assets during the period of leasing. This full recognition entails many consequences. The asset must be recorded in the bank's balance sheet statement, the asset deprecation should follow reasonable and technically agreeable approaches, and banks (lessor) should be responsible for all expenses, risks and rewards in relation to the ownership. These expenditures comprise maintenance expenses, regular services, spare parts replacement, insurance (Islamic *takaful*) contribution, road tax, etc. (Shiyuti et al., 2012). On the other hand, the client as the lessee will be responsible for the costs related directly to the use of the asset (Shiyuti et al., 2012). Thus, Islamic banks still have the chance to uphold the concept of justice for income and wealth distribution by offering *Shari'ah*-based financing that reflects the concept of profit and loss sharing. The empirical findings of the study will provide valuable input for policymakers, particularly central banks and bank management to evaluate the current practice of Islamic finance and correct its shortcomings to uphold the concept of justice for all.

One of the significant limitations that cannot be ignored is its sole focus on the *Shari'ah*-based financing contracts practiced by Islamic banks in Malaysia. The findings and policy suggestions of this study, therefore, will be beneficial only for the community and policymakers in Malaysia. Put differently, the findings cannot be generalized to other Muslim countries. Thus, broadening the scope of this research to encompass the operations of the Islamic banks worldwide will offer a palpable and more substantial basis to evaluate whether the Islamic financing system and its practices provide equitable income and wealth distribution.

5.1 *The Issue of Capital Inflow from Abroad*

The scope of the process could be determined precisely after identification of the gaps in the financial and legal frameworks. Financial sector of Pakistan consists of banks, development finance institutions (DFIs), micro-finance banks (MFBs), and Non-bank finance companies (NBFCs) including mutual funds, investment companies, asset management companies, takaful/insurance companies, leasing companies, mudarabas, mutual funds and plans, pension funds, discretionary & non-discretionary portfolios, and real estate investment trust. Conversion of NBFIs and DFIs should be easy as compared to that of commercial banks as the former could provide commodity and project-based financing. To replace insurance business, takaful coverage could be provided based on Islamic concepts of mutual help and indemnity as the concepts of al-nahad, and aqilah².

Mainly, the transformation process would involve the following areas and sectors:

- i) Central banking and monetary policy
- ii) Banking system including all kind of institutions that provide Cheque books to depositors³.
- iii) The government and the public sector enterprises (PSEs) financing
- iv) Foreign funding by the business and corporate sector, trade credit, etc

² For takaful and re-takaful on the basis of mutual risk sharing, may be seen i) Making Takaful System Really Worthwhile, Journal Of Islamic Business and Management (JIBM), Vol. 4, No, 1, June, 2014; <https://jibm.org/wp-content/uploads/2018/02/Making-Tak%C4%81ful-System-Really-Worthwhile2.pdf> ii) Retakaful: Risk Sharing vs. Risk Transfer: An Examination from the Shariah Perspective, International Shari'ah Research Academy for Islamic Finance (ISRA), IRP, 85/ 2015; <https://ifikr.isra.my/library/pub/7302/retakaful-risk-sharing-vs-risk-transfer-an-examination-from-the-shariah-perspective>.

³ SBP could have prepared a plan to convert all banking operations to Islamic bases within the given timeline of five years, and submit it to the Shariah Court, rather than going for appeal without any work for implementing the judgment.

- v) Foreign funding for the corporate sector – trade credit, loans and advances, FDI, portfolio investment, etc.
- vi) NBFIs like insurance companies, investment banks, Fund Management companies, Leasing companies, National Savings Schemes (NSSs)
- vii) Pension funds, General Provident Funds, etc.
- viii) Corporate debt and funds taken and invested by the Joint stock companies and corporate sector, raising finance from the capital market.
- ix) It would also require simultaneous promulgation of the laws as suggested by the Task Force of the Ministry of Law established in pursuance of the SAB judgment (1999).

