ILSP
Islamic Legal Studies Program
Harvard Law School

Moving Toward an Islamic Financial Regime in Pakistan

by

Parvez Hassan

and

Azim Azfar

Occasional Publications 2
September 2001

ISBN 0-88086-046-4

The **Islamic Legal Studies Program** is dedicated to achieving excellence in the study of Islamic law through objective and comparative methods. It seeks to foster an atmosphere of open inquiry which embraces many perspectives, both Muslim and non-Muslim, and to promote a deep appreciation of Islamic law as one of the world's major legal systems. The main focus of work at the Program is on Islamic law in the contemporary world. This focus accommodates the many interests and disciplines that contribute to the study of Islamic law, including the study of its writings and history.

Frank Vogel
Director

Peri Bearman
Associate Director

Islamic Legal Studies Program
Pound Hall 501
1563 Massachusetts Ave.
Cambridge, MA 02138, USA

Tel: 617-496-3941
Fax: 617-496-2707

E-mail: ilsp@law.harvard.edu

Website: http://www.law.harvard.edu/Programs/ILSP

Table of Contents

Preface

With this second number in our *Occasional Publications* series, we present an article by Dr. Parvez Hassan, a very distinguished Pakistani attorney and world-renowned environmentalist lawyer, who holds his doctorate in law from Harvard Law School, earned in 1969, and by Mr. Azim Azfar, his colleague in the firm Hassan & Hassan, Lahore.

The article is based on a presentation Dr. Hassan made to the Law School's Second Worldwide Alumni Congress, held in Paris in June 2001. The article provides an invaluable introduction and assessment of a momentous event in Pakistan still largely ignored by the outside world, the Supreme Court of Pakistan's December 1999 judgment declaring interest unconstitutional and ordering its rapid elimination from the country's economy. This event is highly significant from many points of view, and deserves the interest of scholars of Pakistani history and law, Islamic law, comparative constitutionalism, legal reform, economic development, and many other fields. With their article Dr. Hassan and Mr. Azfar make the event accessible to us, revealing it from many angles.

Frank E. Vogel
Director, Islamic Legal Studies Program

Moving Toward an Islamic Financial Regime in Pakistan

Parvez Hassan and Azim Azfar[1]

Introduction

The notion that economic advancement needs a mature legal framework is now among the first principles of development planning. In addition to nurturing systems of contract, tort, administrative, corporate, and tax law, a sophisticated commercial law regime has to cater for stable and efficient financial markets. Muslim countries face an even more daunting challenge in adapting their legal systems to modern needs because many of them contain powerful and implacable constituencies that demand a change from the prevalent colonial legal structures—whether based on the English Common Law or the Civil Law tradition—to an Islamic edifice dating back to 1400 years.

In the commercial realm, Islamic law has the most direct and greatest impact on financial markets law owing to the prohibition of interest, a doctrine that has its roots in the sacred sources of Islamic law, the Quran and the Sunna (the practice of the Prophet). While both capitalism and socialism can find a place in the Islamic economic ethos (and politicians of all stripes have manipulated the religion for their ends), this is not so for interest, or the concept of the time value of money, which Islam views with great hostility. In Muslim countries (at least those where Islamic law is a source of inspiration and law reform) the policy makers are caught in this vortex of tradition and modernity as they attempt to devise a financial system that works without interest. The very nature of this task is stupendous because interest (as the yardstick for investment) is the glue that holds the financial system together, affecting as it does all saving and investment decisions made by financial institutions, consumers, and business managers. Because well-functioning financial markets boost economic growth by providing the mechanism for channeling surplus funds from creditors to borrowers who will use them for increased consumer spending and capital investment, a botched experiment of interest-free financing can have very serious repercussions for economic and social stability.

