

## Islamisation of Economy in Pakistan: Past, Present and Future\*

AURANGZEB MEHMOOD

### Introduction

Interest, the linchpin of the modern economic system, is so well-entrenched the world over that hardly any country would be ready to seriously entertain the possibility of operating its economy without it. Islam, on the other hand, has prohibited interest in all its forms. The Muslims of Pakistan, however, have the distinction of categorically expressing the desire and taking some preliminary steps, howsoever modest and tentative, towards establishing a full-fledged Islamic economy a major characteristic of which will be its being free of interest.

The primary purpose of this paper is to study the efforts that have been made in Pakistan, both at the governmental and non-governmental levels, to establish an Islamic economy — which has practically meant developing an interest-free economy plus enforcement of *zakt* and '*ushr* — and to identify the problems and difficulties that are being encountered in this regard. The fifty five years' history of this effort has been divided into two parts. Part I deals with the first three decades after the inception of Pakistan, while Part II deals with the two and a half decades that follow. This latter part centres on examining the process of Islamisation of economy in the country since the late seventies. After acquainting ourselves with the work done in different fields so far, we shall attempt to look at the more recent developments in this regard. Finally, in Part III, we have essayed an analysis of the prevalent situation, mainly from a legal perspective, and have tried to identify the challenges faced by the country on the legal front. This is followed by Part IV, which forms the conclusion of this paper. In it we have essayed to indicate the possible responses to the challenges encountered in this regard.

### I

---

\* The views expressed in this paper are those of the author and do not necessarily reflect the views of any Government institution, department, division or agency.

## HISTORICAL PERSPECTIVE

The last two hundred years have witnessed the establishment and consolidation of an economic system in the world which radically differs from the one that had been prevalent theretofore. One of the major foundations of this system is interest. Muslim countries were also overwhelmed by this new, interest-based economic order.<sup>1</sup> The Muslims of the Sub-continent were no exception to this development. On the other hand, they have been aspiring to establish an economic order based on Islamic principles one of whose salient features is to do away with interest. This aspiration is understandable because one of the main reasons why the Muslim's of this region sought a separate homeland was to be able to fully operationalize Islamic principles both in the individual and collective spheres of life.

Since the late 1940s, a number of theoretical works written by South Asian scholars have been devoted to outlining the main features and arguing for the feasibility of an economic and financial system that conforms to the requirements of the *Shar'ah*.<sup>2</sup> During this period some Muslims gained a degree of experience in establishing and running mutual loan cooperatives which were influenced by the European experiments in the field and were imbued with religious and ethical ideals<sup>3</sup>. This effort of the Muslim scholars of the Sub-continent was further energized with the creation of a separate homeland. Discussion of issues relating to Islamic banking and finance assumed enhanced zeal and enthusiasm. A short-lived experiment was also made in Pakistan in the late 1950s when rural landlords created an interest-free credit network.<sup>4</sup> This could be termed as a period of conceptualization of an alternate to the conventional banking and financial system.

As a preamble to the efforts to develop an independent banking and financial system, Muslim scholars tried to engage, at an academic level, in a critique of interest. In this regard they came up with proposals as to how an alternative system could be established. Maul n Sayyid Ab 'l A'l Maw d , Anwar Iqbal Qureshi, M. Nejatullah Siddiqui, Muhammed Uzair and Mohammad Muslehuddin were among the pioneers of this movement.<sup>5</sup>

<sup>1</sup> See Khurshid Ahmad, "Islamic Finance and Banking: The Challenge of the 21st Century", a paper presented in a conference on "Islamic Banking and Finance: The Concept, The Practice, and the Challenge" held under the auspices of the Islamic Society of North America, 8.

<sup>2</sup> See Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 74.

<sup>3</sup> *Ibid.*, 73.

<sup>4</sup> *Ibid.*, 73.

<sup>5</sup> See Ab 'l A'l Maw d , *S d* (Interest) (Lahore: Islamic Publications, 1951); *idem.*, *Ma' shiy t-i Isl m* (Lahore: Islamic Publications, 1969); Anwar Iqbal Qureshi, *Islam and the Theory of Interest* (Lahore: Ashraf Publications, 1950); Muhammad Nejatullah Siddiqui, *Ghair S d Bank r* (Lahore: Islamic Publications, 1969); Muhammad Uzair, *An Outline of Interestless Banking*

### **Constitution-Making**

The Government of Pakistan was also conscious of its role in creating a socio-economic order commensurate with the teachings of Islam. The first Constituent Assembly set up under the Indian Independence Act of 1947 was charged with the task to frame a constitution and to act as the central legislature of the country during the interim period. Until the framing of the Constitution, Pakistan was to be governed in accordance with the Government of India Act 1935, suitably amended. One of the difficult tasks which faced the framers of the constitution was to identify the role of Islam in the newly created state. It was not easy to reach a consensus as to how the new constitution would incorporate Islam in the structure of the state. For while in principle the importance of Islam was widely recognised, the views of different sections of people on this issue were perceptibly at variance.

The Objectives Resolution placed before the Constituent Assembly on 7 March 1949 outlined the aims and objectives or general principles of a constitution. It was 'a statement of intent' on which the future constitution was to be based.

The Objectives Resolution laid down that the Sovereignty over the entire universe belonged to Allah Almighty and that the authority to be exercised by the people of Pakistan within the limits prescribed by Him was a sacred trust. It also declared that the State was required to exercise its powers through the chosen representatives of the people; that the principles of democracy, freedom, equality, tolerance and social justice, as enunciated by Islam, were required to fully observed. It further declared that the Muslims should be enabled to order their lives in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah.

The first Constituent Assembly, except for passing the Objectives, Resolution, could make little if made very slow progress in framing the constitution with the result that it took the Constituent Assembly about nine years to the first constitution of Pakistan. Unfortunately, this constitution could remain in force for no more than two years and a few months since it was abrogated in 1958. The second constitution was promulgated in 1962, but was abrogated in 1969. The third constitution, the present one, was enacted on 12 April 1973. Among the different parts of the constitution, the Objectives Resolution became a very important document in the constitutional history of Pakistan as it was made the Preamble of all the three constitutions of the country, and in 1985 it was made a substantive part of the constitution.

---

(Karachi and Dacca: Rehan Publications, 1955); Mohammad Muslehuddin, *Banking and Islamic Law* (Karachi: Islamic Research Academy, 1974); and idem., *Insurance and Islamic Law* (Karachi: Islamic Research Academy, 1969).

### **Islamic Provisions in the Constitution of Pakistan**

The distinctive features of the Constitution of 1973 which continues, albeit with numerous amendments, are the provisions which seek to reconstruct the society on the basis of Islamic principles. The Islamic provisions of the constitution of 1973 were more numerous than in the previous two constitutions. The provisions directly relevant to the question under discussion are the following:

- Islam was declared to be the State religion (1973 Constitution);
- All the three constitutions state, with very slight change of wording, that “steps shall be taken to enable the Muslims [of Pakistan], to order their lives, in the individual and collective spheres, in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah”, and that “the principles of democracy, freedom and equality, tolerance and social justice, as enunciated by Islam, shall be fully observed”.
- It was further affirmed that:
  - (a) the State shall eliminate *riba* as early as possible;<sup>6</sup> and that
  - (b) all existing laws shall be brought in conformity with the injunctions of Islam and no law shall be enacted which is repugnant to these injunctions.<sup>7</sup>

Besides the Islamic provisions mentioned above, it would also be pertinent to point out that under the various constitutions of Pakistan, a number of institutions was established to assist in and pursue the task of Islamisation. The following are of specific significance:

#### (a) *The Council of Islamic Ideology*

The Council of Islamic Ideology (hereinafter called the Council) was primarily constituted under the constitution of 1962.<sup>8</sup> The constitution of 1973 also contains provisions regarding the status, composition and procedure of the Council.<sup>9</sup> The functions of the Council are, *inter alia*, to make recommendations to the Parliament and the Provincial Assemblies as to the “ways and means of enabling and encouraging the Muslims of Pakistan to order their lives in accordance with the principles and concepts of Islam”. The

<sup>6</sup> Constitution of 1973, “Principles of Policy”, Article 38(f). Similar provisions are found in the previous two Constitutions of Pakistan. Article 29(f) of the 1956 Constitution provided that: “The State shall endeavour to ... eliminate *riba* as early as possible”; and principle 18 in the “Principles of Policy” contained in Chapter 2 of Part II of the 1962 Constitution stated that: “[*r*]iba (usury) should be eliminated”.