Regarding central banking operations, the following alternative tools could be considered:

5.1.1 Central Bank Operations

Central bank's main function is to regulate the money supply in the economy while ensuring stability of the financial system. The amount of money created under any ethical system needs to be by way of sharing risk and reward as per the related business activity. It requires application of 100 % reserves banking, as was suggested in the 'Chicago Plan' of the 1930s, instead of the fractional reserves banking, which is the basic cause of anomalies and recurring financial crises.

As per Islamic principles, cash, liquid, or financial capital is not entitled to returns on it without incurring business risk. Islam encourages the act of taking calculated risk with the expectation of making profit from any venture or business activity. However, creating risk in a contract by default and trading in such risks is not allowed. The manageable risk must be differentiated from unmanageable risk (gharar), that is, ambiguity and uncertainty injected ab initio in a contract in terms of precise specification of quantity and quality of the subject matter or its recompense. The warning by renowned economist Jon Danielsson of the LSE, an authority on financial risk forecasting, that is, "Trusting your risk models will lose you money in a crisis"

(Moshinsky, 2015) is worth considering and implementing, particularly by the IFIs⁴.

Accordingly, Islamic theory of factors' returns treats liquid capital / money like the entrepreneurs that get residual after making all other payments or paying to other factors involved in production or business (Ayub, 2022). This is possible only if the IFIs resolve to assure that all financing is based on real sector transactions in line with the principles of credit and forward trading as provided in Sharī'ah in respect of shirkah, mu'ajjal and salam contracts. Through such means the monetary authorities would be able to help generate money and credit sufficient to explore the potential of the economy and prevent recessions, but not more than the potential, in order to avoid inflation. It will promote entrepreneurship leading to broad based development and reduce concentration of wealth in fewer hands.

Many direct and indirect measures and tools like Open Market Operations (OMOs), minimum cash reserve requirements; liquidity ratio; overall credit ceilings for banks; mandatory credit targets; selective or qualitative credit control measures; issue of directions regarding credit to priority sectors or profit rates to different categories of deposits, and moral suasion are available to the State Bank except the bank rate instrument and the power to give directions to banks in regard to interest rates on credit and bank deposits (CII, 1980).

In all cases where SBP is empowered to charge penal interest e.g., shortfall in the minimum required reserves, SLR, violations of certain instructions, it would be replaced by a provision to impose fines per day related to the amount and the period of the default. Initially, the bank rate and interest rates on advances and deposits were proposed to be replaced by a device which may not be ribā based but nonetheless help in influencing the demand and supply of loanable funds such as a system of profit/loss sharing in the case of financing and deposits. For this purpose, State Bank would be empowered to prescribe maximum and minimum profit-sharing ratios for banks.

⁴ He adds, "This tricks people into thinking that they work all the time. But when all hell breaks loose, the models will give you wildly different risk assessments, leaving you flying blind. This is bad for banks and hedge funds but even worse for central banks, who have to make policy decisions for everyone else" (Moshinsky, 2015).

Similarly, State Bank's power to vary the bank rate has to be replaced by the power to fix its own profit-sharing ratio/ratios on its financial assistance and purchases of bills etc. /re-finance facilities to banks and other financial institutions. However, the State Bank may also be allowed to provide, at its discretion, interest-free loans/refinance to any institution or sector or purpose.

The monetary policy in the country must be independent from the foreign institutions or unnecessary intervention by the government. Of course, there must be close coordination between the policy makers in fiscal and monetary areas. Similarly, the transformation of non-banking finance companies and the capital market functioning would be necessary for successful transformation of the banking companies' business and the investment avenues for the public. Some of the related functions are:

- a) SBP would be fixing its own profit-sharing ratio/ratios on its finance to banks and other financial institutions which it may vary from time to time as necessary
- b) On cash reserve requirement (CRR), already no return is paid by the central bank to the banks
- c) For statutory liquidity requirement (SLR), banks will be required to replace their holdings in notified instruments like sukuk, NIT units, "Participation Term Certificates - PTCs" open and closed mutual funds and GDP growth related instruments.
- d) The definition of "approved securities" eligible for meeting SLR needs to be revised to suit the changed situation. The State Bank's power to impose penal interest charges in case of default will have to be replaced by power to impose slab based fine.
- e) Government Transactions – federal, provincial, and local bodies; PSEs - autonomous bodies/corporations owned by the government - Their deposits with commercial banks would be held on mudarabah basis in the same manner as private sector deposits with banks; Their Accounts balances may be invested in open and close ended mutual funds, NIT units and other interest-free avenues of investment that would open up under the new system.

- f) Their borrowing from the commercial banks may be on the basis of i) service charge, or ii) rate linked to GDP growth rate with and without adding inflation rate / GDP deflator as discusses in next Section 5.1.2.

For the time being, government needs for servicing the earlier debt may be fulfilled by securities linked to the GDP growth rate by adding a part or full of the GDP deflator depending upon the tenor of the instrument – longer the tenor, more to be added while keeping the combined weight within sum total of ‘1’ (accordingly, the method of assigning weights to different types of deposits by Islamic banks has to be changed).

5.1.2 *Commercial Banking Operations*

Currently in Pakistan, the IBIs provide working capital finance to the corporate sector on the basis of Running Musharaka, the process of which involves certain Shariah and equity-related issues. The second tier PSR practically excludes the bank from sharing the actual profit, which makes the product an exact replica of conventional overdraft. It needs certain refinements to remove the Shariah issue pertaining to determining the share of each partner and distribution of profits as per musharaka rules.

As indicated by the FSC (2022, p.293) some areas of the banking system and economy can be converted into Islamic principles almost instantaneously. One such area is conversion of deposit side of the banking as it has all the legal framework available to convert the banking completely. For this the SBP needs to introduce the deposits mobilization, pools management and profit distribution system introduced by it in 2012 and already being used by 22 IBIs in the country⁵. It will also require the role of the banks’ BODs and the Shariah Boards (SGF, 2015) extended to all banks in the country.

⁵ The pool management system has, however, to be implemented properly while taking notice of the irregularities adopted currently by the IBIs particularly regarding increasing use of ‘Special Musharakah Pools’ (SMPs) that are created to give special return to big depositors at the cost of savings account holders and common depositors that are given lower returns. Many mudarabah or musharakah related conditions, as introduced by the SBP, are not implemented for SMPs with the objective to give higher return to

For the assets side, the FSC (2022) observed, “Whereas on the loans and lending side of the banking, although numerous Shariah-compliant products and instruments approved by the State Bank of Pakistan are available, but the complete transformation of economy will take some time” (FSC, 2022, p.293,). The FSC, however, quoted the Counsel of SBP saying, “if someone wants to do business with banks hundred percent in accordance with the Interest-free Shariah-compliant modes then it is possible for him without any hindrance” (FSC (2022)).

Export finance could be provided on murabaha, pre-shipment salam and istisnā basis, and consignment based musharaka/ mudaraba in cases where the customer has a firm letter for export.

Post shipment export financing could be on salam basis as per the Figure 1 below (and subject to revisions in terms of the exchange rate):



Source: Authors own

corporate clients’ priority deposits.

Working capital could be provided to corporate, micro business and SMEs. In certain cases, Murabaha and salam can also be used for financing. For financing in the form of cash, the concept of average annual rate of profitability for the borrowing firm can be used as the basis for distribution of profit between the entrepreneur and the bank. Annual rate of profitability of a particular customer can be estimated on the basis of customer's past performance, or similar information for business in related area.

Financing for seasonal inputs to the farmers can be provided on the basis of sale-based modes of Murabaha and salam. For bigger farmers, financing can be provided on profit and loss sharing basis. Financing for orchards, fishing, bee keeping, dairy farming and poultry may also be made on profit sharing basis, salam and murabaha. Agricultural machinery and equipment can be provided to agriculturists on installment payment basis or under ijara muntahia biltamleek arrangements. Tube-wells may be made available on lease basis and deferred payment arrangements.