In Pakistan, the country's policy makers are today squarely faced with this challenge. The most pressing item on the country's Islamization agenda today is the reform of the financial and economic sectors on interest-free lines. We use the word "pressing" to highlight the peremptory direction of the Supreme Court of Pakistan in its landmark judgment in Dr. M. Aslam Khaki v Syed Muhammad Hashim[2] announced in December 1999, to create an interest-free economy in the country by 1 July 2001. As this deadline approached, the Supreme Court was asked to review this deadline by one of the country's major banks, as a result of which the Court on 14 June 2001 extended the time period of implementation of the judgment by one year to 1 July 2002. Although the extension has provided the Government with some breathing room, the brief respite has not taken the urgency out of the move to an interest-free financial regime.

In order to oversee the radical and complicated transformation of the economy, the Supreme Court had in its original judgment in December 1999 directed the Government of Pakistan to set up within the aegis of the State Bank of Pakistan a high-powered Commission on the Transformation of the Financial System.

At the time of writing, this Commission, in which one of the authors of this article is a member, is continuing its work which has resulted in two interim reports and a draft Ordinance for the new financial regime. What follows is an analysis and critique of the movement in Pakistan, from the inception of the country to the present day, of reshaping the country's financial system on the interest-free template ordained by Islam.

Islamization in a Constitutional Perspective

To explain why it has taken Pakistan more than fifty years after independence in 1947 to evolve Islamic financial systems, a process that is still not completed, requires us to retrace some key steps in the country's constitutional history. The Islamic orientation of Pakistan's constitutional development was given its biggest impetus when the Constituent Assembly (the body entrusted with the task of framing the first constitution) passed the Objectives Resolution in 1949. To recite the eloquence of the founding fathers:

> Whereas sovereignty over the entire universe belongs to Allah Almighty alone and the authority which He has delegated to the State of Pakistan, through its people for being exercised within the limits prescribed by Him is a sacred trust;
>
> This Constituent Assembly representing the people of Pakistan resolves to frame a constitution for the sovereign independent State of Pakistan;
>
> Wherein the State shall exercise its powers and authority through the chosen representatives of the people;
>
> Wherein the principles of democracy, freedom, equality, tolerance and social justice as enunciated by Islam shall be fully observed;
>
> Wherein the Muslims shall be enabled 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 the Sunna ....

The signal importance of the Objectives Resolution is that its text has appeared with minor modifications as the preamble in all three of Pakistan's Constitutions, from the first in 1956 which gave the country a parliamentary model, to the second in 1962 which provided for a presidential system, to the present (albeit suspended) Constitution of 1973[3] which again reverted to the parliamentary model. In addition to substantially incorporating the text of the Objectives Resolution in the preamble, all three Constitutions ordained that no law shall be enacted which is repugnant to the injunctions of Islam,[4] called for the elimination of *riba* "as early as possible,"[5] and provided for an advisory body presently known as the Council of Islamic Ideology to guide the national legislature in framing laws in consonance with Islam.[6] The framers of the Constitutions recognized the complexity of a transformation to an Islamic system by giving the advisory council a lengthy period to submit its final report on the Islamization of laws.[7] The 1973 Constitution declared that "Islam shall be the State religion of Pakistan" (Article 2).

Although the country's commitment to being an Islamic polity never met with serious challenge,[8] changes on the ground were barely noticeable for the longest time. The pace of Islamization of laws continued to be slow and this was not only because the Council of Islamic Ideology only had powers to make recommendations or because it always had generous time in which to complete its work. Important as these factors were in dragging the process of Islamization of laws, the operative cause for the slow progress lay in a constitutional design that made only fundamental rights (e.g., freedom of assembly, equality before laws) justiciable by the courts. In all three Constitutions, provisions for introducing an Islamic way of life and for eliminating interest were always relegated to a chapter titled "Principles of State Policy." These principles[9] were deemed to be the responsibility of the State but were not under any circumstances to be enforced by the courts.[10] Nor could the Objectives Resolution be of much help in the introduction of Islamic laws. It continued to adorn the Constitution's Preamble but its effect was merely decorative as the Supreme Court held in 1973 in State v Zia-ur-Rahman[11] that as a matter of statutory construction a preamble to an instrument cannot be given operative effect. Therefore, the arresting feature of Pakistan's Islamization process is that in spite of the fact that the country's fundamental law always wore a religious mantle, for more than three decades till the end of the seventies, there was virtually no effect of this on the enactment or enforcement of laws. Islamic provisions in the Constitution—the Objectives Resolution and the Principles of State Policy—were simply not justiciable by the courts; and the Council of Islamic Ideology was merely an advisory body that had no bite. The Islamic canon only cast a shadow over the limited area of family law, but that itself was a carryover from the British colonial period. If robust Islamization of laws were to take place, the country would need a leader who could level the sharp gradient between the high ground of the Objectives Resolution and the plains of public policy.