<sup>7</sup> Constitution of 1973, Article 227. Principle 1 in the Principles of Policy contained in Chapter 2 of Part II of the 1962 constitution and Article 198(1) of the 1956 constitution.

<sup>8</sup> Article 199.

<sup>9</sup> Article 228–231.

Council is also to give advice to the Parliament, Provincial Assemblies, the President or Governors as to whether a proposed law is or is not repugnant to the injunctions of Islam. The Council is further required to submit its final report as to the measures for bringing the existing laws into conformity with the injunctions of Islam. The first annual report submitted by the Council was in the year 1964 and comprised of no more than two pages.<sup>10</sup>

(b) *Federal Shariat Court*

In 1979, General Muhammad Zia-ul-Haq promulgated the Constitution (Amendment) Order, 1979, whereby four *Shariat* Benches were established in the various High Courts of the country and a *Shariat* Appellate Bench was set up in the Supreme Court. The four *Shariat* Benches in the High Courts were replaced by a Federal *Shariat* Court<sup>11</sup> (FSC). The FSC consists of eight Muslim judges including the Chief Justice. The Chief Justice is a person who is qualified to be a judge of the Supreme Court of Pakistan or who is or has been a permanent judge of the High Court. Of the judges not more than four shall be persons each one of whom is or has been or is qualified to be a judge of a High Court and not more than three shall be Ulema who are well versed in Islamic Law. The principal seat of the Court is at Islamabad, but the Court can sit, from time to time, in such other places in Pakistan as the Chief Justice may, with the approval of the President, appoint. The Court has the power to examine and decide, either on its own motion or on the petition of a citizen of Pakistan or the Federal Government or a Provincial Government, the question whether or not any law or provision of law is repugnant to the injunctions of Islam, as laid down in the Holy Qur' n and the *Sunnah* of the Holy Prophet. However, this authority has been limited by the constitution itself and does not extend to the constitution, the Muslim Personal Law and the law relating to the procedure of a court or tribunal. Initially the Court was also barred from looking into the fiscal and financial laws. This bar was, in the beginning, for a period of three years and was provided on the plea that *riba* could not be eliminated with one stroke of a pen and required a gradual move. The period was, however, subsequently extended to ten years<sup>12</sup> and came to an end on 26 June 1990. The parties to the cases on which FSC has given its judgement have

<sup>10</sup> Afzal Iqbal, *Islamisation of Pakistan* (Lahore: Vanguard Books Ltd., 1986), 81.

<sup>11</sup> Substituted by Constitution (Amendment) Order 1980, P.O. No. 1 of 1980 w.e.f. 26 May 1986.

<sup>12</sup> The word "four" was substituted for the word "three" by the Constitution (Second Amendment) Order, 1983 (P.O. No. 7 of 1983), section 2 (w.e.f. 19 May 1983); which was substituted by the Constitution (Second Amendment) Order, 1984 (P.O. No. 2 of 1984), section 2 (with effect from 26 April 1984) by the word "five"; which was again substituted by the above by P.O. No. 14 of 1985, Art. 2 and Sch., item 42 (w.e.f. 2 March 1985).

the right to appeal before the Supreme Court of Pakistan against the decision of the Federal *Shariat* Court.<sup>13</sup>

(c) *Islamic Research Institute*

The Islamic Research Institute (IRI) was founded in 1958. It was a requirement of the constitution of 1956 which had provided (vide. Art 197) that the President “. . . shall set up an organisation for Islamic research and instruction in advanced studies to assist in the reconstruction of the Muslim society on a truly Islamic basis”.

Article 207 of the constitution of 1962 also provided for the Institute. The provision regarding the Institute was, however, omitted in the constitution of 1973 with the result that since then it has been working as an autonomous body. The objectives of the Institute, *inter alia*, are: to define Islam in terms of its fundamentals in a rational and liberal manner and to emphasize, *inter alia*, the basic Islamic ideals of universal brotherhood, tolerance and social justice; to carry out research in the contribution of Islam to thought, science and culture with a view to enabling the Muslims to recapture an eminent position in these fields; and to take appropriate measures for organizing and encouraging research in Islamic history, philosophy, law jurisprudence, etc. Since the establishment of the Islamic University in 1980, which was upgraded as International Islamic University in 1985, the Institute has been a part of that University, and its role as a support institution of the Government of Pakistan has gradually diminished.

To sum up, a cursory study of the Islamic provisions in the Constitution and the institutions created to facilitate the process of Islamisation, would reveal that a concerted attempt was made to develop this country into an Islamic state. However, the legal analysis of the relevant provisions shows that there remained some technical lacunae which needed to be addressed for a proper enforcement of the Islamic provisions. For instance, the provision regarding the elimination of *riba*<sup>14</sup> was made part of the Principles of Policy although it was known that no action or law could be called into question merely on grounds that it was not in accordance with the Principles of Policy, and no such action could be initiated against the State, any organ or authority of the State or any person on that ground.<sup>15</sup> Similarly, when the Federal Shariat Court was created to examine the validity of laws in accordance with the Injunctions of Islam, it was barred from examining any fiscal law or any laws relating to the levy and collection of taxes and fees or banking and insurance practices and procedures until the expiration of a period of ten years.

---

<sup>13</sup> Ibid., Article 203A–203J.

<sup>14</sup> Ibid., Article 38(f).

<sup>15</sup> Ibid., Article 30(2).

## II

REVIVAL OF THE PROCESS OF ISLAMISATION  
OF ECONOMY

During the first three decades of Pakistan's existence, the problem of eliminating *riba* from the economy could not receive the attention it deserved except for the incorporation of some important Islamic provisions in the Constitution. This has been pointed out by the Council in its report:<sup>16</sup> "It is unfortunate that during the first three decades of the country's existence as an independent State no attention was paid to the elimination of *riba*".

The Council in its report<sup>17</sup> in response to a reference from the Ministry of Finance, Government of Pakistan, gave its opinion and advice in December 1969 as follows:

The Council is unanimously of the view that Riba is forbidden in all its forms and any increase or decrease in rate of interest does not affect its prohibitive character.

. . . The Advisory Council of Islamic Ideology recommends that the Government of Pakistan may appoint a Committee of accredited leaders of juristic thought, experts and specialists in modern finance, banking and law in the country in order to assist and advise the Advisory Council of Islamic Ideology in determining the steps to be taken for the reformation of the existing system in the light of the teachings of Islam. The Council is hopeful that with concerted efforts such reformation is possible.<sup>18</sup>

The work on finding ways and means to eliminate *riba* started in right earnest only after the installation of a new regime in 1977 with General Muhammad Zia-ul-Haq as its head. Most of the executive measures taken by the government in the years to come were in fact initiated by him. In pursuance to the constitutional requirement of Islamisation we can observe three different kinds of Initiative: (1) Executive Initiative;<sup>19</sup> (2) Legal Initiative; and (3) Judicial Initiative.

---

<sup>16</sup> Report of the Council of Islamic Ideology on "*Elimination of Riba from the Economy & Islamic Modes of Financing*" (1991), xiii.

<sup>17</sup> *Ibid.*, 136.