Foreign bills purchased that generally relate to the negotiation of export bills under letters of credit established by the foreign importers in favour of the exporters do not involve post-shipment bank financing and would, therefore, continue to be handled by the banks on the existing pattern subject to recovery of commission and handling charges in accordance with the terms and conditions of the export L/C. In a few cases where customers approach the bank for purchase of export bills in the absence of export letters of credit, the bank may grant bills purchase facility on single transaction basis on recovery of specific service charges against each bill.

Regarding personal finance, generally for unavoidable consumption needs of the poor, students, sick, etc.; and for micro-level entrepreneurs, a hypothetical real money needs to be introduced that could be gold or any other precious commodity. The interest-free loans/financing will be made in Rupees calculated in terms of value of real money. The borrowers will be required to repay the real money while taking into account the inflation level / GDP deflator. SBP may like to give special instruction to the banks for granting such loans, may be 1.0 % of their total investment portfolio. In this way, banks will also be fulfilling their CSR Related obligations. Of course,

this scheme of banking operations in ‘Real Money’ might not be possible at the national / system level. For that purpose, the banks or other financiers may like use exchange / business contracts like sale, lease, mudaraba or other partnership-based arrangements

It may be added regarding loans that incurring loans has not been liked by the Holy prophet (PBUH). Lending has been equated with sadaqah or charity and in some cases even better than sadaqah. Generally, neither anyone asks for loan as a sadaqah to do business, nor people will give Sadaqah for business except in case of kin or a near friend. The latter case is a virtue with the relatives, kin or the friends, and in that case requiring them to pay extra amount on the principal on account of inflation or any other reason does not make any sense. Hence, in case a person helps a needy by giving him resources for some time, it must not be business or for getting benefit. In case of dire consumption needs or for small / cottage businesses, the state or the banks may provide financing with liability to repay in ‘Real money’.

Commercial banks may jointly establish ‘Corporate Equity Fund’ (CEF) and Venture Capital Fund’ (VCF) for providing equity support to corporate entities in need of medium and long-term funds. The CEF will also underwrite the public issue of shares while considering the Shariah imperatives. The VCF will provide equity support to the Startups in SME for commodity producing and business sectors.

Other functions of the CEF would be:

- a) Floatation of Venture Capital, Mudarabas and mutual funds.
- b) Arrange syndicating of stocks and term finance for BMR both in rupees and foreign currencies.
- c) Promote and co-sponsor projects on mutually agreed basis.
- d) Assist the takeovers, mergers, disinvestments, reorganization and rehabilitation of private companies.
- e) Provide technical and consultancy services to the companies/projects and Undertake management of investment portfolios.

By taking funds from IsDB and other multilateral institutions, the CEF would provide Shariah-compliant funding also in foreign currency. In case foreign funding is not available on shariah compliant terms, it may facilitate the FDI for specific sectors by investing a part of the total investment projects.

IsDB and WB signed in October 2015 a Deep Dive Initiative (DDI), a strategic partnership framework aimed at scaling-up development assistance in common member countries (FSC, 2022). In 2016, combined financing reached USD 2.4 billion (USD 910 million from IsDB and USD 1.5 billion from WB) for eight projects in agriculture (Cameroon, Sahel), agriculture and infrastructure (Indonesia), energy (Palestine, Pakistan), and water (Kyrgyzstan and Mali).

A publication, “Islamic Finance for Infrastructure projects,” by the World Bank Group, PPAF and IsDB 2019, prepared by different financial and banking experts, suggested that some of the Shairah-Complaint modes of financing can be used to convert the interest-based debt of Pakistan into Shariah-Complaint Mode of Financing (FSC, 2022, pp.240-242). The Guide outlines some Islamic finance structures that are used to finance infrastructure projects including *istisnā*, *ijarah*, *wakālah-ijarah* and *musharakah- istisnā’a- ijarah*-based financing structures.