This is indeed what happened when General Zia-ul-Haq rode the military horse to power in 1977. Promising to stay three months, the religiously-minded military ruler remained in power for just over ten years and set the country on an Islamic course that continues to the present day and is not likely to be reversed in the future. Among the constitutional amendments introduced by General Zia's regime, two are worthy of special note as the engines of his Islamization drive. Both amendments were arbitrary and unilateral impositions by a military dictator, without the support, direct or indirect, of the people or of any institution of Pakistan, and were to irrevocably change the future direction of Pakistan.

The first was the addition through President's Order 1 of 1980[12] of Chapter 3A in Part VII of the Constitution which set up the Federal Shariat Court (FSC) with jurisdiction to determine whether a law is contrary to the injunctions of Islam and to strike it down if it is so determined. The composition of the FSC as per Article 203C of the Constitution provided that not more than three of the eight judges would be Ulema-e-Din (religious scholars) well versed in Islamic law. Appeals from the decisions of the FSC were to be made to the Shariat Appellate Bench of the Supreme Court of Pakistan set up under Article 203F, which was composed of not more than two Ulema-e-Din out of a total strength of five judges. In addition to the hitherto unprecedented creation of Shariat courts, the second significant constitutional development that occurred in this period was the introduction of Article 2A in the Constitution through President's Order No.14 of 1985.[13] This amendment made the Preamble to the Constitution (the Objectives Resolution) a substantive part thereof in the following terms:

> The principles and provisions set out in the Objectives Resolution reproduced in the Annex are hereby made substantive part of the Constitution and shall have effect accordingly.

General Zia had executed a skillful legal maneuver. Islamic law was now a substantive part of the Constitution because of the insertion of Article 2A in the Constitution. The clerics once secluded in the shade of the seminary or on the political fringe were now in the mainstream of the process of legal development as powerful members of the nation's superior judiciary. The combined effect of incorporating the Objectives Resolution as a substantive part of the Constitution and of setting up the FSC and the Shariat Appellate Bench of the Supreme Court has been extremely potent for the Islamization of Pakistani laws. Imbued with the power to strike down un-Islamic laws, these special courts have reviewed all manner of laws ranging from the contract principle of caveat emptor[14] to the retirement process of civil servants[15] in the light of Islamic law.

The exuberance felt at the time by Islamic reformers at the aforesaid constitutional amendments can be gleaned from a speech of that period given by Justice Nasim Hasan Shah (later Chief Justice) of the Supreme Court of Pakistan at the First Lawyers Shariah Course at the International Islamic University in Islamabad. After recounting the various instances where the judiciary had invoked Article 2A in striking down un-Islamic laws, the Judge concluded:

> New and exciting prospects have appeared on the horizon and a new dawn is rising. It is now up to you, my dear friends, by your earnest endeavors, research and dedication to secure to the Muslims in Pakistan justice according to the precepts of Islam and restore to them their glorious heritage.[16]

This is heady language. However, as experience has shown, it is one thing to feel elated about powers given by the sweeping language of constitutional enactments and another to apply Islamic precepts in the context of the present age. Nowhere is this truer than in the intractable challenge of Islamic banking which affects such a vital sector of the modern economy.