<sup>18</sup> *Ibid.*

<sup>19</sup> The executive measures can be divided into two parts: the first part deals with those measures which were taken by the government before any judicial decision is given in this regard; and the second part deals with those measures which were taken by the government in compliance with the directions of the SCP.

### **Executive Initiative I (Prior to the Judgment of the Supreme Court)**

The Zia-ul-Haq regime took many executive measures to Islamise the economy. These executive measures were taken in response to the constitutional requirement to Islamise the country. The significant executive measures are as follows:

#### *(a) Reconstitution of the Council of Islamic Ideology*

One of the first measures adopted by General Ziaul Haq was the reconstitution of the Council of Islamic Ideology quite soon after his seizure of power. In his inaugural address on 29 September 1977 in the inaugural meeting of the newly constituted Council, he directed the Council to give top priority to preparing a Report suggesting measures to rid the economy of *riba*. He specifically asked the Council to prepare a blueprint of an interest-free economic system and later, on 12 Rabiul-Awwal, 1399 (10 February 1979), set a time limit of three years for the elimination of interest from the economy.<sup>20</sup> With this, perhaps, Pakistan became the first country to embark on a full Islamisation of its economy.

#### *(b) Introduction of Zakat and Ushr*

To facilitate its task of drawing up the blueprint of an Islamic economy the Council of Islamic Ideology appointed a Panel of Economists and Bankers in November 1977 related to the reconstructing the economic system in conformity with the Qur' n and the *Sunnah*. In accordance with the priorities set by the Council, the Panel devoted itself, in the first phase of its work, to evolving a framework for the introduction of *Zakat* and *Ushr* in the country and submitted its Report to the Council in this regard in March 1978.

#### *(c) Report on the Elimination of Interest from the Economy, 1980*

In the next phase, the Panel directed its attention to the issues involved in eliminating interest from the economy and evolving an alternative system conforming to the *Shar 'ah* that should, at the same time, be fully capable of meeting the requirements of the contemporary situation. The Panel considered the outlines of a scheme for the elimination of interest from the commercial banking system prepared by the three banker members of the Panel. This provided a valuable basis for discussion on the subject. Early in its deliberations, the Panel arrived at the conclusion that keeping in view the complexity of the task it would be advisable to eliminate interest from the economy in stages. In this context it submitted an Interim Report to the Council in November 1978 incorporating the Panel's recommendations for

---

<sup>20</sup> Ibid., xiii.

elimination of interest from the National Investment Trust, the Investment Corporation of Pakistan and the House Building Finance Corporation.

The Panel eventually submitted a comprehensive Report in February 1980 which, after some modifications by the Council, was presented to the Government in June 1980. In this report the Council presented an action plan spread over three phases so as to achieve complete elimination of interest from domestic transactions by the end of December 1981.

(d) *Introduction of isbah*

Pakistan was also the first Muslim country to attempt to revive the old Islamic institution of *isbah*, the office that supervised markets, provided municipal services and settled petty disputes. In its revived form, however, the institution has a much more limited role of protecting ordinary citizens from administrative wrongs.<sup>21</sup>

(e) *Introduction of Interest free Counters in Banks*

The Presidential declaration specifying the time limit regarding the elimination of interest from the economy was to expire in December 1981. Yet hardly had any real headway been made towards the elimination of interest from the country's economy. From January 1981, the Government directed all the nationalised commercial banks to open interest free counters (PLS) alongside the existing normal interest-bearing counters in the banks. The initiative was strongly opposed by the Council as this action gave the impression that *riba* was something which ought to be avoided only by the more pious Muslims who were being enabled to conduct business through the interest-free counters. This was hardly an acceptable proposition because the unlawfulness of *riba* was meant to apply to all Muslims without any distinction.<sup>22</sup> The Council expressed strong opposition in its Report on the "Elimination of Interest from the Economy" strongly opposed the opening of separate interest-free counters in the commercial banks, as in its opinion, such measures were likely to entail perpetuation of the interest-based system and to undermine the efforts aimed at introducing interest-free banking in the country. The apprehensions of the Council proved true and the end of interest was not at all in sight.<sup>23</sup> The Council also identified the controversial steps taken by the Government at that time which were perceived to indicate the dual and half-hearted policy of the Government.<sup>24</sup>

---

<sup>21</sup> Muhammad Akram Khan, *An Introduction to Islamic Economics* (Islamabad: The International Institute of Islamic Thought and Institute for Policy Studies, 1994), 83.

<sup>22</sup> *Ibid.*, 140.

<sup>23</sup> *Ibid.*, 141.

<sup>24</sup> *Ibid.*, 138–140.

(f) *Parallel Islamic Banking*

The Finance Minister in his budget speech on 14 June 1984 announced that interest would be completely eliminated from fresh domestic banking operations in the country effective 1 July 1985. Consequent upon this announcement, the State Bank of Pakistan (SBP) issued a directive to the banks on 20 June, 1984 in regard to the programme to be followed by them for the final phase of cleansing the banking sector from interest.<sup>25</sup> SBP also advised the banks regarding the various non-interest modes of financing that were permissible.<sup>26</sup>

This final phase of the Islamisation of economy, as it was called by the government, started from June 1984 and was supposed to end on July 1985. During this period SBP issued 23 circulars to eliminate interest from the economy.<sup>27</sup> In reality, however, huge loopholes remained, and the successive

<sup>25</sup> State Bank of Pakistan, BCD (Banking Control Department) Circular No. 13 of 20 June 1984.

<sup>26</sup> The permissible modes of financing are: (A) Financing by lending: (i) Loans not carrying any interest on which the banks may recover a service charge not exceeding the proportionate cost of the operation, excluding the cost of funds and provisions for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the State Bank from time to time, (ii) *Qard-e-Hasana* loans given on compassionate ground free of any interest or service charge and repayable if and when the borrower is able to pay; (B) Trade-related modes of financing including the following: (i) Purchase of goods by banks and their sale to clients at appropriate mark up in price on deferred payment basis. In case of default, there should be no mark-up on mark-up, (ii) Purchase of trade bills, (iii) Purchase of movable or immovable property by the banks from their clients with Buy-Back Agreement or otherwise, (iv) Licensing, (v) Hire-purchase, (vi) Financing for development of property on the basis of a development charge; (C) Investment type of modes of financing including the following: (i) *Musharika* or profit and loss sharing, (ii) Equity participation and purchase of shares, (iii) Purchase of participation term certificates and *Modaraba* certificates, and (iv) Rent-sharing.

<sup>27</sup> State Bank of Pakistan: (1) BCD Circular No. 13 of 20 Jun 1984 regarding "Elimination of 'Riba' from the Banking System"; (2) BCD Circular No. 26 of 26 November 1984 regarding "Rate of Service Charge Recoverable on Finances Provided by Way of Lending Other than *Qard-e-Hasana*"; (3) BCD Circular No. 27 of 26 November 1984 regarding "Elimination of 'Riba' from the Banking System-Rate of Return in the Case of Trade Related Modes of Financing"; (4) BCD Circular No. 28 of 26 November 1984 regarding "Elimination of 'Riba' from the Banking System-Rate of Return in the Case of Investment Type Modes of Financing"; (5) BCD Circular No. 31 of 26 November 1984 regarding "Elimination of 'Riba' from the Banking System-Making of PLS Term Deposits by Banks/DFIs With the State Bank; (6) BCD Circular No. 32 of 26 November 1984 regarding "Bank Charges"; (7) BCD Circular No. 33 of 26 November 1984 regarding "Finances Provided by the State Bank of Pakistan to Banks and DFIs for Meeting Temporary Liquidity Difficulties (Including T.T. Discounting Facilities)"; (8) BCD Circular No. 34 of 26 November 1984 regarding "Determination of Rates of Profit on Various Types of PLS Liabilities of the Banks and DFIs"; (9) BCD Circular No. 37 of 10 December 1984 regarding "Rates of Profit in Case of Trade-Related Modes of Financing"; (10) BCD Circular No. 38 of 10 December 1984 regarding "Rates of Profit in the Case of Investment Type Modes of Financing"; (11) BCD Circular No. 39 of 10 December 1984 regarding "Scheme for Financing Locally Manufactured Machinery"; (12) BCD Circular No. 40 of 10 December 1984 regarding "Export Finance Scheme"; (13) BCD Circular No. 3 of 5 January 1985 regarding "Classification of Accounts in the Weekly Statement of Position-Hire-Purchase"; (14) BCD Circular No. 7 of

governments, despite their numerous announcements in the public, could not bring about any substantial change in actual practice. It seems that, on the whole, the authorities took steps to ensure that the new modes of financing did not upset the basic functioning and structure of the banking system. As a result, the exceptions proved more important than the rule itself and the government was thus caught between two sets of conflicting forces. On the one hand the religious groups as well as a large domestic constituency urged effective Islamisation. On the other hand, Pakistan had a long tradition of conventional, interest-based banking and was under pressure from the IMF and other foreign institutions to privatize its banking sector and liberalize its economy.