Foreign currency deposits can be accepted and operated at the Rupee-conversion rate plus a token amount as service charge not exceeding 1 % of the converted rupee balance.

For the purpose of transformation, banks would be required to replace their holdings of interest-bearing government and other approved securities by such financial instruments as are permissible under Shariah. Of course, it may take longer time based on the maturity of long-term debts held by the banks. Banks can be asked to meet the liquidity ratio requirement through an increase in cash holdings (in their own vaults or with the State Bank) and through purchase of other securities, such as “Participation Term Certificates” or *sukuk*.

All above areas can be easily covered in the transformation within the given time of five years, except the public debt held excessively by the banks that may involve serious issues due to current debt and debt servicing profile of the Federal and the Provincial

governments and the PSEs. Pakistan's domestic debt and its servicing increased immensely over last few decades. Problems started aggravating in late 1990s when the issuance of ad hoc Treasury Bills⁶ @ 0.5% (IBRD, 1989) for a kind of floating debt was stopped and all SBP borrowings by government were linked to market rate.

The situation exacerbated by the SBP Amendment Act, 2021 passed by the Parliament as pressurized by the IMF. The Act (2021) gives extraordinary autonomy which no other institutions of the country possess; and is nowhere in the world. The monetary and fiscal policies coordination board of the SBP has been abolished. The new law restricts the SBP officials to hold any conversation with anybody in the Federal Government. A relevant section of the Act reads:

“The banks, the members of decision-making bodies and its staff shall neither request, nor take any instruction from the government or quasi-government entities. The autonomy of the bank (SBP) shall be respected at all the times and no person or entity seek to influence the members, executive committee, monetary policy committee, or the staff of the bank in the performance of their functions”. (SBP Amendment Act, 2021).

Ban has been imposed on the direct borrowing of government from the central bank and all government borrowing has to be done from the banks. In case banks do not have funds and there is a liquidity crunch in the market, SBP will lend to banks to enable them to lend to the government. In August 2022, SBP provided a huge amount of around PKR546 billion to conventional banks for 63 days and another PKR158 billion for seven days via open market operations (OMOs). Similarly, it provided PKR1.10 trillion to Islamic banks for 63 days and another PKR38 billion for seven days. Earlier, during May to July 2022 the banks borrowed in the range of PKR1.19 trillion to PKR1.86 trillion for 63 days a couple of times and acquired funds multiple times in the range of PKR2 trillion to PKR3.56 trillion for seven days from late February to May 2022. It enriches the banks at the cost of public (3 months T-bill currently at 15.6%, a premium of 60bps above policy rate 15%). Banks may also exploit as a cartel. While the SBP's key policy rate, stands at 15%, the OMO rate stands higher leading to an

⁶ Ad hoc treasury bills of three months maturity and renewable, were issued by the Federal Government to the State Bank to meet specific financial needs.

excessively high rate for public sector borrowing that is not sustainable in any way.

All actions in economic management like targeting money supply, prices and growth rate, operational targets in terms of exports, exchange, production and businesses require effective coordination between the central bank and the Government. In that case only the system might be working smoothly subject to the ‘measured accountability’ of SBP and other related institutions in case of not realizing the targets.

5.1.3 Concern for the End-results of the Transformation Process

In addition to expanding the scope of transformation to the so far neglected areas and aspects, the current paradigm of Islamic finance is also to be revisited. The FSC (2022) has discussed a novel concept for Ijtihad and legal reasoning i.e. Ma’alat i.e. prospects and the end results. The principle was first developed by Imam Shatibi in his famous book “Al-Muwafaqat”. The wording of the principle is “Ma’alat al-Afa’al Mu’tabaratur Shar’an”⁷. The principle suggests that a mujtahid should not remain confined to his verdict rather it should also monitor and review its post-judgement or post-fatwa effects. The Shariah boards of IBIs in Pakistan have been approving the banking products without considering their end-result in terms of socio-economic justice.