Legal Developments in Islamic Banking

1. Early Challenges in the Courts

As adumbrated above, the elimination of interest, or *riba*, as it is known in the Islamic lexicon, has been a part of Pakistan's constitutional heritage since the first Constitution of 1956 declared it a principle of State policy; this formulation was repeated in the next two Constitutions.[17] However, this principle of State policy remained a lofty (but unenforceable) national commitment until the amendments to the 1973 Constitution by General Zia-ul-Haq. As indicated above, an effective framework for enforcing Islamic provisions in law was not in place until the reforms of the Zia regime. Moreover, the State could hardly eliminate an interest-based system without providing for a replacement and here there was considerable uncertainty about the shape of the new system and a notable absence of mature models at home and abroad. Faced with the urgent need to buy time, the Zia government, while setting up the FSC in 1980, inserted a provision in the Constitution that for a period of three years[18] (finally extended to ten[19]) the FSC could not adjudicate on fiscal and banking matters.

Because of the moratorium on the FSC, defendants of banking suits in the 1980s attempted to seek relief from the ordinary courts to declare interest in various statutory provisions as un-Islamic now that the Objectives Resolution was a substantive part of the Constitution through Article 2A. Thus it was the mainstream judiciary and in particular the Sindh High Court in the nation's commercial capital, Karachi, that had the first opportunity to examine the legality of interest in light of the Zia reforms. But the cases of this era produced a very haphazard jurisprudence that only promised future legal battles to settle the uncertainty. To illustrate, in two judgments delivered in the Sindh High Court on the same day (11 June 1987) by the same judge, Mr. Justice Tanzil ur Rahman, provisions for interest were upheld in one and struck down in the other. In Irshad H. Khan v Parveen Ajaz,[20] the plaintiff had sued on a demand promissory note for both principal and interest. The court decreed only for the principal on the basis that interest was repugnant to the principles of Islam and these principles were now a part of the substantive and procedural law of Pakistan. After quoting the relevant extract from the Objectives Resolution, the court observed:

> So, it is the Constitutional command for the State (Islamic Republic of Pakistan) to take such steps as would 'enable' the Muslims of Pakistan to live as Muslims. Therefore, any law which not only disregards such a commitment but positively violates it, is to be disregarded. In view of Article 2-A, the provisions of Sections 79 and 80 of the Negotiable Instruments Act, 1881, Section 34 and Rule 2 of Order XXXVII, C.P.C [Code of Civil Procedure, 1908] so far as they relate to awarding interest on money claims are clear violations of the Constitutional mandate, as provided in Article 2-A read with clause 3 of the Objectives Resolution referred to above.

However, the same judge felt constrained to uphold interest in the simultaneous judgment delivered in Habib Bank Limited v Muhammad Hussain.[21] Whereas

Irshad H. Khan v Parveen Ajaz (supra) had individuals on both sides, this time a bank was one of the parties and the case turned on the Banking Companies Ordinance, 1979. A Full Bench of the Sindh High Court had held earlier in the year[22] that Article 270-A of the Constitution protected all laws enacted between the date of proclamation of martial law in 1977 and the incorporation of the said Article on 2 March 1985. The consequence was that the impugned banking Ordinance, which fell within this period, was protected, and Article 2A could not override another Article of the Constitution. Bound by this ruling, the single judge proceeded to award interest but not before recording his disappointment at having to follow the Full Bench Judgment:

> I am, therefore, constrained to say, with a heavy heart, that the plaintiff is entitled under section 8 (2) of the Banking Companies (Recovery of Loans) Ordinance, 1979 to claim interest for the period of pendency of the suit .... [23]

The banks had escaped this time because of the timing of enactment of the Banking Companies Ordinance, 1979, but it was clear that this fortuitous technical victory would be subject to more robust legal challenges in the future. The forum for the battle on

interest was, however, destined to shift from the mainstream courts since their use of Article 2A to declare laws un-Islamic was always seen as controversial, and the Supreme Court finally ruled in 1992 that Article 2A could not be used as a self-triggering device.[24] What the Supreme Court wished to prevent was an unsettling scenario in which all courts in the country were free to test the Islamic credentials of any law before them merely by invoking Article 2A.