### **Legal Initiative**

#### *(a) Promulgation of Zakat and Ushr Ordinance, 1980*

Following the recommendations of the Panel of Experts the Government promulgated the *Zakat and Ushr Ordinance, 1980*. The *Zakat* collected from a 2.5 percent per annum levy on saving accounts, various kinds of bank deposits, unit trusts, government securities, corporate shares and debentures, annuities, life insurance and other comparable assets was to be distributed through an elaborate voluntary system of *Zakat* committees at Federal, Provincial, and District levels. The committees in turn were to channel the money so collected to benefit the deserving, or those living below the poverty line. The *Ushr* was to be imposed at a rate of five percent on all agricultural produce above a given minimum level.

The Government, in accordance with the provision of this Ordinance, created a Central *Zakat* Fund at the federal level, a Provincial *Zakat* Fund for each province, a District *Zakat* Fund for each district, and a Local *Zakat* Fund

---

11 February 1985 regarding "Determination of Rates of Profit on Various Types of PLS Liabilities of the Banks and DFIs"; (15) BCD Circular No. 15 of 11 February 1985 regarding "Provisions of Finance by Banks and DFIs. to their Employees for Various Purposes Under Rules Framed by Them"; (16) BCD Circular No. 9 of 12 February 1985 regarding " Scales of Fines for Defaults by Exporter/Suppliers.—Export Finance Scheme"; (17) BCD Circular No. 10 of 20 February 1985 regarding "Determination of Rates of Profit on Various Types of PLS Liabilities of the Banks and DFIs—Certificate from the External Auditors about Correctness of information Provided to the State Bank of Pakistan"; (18) BCD Circular No. 19 of 7 May 1985 regarding "Penalty for Defaults in Maintenance of Cash Reserve and Liquid Assets by the Banks"; (19) BCD Circular No. 23 of 25 May 1985 regarding "Rates of Profit in the Case of Trade-Related Modes of Financing"; (20) BCD Circular No. 24 of 25 May 1985 regarding "Rates of Profit in the Case of Investment Type Modes of Financing"; (21) BCD Circular No. 27 of 8 June 1985 regarding "Rate of Service Charge Recoverable on Finances Provided by Way of Lending Other Than 'Qard-e-Hasana'—Total Assets"; (22) BCD Circular No. 28 of 8 June 1985 regarding "Determination of Rates of Profit on Various Types of PLS Liabilities of Banks and DFIs—Reserves"; and (23) BCD Circular No. 29 of 12 June 1985 regarding "Elimination of 'Riba' from the Banking System".

for each local committee. The Central *Zakat* Fund consists of the *Zakat* deducted at source, the *Zakat* paid into it voluntarily including the voluntary contributions made by Pakistani citizens, both those living in the country and those living abroad, the transfer, if any, from the Provincial *Zakat* Fund and the grants (*atiyyat*) and any other receipts including voluntary contribution made by Pakistani citizens and citizens living abroad. Money is transferred from the Central *Zakat* Fund to each Provincial *Zakat* Fund, from where it is distributed to the District *Zakat* Funds, and thereafter to the Local *Zakat* Funds where Local *Zakat* Committees distribute it among the needy people. In this manner the Government created a fairly well-organised system for the distribution of *Zakat*.

To provide policy guidelines and exercise general superintendence and control over matters relating to *Zakat* and *Ushr* (particularly the *Zakat* Funds), the Federal Government established a Central *Zakat* Council. Each Provincial Government also established a Provincial *Zakat* Council to exercise general superintendence and control over matters relating to *Zakat* and *Ushr* in the Province in accordance with the policy guidelines given by the Central Council.

(b) *Shari'at Ordinance, 1988*

The President of Pakistan, General Muhammad Zia-ul-Haq, on 15 June 1988 took another initiative in the direction of Islamisation and promulgated a *Shari'at Ordinance, 1988*.<sup>28</sup> In pursuance of the provisions of this Ordinance, a "Permanent Commission for the Islamisation of Economy" was appointed by the President. The Ordinance was, however, not placed before the National Assembly and ceased to be operative on 15 February 1989. The Commission worked for about eight months and also did some work but the Interim Report of the Commission is not traceable.

(c) *Enforcement of Shari'ah Act, 1991*

While maintaining its theoretical commitment to the process of Islamisation, a law entitled "the Enforcement of *Shari'ah Act, 1991*" was promulgated. Under this law, the State is required to "take steps to ensure that the economic system of Pakistan is constructed on the basis of Islamic economic objectives, principles, and priorities".

A Commission for Islamisation of Economy (CIE) was appointed in accordance with this law. One of the functions of the Commission was to "oversee the process of elimination of *Riba* from every sphere of economic activity in the shortest possible time and also recommend such measures to the

---

<sup>28</sup> On the expiry of this Ordinance, after four months of its promulgation, it was again promulgated by the President, Ghulam Ishaq Khan, as *Shari'at Ordinance (Revised)*, on 15 October 1988.

Government as would ensure the total elimination of *Riba* from the economy". It was also required to undertake the examination of any fiscal law or any law relating to the levy and collection of taxes and fees or banking or insurance law or practice and procedure to determine whether or not these are repugnant to the *Shari'ah* and to make recommendations to bring such laws, practices and procedure in conformity with the *Shari'ah*. It protected, however, the existing and international financial obligations of the public sector till such time that an alternative system was introduced or evolved.

### **Judicial Initiative**

#### *(a) The Decision of the Federal Shariat Court*

When the jurisdiction of the Federal Shariat Court to examine the fiscal laws was restored effective 26 June 1990, a number of *Shariat* petitions were filed in the Court, challenging various fiscal laws containing provisions regarding interest therein. The hearing of these petitions was started on 11 December 1990 and continued, with intervals, till 24 October 1991. At the conclusion of the hearing, the Federal Shariat Court passed its judgment on 14 November 1991.<sup>29</sup>

In this judgment the Court disposed of 115 *Shariat* Petitions and three *suo motu* Shariat Notice cases challenging the various provisions of 'interest' provided in several statutes, namely:-

The Interest Act, 1839; The Government Savings Banks Act, 1873; The Negotiable Instruments Act, 1881; The Land Acquisition Act, 1894; The Code of Civil Procedure, 1908; The Co-operative Societies Act, 1925; The Co-operative Societies Rules, 1927; The Insurance Act, 1938; The State Bank of Pakistan Act, 1956; The West Pakistan Money Lenders Ordinance, 1960; The West Pakistan Money Lenders Rules, 1965; The Punjab Money Lenders Ordinance, 1960; The Sind Money Lenders Ordinance, 1960; The N.W.F.P. Money Lenders Ordinance, 1960; The Baluchistan Money Lenders Ordinance, 1960; The Agricultural Development Bank of Pakistan, Rules, 1961; The Banking Companies Ordinance, 1962; The Banking Companies Rules, 1963; The Banks (Nationalization) (Payment of Compensation) Rules, 1974; and The Banking Companies (Recovery of Loans) Ordinance, 1979.