Proper deposit management and just system of profit distribution among the deposit account holders/investors is a precondition for achieving the objectives of Islamic economic system. Deposits management and profits distribution system that involves assigning weightages have to be changed (Ayub and Shahul, 2013; Mujaddidi, 2017; Haider and Siddiqui, 2018). This system must ensure that i) smaller deposits of any tenor are not assigned lower weightages, ii) business targets for the staff do not specifically involve current and savings accounts (CASA) and related targets; iii) IBIs may be subjected to special investigation in case profits they give to any category of depositors are less than the conventional market

⁷ End results and prospects of an act must be considered (in Ijtihad) and that Shariah recognizes end result (as a valid source).

benchmark, while the shareholders are getting relatively high profits, and the BOD members and executive management are getting hefty packages / bonuses and perks (Ayub, 2019, pp.5-7).

On the assets side of banking, to ensure the positive role of Islamic finance in the development of the economy and shared growth it would be necessary to create an environment that could oblige the banks to divert more funds for *mushārah*/*mudārah* based financing of productive units, particularly of small enterprises. These 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. It could be possible by promoting venture capital, mutual funds, and project-based crowdfunding. Shariah scholars may guide the government and the regulators of financial markets while ensuring that the objective of transformation as indicated by the Court (para. 155) is realized, and the economy and the people of the Islamic Republic of Pakistan get rid of *ribā* both in form and substance.

5.1.4 Need for Strengthening the Regulatory Environment

The current regulatory approach is restricted to strengthening the banking system in terms of capital adequacy and risk management. That's good; but the social, ethical and Islamic perspectives has also to be considered. The approach to maximize returns, particularly by the banking companies, has to be brought under discipline by providing a social compass to banking and finance policies. Shariah compliance in substance would be possible if conflicts in Shariah advisory system are removed (Ayub, 2021). The ultimate target in terms of business would be promoting entrepreneurship at the micro level, enhancing financial and social inclusion, and reversing the process of widening the gap between the rich and the poor (Ayub, 2015, 2021).

The regulators may also ensure that IBIs keep in view the distinctive features of Islamic banking and finance so that people in general and stakeholders may find clear differences between Islamic and conventional systems of financial intermediation. SBP has expressed commitment in its third strategic plan (2021-2025) to promote Islamic banking to increase its market share up to 30 percent

of overall banking industry by 2025. The Plan is said to have an “extensive focus on improving public perception of Islamic banking as a distinct and viable system capable of catering to financial services needs of various segments of the society. It would capitalize on potential of Islamic finance for achieving the shared vision of a vibrant and sustainable Islamic banking sector in Pakistan” (SBP, April 2021, p.6).

Further, the regulations have to ensure that the system as transformed takes care of the following (Mansuri, 2020):

- a) Islamic bank distributes fair returns to depositors.
- b) It does not give preferential treatment to corporate clients by giving them high rates as depositors, as Islamic banks are currently doing by assigning higher weightage to the accounts of bigger amounts (with the same tenor), and by charging at a lower rate while providing them facility vis-à-vis the consumers and SMEs / micro businesses.
- c) The banking transactions generate real economic activity.
- d) The bank does not make money on money.
- e) The banking transactions do not cause the concentration of wealth in the hand of the rich segment of society.
- f) It provides financial services to the disadvantaged so far, and other vulnerable groups including SMEs and micro-businesses as well as small farmers.
- g) It contributes to enhancing the social well-being of society.
- h) The bank avoids fictitious and haram based transactions.