It had also been urged by some quarters that Article 2A was an unnecessary and destabilizing Constitutional amendment insomuch as the FSC could perform the task of Islamizing laws in a gradual and smooth manner.[25] In view of the difficulties surrounding the powers of the ordinary courts to test the repugnancy of laws to Islam, it was to be expected that the legal trajectory of interest would make its way to the FSC once its ten-year moratorium on adjudicating fiscal and banking matters ended at the end of May 1990. Although the Government was not a party to the legal battles in the 1980s, it had started a soft movement at the beginning of the decade to initiate the banking sector in Islamic banking in anticipation of a future interest-free regime.

.. Banking Reforms of the 1980s

In June 1980, the advisory Council of Islamic Ideology, then headed by Justice Dr. Tanzil ur Rahman, published its first complete report on the elimination of *riba*, which took the view that the system of interest prevalent in the country was diametrically opposed to Islamic teachings on the subject. In response to this report, the Government made certain amendments to banking laws and authorized the creation of new accounts to facilitate Islamic finance. In 1981, banks were allowed to create profit and loss sharing (PLS) deposits[26] with the objective of allowing people to avoid fixed-return schemes and to share in the profits and losses of banks. A law called the Modaraba Ordinance, 1980[27] was promulgated which allowed companies to mobilize funds from the market on a participative basis and to restrict their business on the basis of instruments compatible to the Shariah. Two new instruments were also developed, the first a Participation Term Certificate (PTC),[28] a form of preferred or redeemable capital investment, and the second a *musharaka*[29] (joint venture) investment. In 1985, the State Bank announced that all banks were to restrict their operations to twelve permissible modes of interest-free financing. These included trade-related loans (mark-up agreements of sale of goods), leasing, hire-purchase, and investment-related modes (*musharaka* and *mudaraba*).

In spite of all the hype, the first glimmers of Islamic banking proved to be a false dawn. In due course, the banks were permitted to invest their PLS accounts in the interest-banked government securities, thereby turning the variable and uncertain return that was supposed to be associated with these accounts on its head. The PTCs, which had some semblance to Islamic finance,[30] were freely converted by the banks and development financial institutions into mark-up based Term Finance Certificates. The *musharaka* instruments never really took off, owing to the reluctance of banks to enter into the uncharted territory of joint ventures with clients and the absence of a specific statute to govern these instruments. Even the amendments in the laws showed the Government's hesitation in exposing the banks to the full rigors of Islamic banking. This is illustrated by the insertion of Section 6A in the Partnership Act, 1932, which barred the application of the Act (providing for unlimited liability on all partners) to banks operating PLS schemes.

If the Government itself was cautious, the banks were even more reluctant to blaze new paths. During this period, the standard instrument that banks developed was a buy-back agreement in which the banks bought goods from the clients who were obligated to buy them back at an agreed mark-up in price. Instead of a revolution of Islamic finance, there had occurred only a shift in nomenclature. The taboo term "interest" had become "mark-up" and loan transactions were now made in the guise of buy-back arrangements.

3. The Enforcement of Shariah Act, 1991

In the campaign for interest-free financing, the Government should have been an active participant, being the biggest debtor in the country and relying heavily on interest-based savings schemes to generate revenue. But instead of leading by example, the Government's consistent approach, apart from goading banks into taking symbolic steps towards Islamic finance, was to exempt itself from the time being from interest-free transactions. This strategy to buy time was evident throughout the 1980s and also in the passage of the Enforcement of Shariah Act, 1991.[31] Ostensibly meant to placate the Islamic constituencies in the

country, the Act explicitly protected international and local financial agreements made by the Government until an alternate Islamic economic system had been established.[32] This sought to move forward to an almost indefinite future for international, governmental and banking transactions generally the ten-year immunity given to fiscal and banking matters before the Federal Shariat Court.[33] Progress toward Islamization of the economy and in particular the elimination of interest was to be made through the work of a Commission to be set up under Section 8 of the Act.[34]

4. First FSC Riba Judgment (1992)

Before the Commission on Islamisation of Economy set up under the Shariat Enforcement Act, 1991 had finished its first report in 1992, the action had again shifted back to the courts. In 1990, the ten-year bar on the FSC to examine banking and fiscal laws had lifted and the challenges to interest-based laws came thick and fast. In 1992, the FSC in Dr. Mahmood-ur-Rahman Faisal v Secretary, Ministry of Law, Government of Pakistan[35] gave its first major ruling on interest in 115 petitions impugning twenty laws.

