

# Evolution of islamic banking assignment

[Finance](#), [Banks](#)



Evolution of Islamic Banking The Governor of the State Bank of Pakistan, Dr. Ishrat Husain gave a comprehensive outline on the evolution of Islamic Banking in Pakistan. He presented his paper at a seminar on Islamic Banking held recently at the Islamic Chamber of Commerce & Industry building, Karachi sponsored by Meezan Bank Limited. Meezan Bank's senior management had also participated in the occasion, highlighting the vision as the first Islamic bank in Pakistan and key challenges faced. Dr.

Ishrat commended the innovative and dedicated professionals involved in Islamic Banking at Meezan Bank and emphasized the further need of amelioration in the sector. The following is complete speech of Dr. Ishrat Husain delivered in the seminar. EVOLUTION OF ISLAMIC BANKING Dr. Ishrat Husain, Governor SBP THE ISLAMIC PERSPECTIVE ??? Islam is not a new religion; it is the same truth that God revealed through all His prophets. All religions are the same in essence, whether given, for example, to Noah, Abraham, Moses, or Jesus, or to the holy Prophet of Islam.

For a fifth of the world's population, Islam is both a religion and a complete code of life. Economic growth is the main transmission channel for ??? development. Islam does not contradict growth; it promotes sustainable development and growth. Socio-economic (distributive) justice: The ultimate objective of an ??? Islamic economy. Achieving development, based on socio-economic justice, care and compassion for all, in terms of complete human personality.

The economic policies that facilitate unhindered flows of ??? international trade, capital and participation in labour flows like reduced tariff and removal

of non-tariff barriers, removal of price distortions, flexible regulations and legislation of labour, healthy and sound financial sector and capital markets, investment in skill development and technological assimilation and macroeconomic stability are quite according to the economic principles of Islam. Transmission channels for globalization to development and poverty reduction are international trade and capital flows, international labour flows and technological change particularly in information technology (IT) and telecommunications. International and regional institutions and arrangements such as WTO and the policies of developed countries and governments can facilitate or hamper these flows. High economic growth may not automatically result in poverty reduction.

Complementary domestic policies, good governance and institutions delivering public services to make a big difference. Tools prescribed to achieve the socio-economic objectives of the Islamic economic system are the system of Zakat, prohibition of Riba and the Islamic Law of Inheritance. Zakat redistributes wealth among the existing generation every year. Prohibition of Riba is the cornerstone of Islamic financial transactions; the basis of cooperation between capital and enterprise in Islam is sharing of the risks and gains between the two.

The Holy Quran has specifically prescribed a long list of inheritors in accordance with the degrees of relationship and, as a result, the inherited wealth gets widely distributed among the inheritors including women. The Islamic Law of Inheritance has been in vogue in Pakistan since the pre-partition days and has been instrumental in achieving the intergenerational

redistribution of wealth. Measures taken for Islamisation in Pakistan: ??? As per Article 2 of the Constitution, Islam is the State Religion of Pakistan.

The Objectives Resolution was adopted by the first Constituent Assembly in 1949; it was the preamble of the 1956, 1962 and 1973 Constitutions. It provided that no law should be enacted that is repugnant to the injunctions of Islam. It was made substantive part of the Constitution in 1985. The Eighth Amendment of the 1973 Constitution, adopted by the ??? National Assembly in 1985, also made room for creation of the Federal Shariat Court (FSC).

Creation of the Council of Islamic Ideology (CII) in 1962.

The ??? report of the CII on Elimination of Interest (June, 1980) is genuinely considered to be first major comprehensive work in the world undertaken on Islamic banking and finance. Practically, measures taken included the introduction of Zakat ??? (June, 1980) and Ushr (tithe) (March, 1983) and elimination of interest from the operations of Specialized Financial Institutions (July, 1979 to July, 1985) and the commercial banks (January, 1981 to July, 1985). ??? Commercial banks transformed their nomenclature during January 1981 to June 1985 based on the 12 modes.

From July 1, 1985 all commercial banking in Pak Rupees was made interest-free. However, foreign currency deposits in Pakistan and on lending of foreign loans continued as before. However, procedure adopted by banks was declared un-Islamic by ??? the Federal Shariat Court (FSC) in November 1991. The Government and some banks/DFIs preferred appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan. SAB delivered its judgment of December 23, 1999 rejecting the ??? appeals and

directing that laws involving interest would cease to have effect finally by June 30, 2001.

However, SAB gave exemption for dealing with foreign parties on the basis of interest. The Government, in line with directives of SAB, constituted a high level Commission and a number of task forces and Committees to study the prospects of transformation of Pakistan's financial system for interest based to Shariah compliant and to chalk out the transformation plan. However, the Government came to the conclusion that transformation of the financial system as whole was not possible in short term due to a variety of factors/reasons.