The Court also gave a broad definition of *Riba* in the following words: "It may, therefore, be stated that *Riba* forbidden in the Qur'an and Sunnah includes interest due on the loans taken or given for commercial or productive purposes by banks or other financial institutions".<sup>30</sup>

<sup>29</sup> Dr. Mahmood-ur-Rahman Faisal vs. Secretary, Ministry of Law and Others, PLD (ALL PAKISTAN LEGAL DECISIONS) 1992 FSC 1.

<sup>30</sup> Ibid., 74.

The Court further observed:

... All the above quotations provided ample evidence that loans on interest or on *mudarabah* for commercial purposes were in practice among the Arabs at the time of revelation the Holy Qur'an and when Holy Qur'an prohibited interest, it applied to the interest on commercial loans for productive purposes as well as to the interest on consumption loans.<sup>31</sup>

The Court declared, as we have mentioned earlier, twenty three financial laws or the provisions of those laws, as un-Islamic. These laws or the provisions of these laws would become null and void effective 1 July 1992.

Against the decision of the FSC many appeals were filed in the Supreme Court (*Shariat Appellate Bench*). For some reason, these appeals were not given a hearing by the Court until 1999.

(b) *The Decision of the Supreme Court of Pakistan (SCP), Shariat Appellate Bench, 1999.*

On 23 December 1999, the SCP, in its revolutionary judgment in the *Khaki Case (Riba Judgment)*, upheld the decision of the FSC. In this judgment the Court, while disposing of fifty files appeals on the subject, has primarily done two things: First, the Court has, definitively defined the term "interest",<sup>32</sup> held that:

Any amount, big or small, over the principal in a contract of loan or debt is 'Riba' prohibited by the Holy Qur'an, regardless of whether the loan is taken for the purpose of consumption or for some production activity.<sup>32</sup>

With the definition of the term *riba* the Court decided the long outstanding issue whether the term includes all forms of interest or not. As a consequence it declared the following laws to be repugnant to the Injunctions of Islam:

- (i) The Interest Act, 1839;
- (ii) The West Pakistan Money-Lenders Ordinance, 1960;
- (iii) The West Pakistan Money-Lenders Rules, 1965;
- (iv) The Punjab Money Lenders Ordinance, 1960;
- (v) The Sindh Money Lenders Ordinance, 1960;
- (vi) The N.W.F.P. Money Lenders Ordinance, 1960;
- (vii) The Baluchistan Money Lenders Ordinance, 1960; and
- (viii) Section 9 of Banking Companies Ordinance, 1962.

These laws, according to the judgement, were to cease to have effect from 31 March 2000. The SCP further held that the other laws<sup>33</sup> or the provisions

<sup>31</sup> Ibid., 81.

<sup>32</sup> Dr. M. Aslam Khaki and Others vs. Syed Muhammad Hashim and Others, *PLD* 2000 SC 225.

thereof to the extent that those had been declared to be repugnant to the Injunctions of Islam would cease to have effect from 30 June 2001.<sup>34</sup> Second, the Court also outlined a comprehensive scheme to be followed by the government to transform the banking and financial system into one conforming to the *Shar'ah*.

(i) *The Transformation Path*

As a first step, the government was required to prepare an infrastructure (including legal, financial and economic) which would provide the basis for elimination of interest from the banking and financial system. While directing the government to follow the defined path and prepare a suitable infrastructure to implement the decision, the Court went beyond its judicial scope in two respects: it did not confine itself to the limits of the petitions nor limit itself to making amendments in those specific legislations which were mainly concerned with the banking and financial sectors. The Court not only directed the elimination of interest from those legislations but also addressed the following four facets of the economy: banking and financial sector, share market, debt/bond market, and government borrowing and lending. Perhaps the Court had foreseen the implications of its judgment on the whole economy of the country and sought thereby to provide the basic guidelines that ought to be followed by the government in process of bringing about total economic transformation.

The Court also suggested various measures to strengthen these factors by: (i) requiring individual credit history, (ii) requiring industries' rating, (iii) developing debt markets in Pakistan, (iv) establishing data collection firms, (v) strengthening the loan and finance recovery system, (vi) training officers and staff of financial institutions, and (vii) developing proper accounting and auditing standards for the Islamic financial institutions in Pakistan.<sup>35</sup>

It further required the government to take the following measures for the provision of a proper infrastructure and legal framework. It specifically suggested the following:<sup>36</sup>

- (1) Strict austerity measures to drastically curtail the Government expenditure should be adopted and implemented and deficit financing should be controlled as therein lies the solution to economic revival.

<sup>33</sup> The Government Savings Banks Act, 1873; The Negotiable Instruments Act, 1881; The Land Acquisition Act, 1894; The Code of Civil Procedure, 1908; The Co-operative Societies Act, 1925; The Co-operative Societies Rules, 1927; The Insurance Act, 1938; The State Bank of Pakistan Act, 1956; The Agricultural Development Bank of Pakistan, Rules, 1961; The Banking Companies Rules, 1963; The Banks (Nationalization) (Payment of Compensation) Rules, 1974; and The Banking Companies (Recovery of Loans) Ordinance, 1979.

<sup>34</sup> The time limit was extended by the SCP till 30 June 2002 in a Review Petition.

<sup>35</sup> *PLD* 2000 SC 341–344.

<sup>36</sup> *Ibid.*, 344–345.

- (2) An Act to regulate the Federal Consolidated Fund and Public Account, Provincial Consolidated Fund and Public Account requires to be enacted by the Parliament and the Provincial Assemblies respectively. This law will have to take care of borrowing powers, purpose and the scope of borrowing, its utilization, regulation and monitoring process including all ancillary matters.
- (3) Law providing for necessary prudential measures ensuring transparency be enacted. These laws may include laws like Freedom of Information Act, the Privacy Act and Ethics Regulations of United States, Financial Services Act of Britain.
- (4) Establishment of institutions like Serious Fraud Office to control white collar and economic crimes.
- (5) Establishment of credit rating agencies in the public sector.
- (6) Establishment of evaluators for scrutiny of feasibility reports.
- (7) Establishment of special departments within the State Bank:
  - (a) *Shari'ah* Board for scrutiny and evaluation of the Board's procedures and products and for providing guidance for successfully managing the Islamic economics.
  - (b) A Board for arranging exchange of information, financial institutions about feasibility of projects, evaluation thereof and credit rating of institutions, corporations and other entities.
  - (c) A Board for providing technical assistance to the financial institutions/banks with regard to the anomalies emerging in the practical operation of the financial institutions or difficulties arising during operation of financial products, transactions or arrangement between the financial institutions and the consumers/clients. This may also take the shape of Islamic Financial Service Institution. Such Institutions will also work in the field of shares and investment certificates underwriting promotion and market making to help in the activation of primary and secondary markets. The rise of such institutions, whose functions would include the promotion of financial instruments and to work as their catalysts in the financial market, would be of great help and support to Islamic Banking. Among the factors which would help the creation and spreading of such institutions is the extension of tax incentives to their operation as well as to Islamic banks to benefit from their services.

The above mentioned measures were not only considered by the Court as very important, but it also recognised that the required infrastructure and legal framework could not be provided in a short span of time. Keeping all aspects in view, the Court decided to appoint different dates for different phases of transformation. These phases, as determined by the Court, are as under:

- (1) The Federal Government shall, within one month from the announcement of this judgment, constitute in the State Bank of Pakistan a high-level Commission fully empowered to carry out, control and supervise the process of transformation of the existing financial system to the one conforming to *Shari'ah*.

It shall comprise *Shari'ah* scholars, committed economists, bankers and chartered accountants.