The FSC had waited long for its opportunity and it struck a sweeping blow to the old order. In some ways this was not surprising. The FSC is in essence a court of Islamic ideology; partially composed of religious scholars, its only mandate is to reverse the secularization of laws and bring these in line with the corpus of Islamic jurisprudence. In its landmark judgment on interest, it gave full proof of its conservative orientation. Relying on the Quran, Sunna, and the work of Islamic jurists of the classical period, the court resisted all attempts to narrow the scope of the Islamic prohibition on interest. First, it rejected the contention that Islam only prohibited usury and not interest per se.[36] Secondly, the court said that there was no merit in the claim that interest was only prohibited in personal loans and was permissible in commercial transactions.[37] The use of indexation to compensate for inflation was also declared un-Islamic as it was held that Islam only permitted investment and trade in physical assets and there could be no fixed return of any form on monetary loans.[38] This took care of the major arguments deployed in the country in favor of a restrictive interpretation of interest. In the end, no concessions were made for modern conditions in what had been an emphatic legal victory for the orthodox Islamic view on interest.

The court had focused less on the permissible modes of Islamic financing but did note that Pakistani banks had made very little progress in introducing Islamic banking since the report of the Council of Islamic Ideology on the elimination of interest appeared in 1980. The court held that in fact the PLS (profit and loss sharing) accounts introduced by these banks as an Islamization measure was only a nominal and not a substantial change.[39] In closing, the court declared the interest-related provisions of various laws including inter alia the Banking Companies (Recovery of Loans) Act, 1979, the Negotiable Instruments Act, 1881, and the Code of Civil Procedure, 1908 repugnant to the injunctions of Islam and ordered that they would cease to have effect by 1 July 1992.

The timing and scope of the judgment could not have pleased the then government of Prime Minister Nawaz Sharif, given the absence of preparatory work in this area and the desire not to jeopardize ongoing efforts to boost local and foreign investment in the country.[40] Not surprisingly, the Government went into appeal against the FSC judgment to the Shariat Appellate Bench of the Supreme Court, which suspended the FSC order until the final determination of the appeal. While the appeal languished in the legal pipeline for seven years, the Commission on Islamisation of the Economy, set up under the Enforcement of Shariah Act, 1991, launched two reports on the lessons learned from the experience of Islamic banking in the country and gave guidelines for future action.

5. Reports of the Commission on Islamisation of the Economy (1992 and 1997)

The first report, termed the "Report on Banks and Financial Institutions" and popularly known as the Hanfi Report (after the name of its Chairman), was completed in 1992 after the handing down of the FSC Riba Judgment. The Hanfi Report noted that during the last decade there had been no substantial progress towards Islamic banking and that the mark-up based transactions in vogue in Pakistan were rightly condemned by the FSC and Shariah experts as a perversion of the Islamic system of financing. The report deplored that the joint-venture instrument of *musharaka*, which was the ideal Islamic instrument,[41] had yet to gain acceptability in the banking industry. It was recommended inter alia that (i) the *musharaka* be given specific statutory cover, (ii) a mass campaign of public education on Islamic banking and training of

bank personnel be launched, (iii) a specific law on prohibition of interest be promulgated, and (iv) bank recovery laws be made more stringent.[42] The report ended by stating that Islamic banking could not succeed without "moral building and eradication of the false values of life."[43]

It is doubtful that such moral building did take place because the next report of the Commission in 1997, titled the "Report on Elimination of Riba," again called for a massive motivational campaign to inculcate in society the core values of an Islamic way of life. On the conceptual plane, this report of the Commission prepared under the chairmanship of Senator Raja Zafar-ul-Haq, attempted a more comprehensive treatment of the challenge of *riba* and included in its ambit private domestic transactions, government finances, foreign transactions as well as reforms in banking law. Sounding an upbeat note, the report stated that Islamic finance, being asset-based, was perfectly suited for any activity enabling the creation or acquisition of assets and goods. Yet the report warned that selective application of Islamic finance would create distortions in the economy, and it was therefore recommended that the prohibition of interest be effected in the form of an Act which would cover all facets of economic life without any exceptions, the only allowance being a phased implementation for private domestic transactions (by 1 January 1998), foreign transactions (by 1 January 1998), and government finances (by 1 July 1998).