Developing a viable and complete model of Islamic finance and putting it into practice was complex and difficult tasks and it would not be wise to under-estimate those difficulties and risks. Therefore, it was decided to promote Islamic banking on parallel basis with conventional system. State Bank has issued the criteria for establishment of Islamic banks in private sector and subsidiaries and stand-alone branches by existing commercial banks to conduct Islamic banking in the country.

A Musharaka-based Export Refinance Scheme has been designed by the State Bank in order to provide export finance to eligible exporters on the basis of Islamic modes of financing. Efforts are underway to develop Islamic money market instruments like Ijarah Sukuk to facilitate the banks in respect of liquidity and SLR management. In addition to Meezan Bank as a full-fledged Islamic bank operating exclusively on Shariah compliant basis, three

banks are operating seven IBBs (MCB, BoK, Bank Alfalah). Habib Bank Limited has also been given in principle approval for one stand-alone branch.

State Bank has received applications for 24 IBBs to be opened in 2004. A full-fledged Islamic Banking Department has been created in the State Bank that would serve as a focal point for all matters relating to Islamic banking and finance in the country. A Shariah Board comprising two Shariah scholars and three experts in the areas of banking accounting and legal framework has been established in the State Bank of Pakistan to advise it on modes, procedures, laws and regulations for Islamic banking ensuring Shariah compliance and smooth operations of Islamic banks. Anti Money Laundering Measures: The ease with which huge sums can be transferred across the globe with a single push of a button has facilitated international trade and settlements, but the capability itself has given nightmares to the managers of developing economies trying to compete in an increasingly market based competitive environment, as also for developed economies by facilitating money laundering and terrorism. Islamic banks, by their nature, are less likely to engage in money laundering and other illegal activities such as financing of terrorism than the conventional banks.

Their disclosure standards are stringent because they require the customers to divulge the origins of their funds in order to ensure that they are not derived from illegal means. Islamic financing modes are used to finance specific physical assets like machinery, inventory, and equipment. Further, the role of Islamic banks is not limited to a passive financier concerned only with timely interest payments and loan recovery. Islamic bank is a

partner in trade and has to concern itself with the nature of business and profitability position of its clients.

A stringer ' Know Your Customer' (KYC) policy is an inbuilt ??? requirement for an Islamic bank. Before entering into a contract Islamic banks are expected to have: Knowledge of business of the client – Knowledge of the individual or collective management and their bonafides – An internal code of ethics in negation of a singular profit objective – Awareness of the spirit and basis of governing laws and regulations. Pakistan has adopted a strategy by adopting uniform international ??? standards to ensure fairplay by all kinds of banks and financial institutions also including Islamic banks.

It has also put in place stringent regulations in order to effectively curb money laundering. An Anti Money Laundering law has been developed and is in the stage of finalization. Introduction of Zakat and Ushr: Zakat and Ushr Ordinance, 1980; Applied to Muslim citizens of ??? Pakistan only; assets subject to Zakat were divided into two categories viz; subject to compulsory levy of Zakat and those at which payable voluntarily at discretion of the owner. @2-1/2% of the asset value on the Valuation Date; As against the rate of 2. % in the case of Zakat, the rate of Ushr, a form of Zakat levied on land produce, is 5% in the case of irrigated land, 10% for rain-fed land. The rate is 20% for the produce of forests and mines. The difference in the rates is in inverse proportion to the human labour and cost involved in the production of the various items. ??? According to the Ordinance, Zakat receipts are to be used for providing assistance to the needy, the indigent and the poor, particularly orphans and widows, the handicapped and the

disabled, eligible to receive Zakat under the Shariah, for subsistence or rehabilitation.

Today, over Rs. 20 billions of Zakat funds are lying idle for lack of ??? an efficient distribution system. The program has come under a great deal of criticism for the uneven manner in which funds are disbursed. The Government enacted the “ Enforcement of Shariah Act, 1991” ??? under which 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”.

Protection granted to foreign Commitments: Section 18 of the Shariah Act, 1991 provides that notwithstanding any other provision of this Act or any decision of any Court, financial obligations incurred and contracts made between a National Institution (which includes the government, a statutory corporation, a company, or any person in Pakistan), and a Foreign Agency (which includes a foreign Government, a foreign financial institution, foreign capital market, including a bank and any lending agency and individuals, as well as suppliers of goods and services) shall continue to remain, and be valid, binding and operative.

PROSPECTS: Future depends upon innovative instruments to enhance liquidity, 1. develop secondary money and capital markets and introduce public finance instruments. We need appropriate institutional arrangements, legal framework, 2. taxation issues and human resource development need to be taken care of. CHALLENGES: ??? Enforcement of contracts is not effective. ??? ??? Inefficient system for early recovery. Ineffective code of



conduct for professionals. Development of Shariah compliant government securities. Research and development in the field of Islamic finance and ??? economies. HR development and training to the banks staff on Islamic Banking ??? and Finance. ??? Education and public awareness about Islamic financial system.