5.1.5 Capacity Building of Islamic Finance Personnel

Training bank personnel and creating awareness among the people about the true nature of Islamic banking and finance is an aspect demanding concerted efforts on a war footing level. The universities and other educational institutions will have to produce people knowing Shari'ah as well as the principles of finance. The Islamic banking industry has a vast scope for employment generation particularly if it

encourages and finances entrepreneurs in SME and micro business sectors. Further, Islamic banking and finance are a part of the Islamic economic system the very basis of which revolves around justice and morality. Therefore, all-out efforts need to be made by the government, the religious and political leadership, and intelligentsia in general for enhancing the ethical business norms in society.

The universities, business schools, and research centres must undertake research and development (R&D) work in collaboration with the banks. Universities may be involved in R & D for the survey of profit margins and rental rates in various sectors and businesses. They need to work on developing benchmark rates for financing of main sectors in the economy based on the market rates for various sectors and transactions. Researchers may also prepare illustrations of various banking and finance products so that the same could be shariah compliant in substance, and helpful in ensuring social justice. They may also review the instruments and products approved by banks' Shariah Boards and implemented by banks. The R&D centres may also be providing practical solutions for the Parliament, Shariah court, and higher judiciary, as and when required. Further, they may provide practical training and orientation for professionals, Shariah board and BOD members of banks, product developers, and middle & senior-level practitioners.

6.0 Conclusion

The FSC Judgment on ribā (2022) is a commendable judicial development towards the Islamization of the financial and economic system in the country. The benchmark for this desired economic system should be avoiding ribā and ghara in all forms and implementing the Principles of Policy laid down in the Constitution of the Islamic Republic of Pakistan.

The FSC in Para 155 of the judgment emphasized the need to have an equitable economic system, free from exploitation and speculation. It implies that all future strategies and courses of action should be linked to this principle and the guideline. Required substitute legislation should also be focused on these principles. Late Zahid Hussain, the first Governor, of State Bank of Pakistan, indicated in his address to the First All Pakistan Economic Conference, Lahore, on

April 28, 1949, “Islam is opposed to interest, all forms of speculation and all concentrations of wealth and power, all of which are basic features of present-day social and economic order....” [Janjua, 2003]

The FSC, on suo-moto notice, or a fresh petition by any individuals or the group, may like to examine the contracts, tools and products being used by Islamic banks in the light of its observations in the above para. It would provide conceptual clarity to the stakeholders and enhance their confidence and trust of the stakeholders in the emerging Islamic banking and finance system. One reason for the low rate of financial inclusion and savings rates in Pakistan is that people wish to avoid ribā in banking deposits and national saving schemes. Promoting Islamic banking in its true spirit and Islamizing the national saving schemes would necessarily help raise the level of financial inclusion, savings and capital formation in the economy.

The timeline given by the FSC is reasonable, but there might be a few cases where more time could be required for conversion because of longer-term debts. The regulators and the policymakers in the State institutions may set a plan and priorities to take steps towards the transformation of the banking system and the capital market, development finance and public sector finance. The Parliament has to ensure the stability of the political system and continuity of the economic policies and projects once approved and initiated irrespective of the change of the government at any time. Revolutionary steps are needed for transforming the system of public finance, The FSC (2022) has identified some possible moves already being made by the Islamic Development Bank, Jeddah in collaboration with the World Bank and other institutions.

As suggested by the IMF team that visited the SBP upon invitation of the Transformation Commission in 2001 and the CTFS, awareness must be created among the masses. A huge majority of people in Pakistan believe that bank interest is prohibited. But they also have apprehensions and a lack of knowledge about Islamic banking. There is a misperception that Islamic banking is similar to conventional banking in every respect. Islamic banks, the SBP and the Shariah scholars need to remove this misconception by enhancing awareness about the principles of Islamic law of contracts and by

removing the lacuna in the shariah governance framework. Shariah compliance has to be ensured both in form as also substance.

The limitation of this study is that it discusses related issues mainly from the perspective of banking institutions. Further, it presents little empirical evidence due to non-availability of macro level economic data. Hopefully, researchers will cover the other subsectors of the financial system.

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