The proposed "Prohibition of Riba Act," 1997 (a draft of which was attached as an appendix to the report), would provide for the adjustment in the transitional period, prescribe the permissible modes of financing, and outline the method of settlement of government liabilities. A permanent supervisory board was recommended to be set up which would advise the State Bank on matters connected with the transition period and with future implementation of the Act. Although unimplemented, the Zafar-ul-Haq report contained a detailed set of guidelines (including a statutory model) for the Government to follow once it developed the will to introduce a comprehensive (and not just cosmetic) interest-free regime.

In the event, this policy imperative was once again not to come from the Government but from the judiciary. On the political front, the period 1988–1999 was very unstable and the ruling parties were more preoccupied with their own survival; in addition, none of the post-Zia regimes had ever shown great enthusiasm for

the complicated policy challenge of Islamic finance. But delays notwithstanding, the country's constitutional compass was pointing to the Islamic Shariah and the legal process was going to eventually run its course.

6. Judgment of the Supreme Court (1999)

The FSC Riba Judgment (1992) was stuck in appeal in the Shariat Appellate Bench of the Supreme Court for more than seven years, partly because the Government as part of its dilatory tactics kept putting on hold the appointment of Ulema judges on the Bench.[44] The Shariat Appellate Bench of the Supreme Court ultimately delivered its verdict on 23 December 1999 in a judgment reported as Dr. M. Aslam Khaki v Syed Muhammad Hashim,[45] which disposed of 55 appeals filed against various judgments of the FSC relating to interest, including the first historic verdict in 1992. Even by Pakistani standards it was an extremely voluminous judgment, extending to 400 pages,[46] much of the space being devoted to commentaries on Islamic jurisprudence and remarks of a host of Islamic experts who appeared as amici curiae. It is astonishing to note that the Federal Government led by the Attorney General is on record as not having made arguments in the appeal. This ostrich approach may have reflected a deep-rooted ambivalence on the part of the Government in tackling such a difficult and sensitive policy issue, even though it was the original appellant in the first FSC Riba Judgment in 1992 (supra). For adherents of the maxim that justice is best served by powerful arguments on both sides of the question, the Government's muteness in the supreme appellate forum is both disappointing and blameworthy.

In contrast, the Shariat Appellate Bench of the Supreme Court was eager for a definitive ruling and in its verdict it gave a strong endorsement to the line adopted by the FSC in its landmark judgment. As held below by the FSC, the Supreme Court defined *riba* as "the pre-determined, fixed and time-related increase over and above the principal of a loan or debt"[47] and declared that "any amount, big or small, over the principal, in a contract of loan or debt is 'riba' prohibited by the Holy Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity." Having struck down the incentive of interest, the Court declared that the role of the banks in the Islamic system would be as follows:

> All transactions should be in exchange of commodities, goods, services or labour. No purely monetary transaction should be made because such transactions lead to opening the door of Riba ... Banks under the Islamic system shall be primarily financial intermediaries to finance through equity, participation or partnership. Banks may also work as holding companies and may, where feasible, also directly engage themselves in commercial, industrial, agricultural and other enterprises and businesses.[48]