- (2) Within two months from the date of its constitution, the Commission shall chalk out the strategy to evaluate, scrutinize and implement the reports of the Commission for Islamization of the Economy as well as the report of Raja Zafarul Haq Commission after circulating it among the leading banks, religious scholars, economists and the State Bank and Finance Division, inviting their comments and further suggestions. The strategic plan so finalized shall be sent to the Ministries of Law, Finance and Commerce, all the banks and financial institutions to take steps to implement it.
- (3) Within one month from the announcement of this judgment, the Ministry of Law and Parliamentary Affairs shall form a task-force, comprising its officials and two *Shari'ah* scholars from the Council of Islamic Ideology or from the Commission on the Islamization of Economy, to:
  - (a) Draft a new law for the prohibition of *riba* and other laws as proposed in the guidelines above.
  - (b) To review the existing financial and other laws to bring them into conformity with the requirements of the new financial system.
  - (c) To draft new laws to give legal cover to the new financial instruments. The recommendations of the task force shall be vetted and finalized by the "Commission for Transformation" proposed to be set up in the SBP, after which the Federal Government shall promulgate the recommended laws.
- (4) Within six months from the announcement of this judgment, all the banks and financial institutions shall prepare their model agreements and documents for all their major operations and shall present them to the Commission for transformation in the SBP for its approval after examining them.
- (5) All the joint stock companies, mutual funds and the firms asking in aggregate finance above Rs.5 million a year shall be required by law to subject themselves to independent rating by neutral rating agencies.
- (6) All the banks and financial institutions shall, thereafter, arrange for training programmes and seminars to educate the staff and the clients about the new arrangements of financing, their necessary requirements and their effects.
- (7) The Ministry of Finance shall, within one month from the announcement of this judgment, form a task force of its experts to find out means to convert the domestic borrowings into project-related financing and to establish a mutual fund that may finance the government on that basis. The units of the mutual fund may be purchased by the public and they will be tradable in the secondary market on the basis of net asset value. The certificates of the existing bonds of the existing government savings schemes based on interest shall be converted into the units of the proposed mutual fund.
- (8) The domestic inter-government borrowings as well as the borrowings of the Federal Government from the State Bank of Pakistan shall be designed on interest free basis.
- (9) Serious efforts shall be started by the Federal Government to relieve the nation from the burden of foreign debts as soon as possible, and to renegotiate the

existing loans. Serious efforts shall also be made to structure the future borrowings, if necessary, on the basis of Islamic modes of financing.

- (10) The following laws being repugnant to the Injunctions of Islam shall cease to have effect from 31st March 2000: The Interest Act, 1839; The West Pakistan Money-Lenders Ordinance, 1960; The West Pakistan Money-Lenders Rules, 1965; The Punjab Money-Lenders Ordinance, 1960; The Sindh Money Lenders Ordinance, 1960; The N.W.F.P. Money Lenders Ordinance, 1960; The Balochistan Money Lenders Ordinance, 1960; Section 9 of Banking Companies Ordinance, 1962.
- (11) The other laws or the provisions of the laws to the extent that those have been declared to be repugnant to the Injunctions of Islam shall cease to have effect from 30th June 2001.

### **Executive Initiative II (Post-Supreme Court Judgment of 1999)**

In pursuance of the judgment of the Court, the government took many executive measures. Since these measures were taken after the judgment, these may be called post-judgment measures. These are as follows:

#### **(a) *Commission for the Transformation of Economy (CTFS)***

As per directions of the SCP, a “fully empowered Commission” was constituted by the government on 23 January 2000 in the SBP under the Chairmanship of Mr I. A. Hanfi, a former Governor of the State Bank of Pakistan. The CTFS submitted its’ First Interim Report to the government in October 2000 in which it identified a number of prior actions which needed to be taken to prepare the ground work for the transformation of the financial system. The Second Interim Report was submitted in May 2001 which basically identified major *Shari’ah* compliant modes of financing, *Shari’ah* essentials of each such mode, model agreements for major modes of financing and the guidelines for conversion of the products and services of banks and financial institutions. Both the interim reports put together form the final recommendations of the Commission in all the matters.

The important recommendations of the CTFS are as follows:

- Establishment of Islamic Funds in the Banks;
- Setting up a Fund supporting the issuing of Islamic Finance Compatible Government securities;
- Enactment of Omnibus Law on Prohibition of Interest;
- Development of Appropriate Financial Instruments/Documents;
- Training of Officials of Banks and Financial Institutions;
- Publicity campaign to educate the public about the new banking and financial system;
- Enactment of Laws that have been cleared by the Commission;
- Elimination of Interest from Inter Government Financial Transactions;

- Establishment of Implementation Cell in the SBP: Establishment of *Shari'ah* Board; Information Exchange Board; Technical Assistance board; Institute to Control Frauds; Credit Rating Agency; Evaluator of Feasibility Reports; and *Shari'ah* Audit Cell in the Financial Institutions;
- General Guidelines for banks and financial institutions e.g. assets side, Liabilities side.
- Seminal Law: "Prohibition of Riba Ordinance" and "Islamization of Financial Transactions Ordinance";
- The CTFS also made a synthesis of the reports of the "Hanafi Commission and Raja Zafar ul Haq Commission".<sup>37</sup>

(b) *Task Force, Ministry of Law*

In pursuance of the directions of the Court, a Task Force was constituted under the Chairmanship of Dr Mahmood Ahmad Ghazi, Minister for Religious Affairs, on 22 January 2000. According to the Order of the Court, the recommendations of the Task Force are required to be vetted and finalized by the CTFS after which the government is to promulgate the recommended laws. The Task Force prepared the following draft laws and forwarded the same to the CTFS on 3 March 2000:

- A draft Ordinance to repeal the Interest Act, 1839
- A draft Ordinance to further amend the Banking Companies Ordinance, 1962
- Five draft Ordinances to bring the laws relating to money lenders in conformity with the injunctions of Islam

The House Building Finance Corporation Act 1952 was also examined and some amendments in the Act were proposed on 27 May 2000 to cater for the needs of that Corporation. The Task Force also considered the amendments in other legislations but the focus remained on the "Prohibition of *Riba* Ordinance". This draft law was also discussed in coordination with the CTFS. The final version of the draft "Prohibition of *Riba* Ordinance" was submitted to the Minister for Law as well as Minister for Finance on 23 May 2001. The Task Force, finally, prepared the following laws:

- Draft Ordinance to repeal the Interest Act 1839
- Draft Ordinance to further amend the Banking Companies Ordinance;
- Draft Ordinance to bring the laws relating to the Money Lenders in conformity with the injunctions of Islam;
- Amendments proposed in the House Building Finance Corporation Act;
- Draft Prohibition of *Riba* Ordinance;

---

<sup>37</sup> The Commission for the Islamisation of the Economy produced the following two reports. The proper name of these reports are: (i) Report on Banks and Financial Institutions, 1992, and (ii) Report on Elimination of *Riba*, 1997. The second report was presented to the Prime Minister in August 1997 but no significant action was taken on it.

- Draft Financial Transactions Ordinance; and
- *Riba* Oriented Repeal and Amending Ordinance, 2002.

(c) *Task Force, Ministry of Finance*

In response to the Court Order, the government formed a Task Force in the Ministry of Finance to convert domestic borrowings into project-related financing and to establish a mutual fund that would finance the government on a *Shar'ah*-compliant basis. The Task Force took about two years to complete the Report and finally submitted it on 3 June 2002. It divided the whole task into two areas: (i) dealing with the existing domestic debt burden and repayment obligations, in light of a transformation to Islamic financing; and (ii) investigating practical modes and types of financing compliant with the *Shar'ah* for future government borrowing.

The Task Force concluded its Report with the following words:

The Task Force, after carefully considering a series of financial data of the Government, the available assets and their remunerative capacity has come to the conclusion that the outstanding government debt cannot be securitized against the pool of the existing assets and a mutual fund based thereon. The Privatization program which is one of the possible way of reducing the debt burden is another complication in the process. It further complicates the possibility of converting GOP borrowing into Islamic modes of financing.

... It is emphasized that none of the possible modes of financing under *Shari'ah* covers the emergencies of the kind faced by the Government presently where it may have perforce to meet a shortfall in revenues through conventional system of borrowings.

... Regarding inter-Government borrowing, the Federal Government cannot afford to simply convert them into interest free loans and shift the burden of debt servicing on its own strained resources.

Finally, the Task Force believes that if the Government could balance its privatization program, so as to retain a minority share in the profitable or potentially profitable PSEs, as Islamic Instrument (I-Bill) could be developed to provide an avenue for the Islamic Bank to invest in Government securities/T-Bills etc".<sup>38</sup>

(d) *Other Executive Initiatives*

Following the directions of the Court the other executive measures taken by Government to Islamise the country's economy are:

---

<sup>38</sup> Report of the Task Force, 53, 54.

- A detailed set of criteria for establishment of Islamic commercial banks in the private sector was issued in December 2001.
- A new fully dedicated Islamic bank, Meezan Bank Limited, has been issued a license and the bank has started its business from 20 March 2002.
- In order to allow existing banks to set up subsidiaries for Islamic banking, draft amendments in section 23 of Banking Companies Ordinance, 1962 have been submitted to the Government for approval.
- A new Islamic Banking Division has been established in the Banking Policy Department for regulation and promotion of Islamic banking.
- Existing Prudential Regulations have been reviewed by SBP for their application on Islamic banks, and revised regulations are being prepared.
- Export Finance Scheme of SBP is being revised to conform to *Musharaka* basis.
- Courses on Islamic economics, banking and finance have been included in the curricula of the Institute of Bankers in Pakistan.
- International Islamic University, Islamabad, conducted a training course for trainers on Islamic Financial System in April 2002. SBP staff along with the staff of other banks attended the course.
- SBP has reviewed its Forms of Financial Statements for banks in the light of newly developed accounting standards.
- A draft Fiscal Responsibility and Debt Limitation Ordinance, 2002 is pending for the Cabinet approval.
- A Freedom of Information Ordinance, 2002 has been promulgated.

Various Governments set up different Commissions to reform the economic system and establish an Islamic banking system in the country. The Reports of these Commissions (pre-judgment and post-judgment), in a nutshell, are as follows:

- Report of the panel of economists and bankers on “The Elimination of Interest from the Economy” submitted to the Council of Islamic Ideology on 28 January 1980
- Report of the Council of Islamic Ideology on “The Elimination of Interest from the Economy” submitted to the Government in June 1980.
- Revised report of the Council of Islamic Ideology on “Elimination of *Riba* from the Economy & Islamic Modes of Finance” (2nd revised and enlarged edition, 1992).
- Report of the Council of Islamic Ideology on “Islamic insurance system”. (June, 1992).
- Report of the expert group on “Banks and Financial Institutions” of 1992.
- Report of the Commission for the Islamisation of Economy (Hanafi Commission Report) on “Banks and Financial Institutions”. (June 6, 1992).
- Report of the Council of Islamic Ideology on “Islamic Economic System” (September 1992).
- Report of the Commission for the Islamisation of Economy on “Government Budgetary Deficit Financing”. (January 1996).

- Report of the Commission for the Islamisation of Economy (Raja Zafar-ul-Haq Commission Report) of August 1997 on "Elimination of *Riba*".
- Report of the Commission for the Transformation of the Financial System. (August 2001).
- Report of the Task Force, constituted in the Ministry of Finance. (June 3, 2002).
- Report of the Task Force, constituted in the Ministry of Law. (July 2002).

### Recent Developments

The United Bank Limited (UBL) filed a Review Petition in the SCP against the *Riba* Judgment during the year 2000. The UBL contended that the judgment was not enforceable in the present form and that the Court had exceeded its jurisdiction while giving the impugned judgment. It sought, therefore, a review of the judgment. The Petition was also accompanied by an application for Interim Injunction. The applicant requested the Court to: (a) suspend the operation of the judgment; (b) extend the time till at least 31 December 2002 for the purpose of enabling the Federal Government to bring the laws mentioned in the judgment in conformity with the Injunctions of Islam; and (c) a status-quo in relation to the operation of all procedural and operative laws be maintained and all the said laws be allowed to continue to be operative.

The SCP announced its Order on the application on 14 June 2001 whereby the court extended the time till 30 June 2002. The Government was required to take effective steps for the implementation of the judgment within the time frame allowed.

The SCP rendered its judgment on the UBL review petition on 24 June 2002.<sup>39</sup> In this judgment, the Court has done two things: (i) it has quashed its earlier judgment of 23 December 1999 (*Riba* Judgment); and (ii) it has remitted the cases to the FSC for determination afresh. The Supreme Court concluded:

... we are of the considered view that the issues involved in these cases require to be re-determined after thorough and elaborate research and comparative study of the financial systems which are prevalent in the contemporary Muslim countries of the world. Since the Federal *Shariat* Court did not give a definite finding on all the issues involved the determination whereof was essential to the resolution of the controversy involved in these cases, it would be in the fitness of things if the matter is remanded to the Federal *Shariat* Court which under the Constitution is enjoined upon to give a definite finding on all the issues falling within its jurisdiction.

Resultantly, ... Review Petition ... filed by the United Bank Ltd is allowed, the judgment dated 23 December, 1999 passed by the *Shariat* Appellate Bench of this Court ... and the judgment dated 14th November, 1991 of the Federal *Shariat* Court ... are set aside and the cases are remitted to the Federal *Shariat* Court for

<sup>39</sup> United Bank Limited vs M/s Farooq Brothers etc., *PLD* 2002 SC 815-816.

determination afresh in the light of the contentions of the parties noted above and the observations made which are germane to the controversy. Besides the points raised before this Court, the parties would be at liberty to raise any other issue relevant to these cases and the Federal *Shariat* Court may also, on its own motion, take into consideration any other aspect which may arise or may be found relevant for determination of the issues involved herein.

### III

#### CHALLENGES TO ISLAMISATION OF ECONOMY

The transformation of the economic system into one conforming to Islamic principles requires, as a first step, the setting up of an interest free banking and financial system. In the last fifty five years Pakistan has made some progress in this regard. The importance of the issue was recognised both by the public and the Government. Recognising the importance of this task the Government took several executive measures during the last two decades. There are, however, many challenges that still face the Government at the legal level. We shall briefly deal with those challenges so that an overall picture of the problem and its possible solutions could be figured out.

#### **The Regulatory Framework**

The establishment and development of Islamic banking requires a proper regulatory framework. Without such a framework the operation of Islamic banks in the country is simply inconceivable. In this respect the SBP should provide the necessary regulations. In our opinion, the following factors should be considered in the formulation of the regulatory framework:

##### (a) *Licensing Framework*

A specially designed set of licensing criteria for the Islamic banks has to be created, one that takes into account, *inter alia*, the specific structure and objectives of the Islamic banks, and the circumstances in which the license can be revoked. The need for an even-handed application of the licensing criteria to all Islamic banks cannot be overemphasized in this regard.

##### (b) *Requirements for the Existing Banks*

The legal requirements for the existing banks that intend to engage in Islamic banking activities should be explicitly provided for by the SBP either through legislation or in the Prudential Regulations issued by SBP from time to time. The appropriate regulation of the existing banks that engage in Islamic banking is very important in view of the fact that new specialized Islamic banks cannot be created overnight. Hence during the transition period of switching over to the Islamic banking system the existing banks should be allowed to engage in

*Shariah* compliant banking activities. The Islamic banking activities by these banks should, however, be strictly monitored. Moreover, it is the responsibility of the regulator to make sure that the banks observe complete compliance with the principles all of the *shar'ah* rule at all levels of operation.

(c) *Relationship of Islamic Banks with Other Banks*

In the modern regulatory framework no bank can think of surviving without having commercial relations with other banks. This relationship has been developed in the last two centuries. In this conventional setup the question of the relationship of Islamic banks with other conventional banks is of paramount importance. A possible solution could be that the Islamic banks are allowed to deal with those conventional banks that have separate branches dealing in Islamic banking transactions or the banks that deal in Islamic products and services which, from an Islamic point of view, are not liable to any objection.

### **Monitoring and Supervision**

Monitoring and supervision of the Islamic banks is another important area which demands special attention of the regulator. A detailed procedure in this respect should be given in the specific banking legislation to create certainty and confidence in the market. The SBP may be empowered to demand regular publication of banks, regular supply of information about certain activities of the banks, and to approve the appointment and removal of Board of Directors, etc.

Moreover, SBP should adopt internationally recognized accounting and auditing standards for the Islamic banks. As the whole structure of Islamic banking is contingent upon the banks' actual conduct of their business and the distribute of their profit on deposits or investments, the lack of certainty as regards such standards could raise questions about the credit-worthiness of the Islamic banks.

### **Institutional Framework**

(a) *Islamic Banking Supervision Department*

For the purpose of monitoring, supervision and other regulatory activities we need to have a comprehensive institutional structure manned by people qualified to perform the functions assigned to them with regard to Islamic banks (e.g. observing the Islamic accounting and auditing standards while supervising and inspecting the Islamic banks). This department should acquire the services of persons well versed in Islamic banking.

In view of the above it should be noted that true Islamic banking cannot be started unless the conventional institutional setup is replaced with a new institution or a new department at least within the SBP with the task as aforementioned. This department could also be assigned the task of prescribing new Prudential Regulations, if necessary, for the Islamic banks.

(b) *Shariah Advisory Board in SBP*

For the purpose of the overall supervision and guidance of Islamic banking in the country, a “*Shariah Advisory Board*” should be created in the SBP. The Board should, on the one hand, advise the SBP in matters pertaining to the regulation and supervision of the Islamic banks, and on the other, to give its final decision on the legal status of any new financial instruments created by the banks or SBP.

If this Board cannot be created for one reason or the other the Council of Islamic Ideology which is a constitutional body, can be empowered to perform the above mentioned jobs. The Council is advantaged in so far as it has representation of all religious groups in the country and it usually does not take any decision unless a consensus is reached. Since the Council is already an established body and enjoys the respect of all sectors of the society, it would be appropriate if it is required to perform this task.

(c) *Shariah Board in Islamic Banks*

A similar “*Shariah Board*”, on the pattern of “*Shairah Advisory Board*”, should be appointed in each Islamic bank or even in the conventional banks involved in Islamic banking operations. The existence of this Board would not only furnish answers to the day to day queries of the bank, but it would also give its opinion on any new Islamic financial instrument created by the bank.

## **Products and Instruments**

(a) *New Financial Instruments*

The core limitation on the Islamic banking in the country is the introduction of new financial instruments. As things stand, the Islamic modes of financing provide long term financial instruments but the banks are facing many problems due to the non-availability or paucity of short-term Islamic financial instruments.

In order to guide Islamic banks and to create certainty in the financial market the Government should enlist the existing Islamic financial instruments in a specific banking legislation. The Islamic banks, however, should be given powers to create new Islamic financial instruments subject to the approval of

*Shariah* Boards in the respective Islamic banks subject to their final approval by the *Shariah* Advisory Board in SBP.

(b) *Government Borrowing*

Government borrowing is a major component of today's economy. No government can be run without borrowing money from banks and financial institutions, let alone from the public. In Islamising the economic system this aspect of the economy also needs a thorough examination. Recognising this fact, the SCP in its judgment directed the government to convert domestic borrowing into a project-related financing and to establish a mutual fund that might finance the government on a *Shariah* compliant basis. The task force, however, showed its inability on the grounds of huge public debt which is a burden on the assets of the government. The government should, however, try to securitize its debt and Islamic debt securities should be devised following the Malaysian experience. The failure in the development of such debt securities would not only create problems in the total transformation of the economic system but also in the mobilisation of savings by the government.

## **Legal Framework**

(a) *Contractual Relationship*

The shift from conventional banking to Islamic banking would result in a corresponding change in the legal relationship of the bank with the customer. The modern banks receive deposits from the public and lend their funds to individuals, firms and companies for investment in projects. The contractual relationship between the bank and the individual is that of a creditor and a debtor. The change in this relationship, therefore, entails a consequent change in the contractual relationship of the parties.

Besides the legal relationship mentioned above the following important legal relationships of Islamic banks with others should also be taken into consideration:

- Bank to depositor;
- Bank to borrower;
- Bank to bank;
- Bank to SBP; and
- Bank to a foreign bank.

(b) *Strict Recovery Law*

The recovery of default loan payments or delayed payments has been a big problem for banks and financial institutions. The problem is further aggravated by the fact that an Islamic bank is not entitled to recover from the debtors in the case of Islamic banking amount in excess of the capital by way of penalty or fine from the defaulter. This is likely to encourage people either to commit loan defaults or to delay payments. A legal remedy can be provided in the form of swift and efficient recovery laws.

(c) *Protection of Depositors*

The shift from a risk-free banking system to a risk-based banking system lead to another concern i.e. protection of the depositors. Since in the conventional banking system, the banks guarantee the principal and also pay dividend, if any, to the customer at the end of the year, the absence of any such advantage in the case of Islamic banks would substantially hamper the development of Islamic banking. This necessitates the development of an alternate mechanism whereby banks should at least guarantee the security of the principal.

#### IV

### CONCLUSION

The purpose of analysing the whole process of Islamisation was to evaluate what we have achieved so far and what remains to be achieved. Pakistan has definitely made some progress on the road to Islamisation. However, after the judgment of the Shari'at Appellate Bench of the SCP, the current status of the Islamisation is that now there is no deadline for the transformation of the existing banking and financial system into one conforming to the *Shar'ah*. The Court has set aside both the earlier judgments (FSC Judgment of 1992 and the SCP *Riba* Judgment of 1999) and the cases have been remitted back to the FSC for fresh determination. By this, we are back to the same position from where we had started in the 1980s. The process has again been reversed, presumably to be initiated afresh albeit on an evolutionary pattern. It is significant, however, that the Court has not directed the government to continue with the process of Islamisation.

The government has, however, expressed its policy commitment to the introduction of parallel Islamic banking in the country. The Finance Minister in his budget speech of 2002–2003 stated:

Let me reiterate the intention of the government to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors.

Moreover, SBP in its annual report of 2001–2002 has also expressed similar commitment of introducing Islamic banking in the country:

The SBP is itself committed to promoting Islamic banking in Pakistan on a parallel basis. The SBP strategy provides for three institutional options: an independent and dedicated Islamic bank; an Islamic banking subsidiary of a conventional bank; or a dedicated Islamic banking branch of a conventional bank with all safeguards to ensure integrity and purity of Islamic banking operations.<sup>40</sup>

At this moment when the case has been remanded back to the FSC with the powers to hear the parties on any point, whether old or new, and the Court is also empowered to include any other point by its own motion, we have to rethink the whole process specially from legal point of view. There is a need for research based development of Islamic banking in the country so that well-thought-out conclusions could be arrived at. These conclusions should be specific to the needs of the country and in conformity with the opinions of Pakistani scholars. We have to devise, in this respect, a completely new strategy keeping in mind the recent judgment of the Court. Furthermore, the public and private sectors, in response to their constitutional and religious responsibility, should come forward and work together for the development of a new system. Perhaps the Government of Pakistan alone might not be able to achieve the target. This further underlines the need for permeating the public and private sectors with unity of thought and approach which can only be achieved through conceptual clarity on the relevant issues in the minds of those engaged in the task.

\* \* \*

---

<sup>40</sup> The SBP Annual Report of 2001–2002, 194.