Adverting to some popular modes of Islamic financing, the Court highlighted sale with deferred payment (*murabaha*), lease (*ijara*), and passive and active joint ventures (*mudaraba* and *musharaka*) and stated that all of these were permissible areas for banks to enter into with proper adherence to the norms of the Shariah. But the court warned that in the past the technique of "mark-up" (especially in *murabahas*) was "distorted to the worst extent by the banks when they applied it in practical terms"[49] and that a "valid [from the Islamic standpoint] mark-up transaction cannot be imagined without a genuine sale effected by the bank."[50] To enable banks to set up trading operations, the Court declared that section 9 of the Banking Companies Ordinance, 1962, which prohibited such trading, was to cease to have effect by 31 March 2000. By this date the Interest Act, 1839 (empowering the courts to grant interest in judgments on debt) was also to cease to have effect as were the various money-lending ordinances. The remainder of the laws containing any validation of interest, such as the Negotiable Instruments Act, 1881, the Insurance Act, 1938, and other Acts dealing with banking companies, were to cease to have effect by 30 June 2001 to the extent that they were repugnant to Islamic injunctions. The Court may have felt generous in allotting these dates for the repeal of the above laws, but given the stupendous task of transforming the entire economy on interest-free lines, the transition period (even after the one-year extension announced on 14 June 2001) appears in retrospect to be uncomfortably short.

In its judgment, the Shariat Appellate Bench went much further than its traditional constitutional role of declaring laws repugnant to Islam and leaving the executive and the legislature to do the needful in bringing about the requisite reforms. Probably tired of the Government's hitherto passive approach to Islamic banking and not wanting to leave anything to chance,

the Supreme Court went on to provide a blueprint,[51] partially reminiscent of the Zafar-ul-Haq report, for carrying out the transformation of the economy.

It was directed that within one month of the judgment, the Federal Government was to constitute a high-level commission in the State Bank of Pakistan to carry out and supervise the transformation of the existing financial system to a Shariah-compliant form. Within the same period, the Ministry of Law was to set up a Task Force (a) to draft a new law for the prohibition of *riba*, (b) to review existing financial laws to bring them in conformity with Islam, and (c) to draft laws to provide cover to the new financial instruments. Addressing the needs of the biggest debtor in the country, the Government itself, the Court ordered the Ministry of Finance to form a Task Force to seek means of converting its domestic borrowing into project-related financing through the medium of mutual funds.[52] Finally, the banks were also co-opted in this giant exercise. They were ordered to train their staff in Islamic financing and also to prepare within a period of six months model agreements to be presented to the State Bank Commission for vetting.[53]

7. The Commission for the Transformation of the Financial System and National Task Forces

The Supreme Court had delivered its verdict but clearly the work of shaping the financial system with Islamic tools under the stewardship of the State Bank Commission had only just begun. What was now contemplated was a sea change in the conventional role of banks; from being providers of financial capital they had to now become traders of goods and joint partners in commercial and industrial enterprises. Instruments of Islamic financing had to be developed which would have both the stamp of the Shariah and the credibility of the marketplace. While creating a new and radical legal and regulatory regime, the Commission also had to ensure that the critical transition period was smooth and orderly. All of this the Commission had to do with the sobering realization that unlike Muslim countries such as Malaysia and Turkey, which have parallel systems of conventional and Islamic banking, the Pakistani experiment had no fallback position.[54]

The composition of the Commission was broad-based and aimed at the right blend of academic sophistication and practical experience. There were representatives from the professions of economics, banking (both

central and private), accountancy, and law. A religious scholar, Maulana Muhammad Usmani of the Council of Islamic Ideology, was also made a member of the Commission to provide the requisite technical depth on the Shariah. Mr. I.A. Hanfi, who chaired the 1992 Report on Banks and Financial Institutions, was appointed as the Chair of the Commission.

Given the tremendous amplitude of the Commission's task, separate Task Forces had been set up, pursuant to the Supreme Court Judgment, in the Ministries of Law and Finance. The Task Force in the Finance Ministry worked on plans for transforming government debt to an interest-free mode while the Task Force at the Law Ministry focused on drafting the main law for the prohibition of *riba* and ancillary laws on foreclosure and fair trade practices. Meanwhile, a separate committee for the development of Islamic financial instruments was formed at the State Bank, which would undertake the laborious task of preparing the standard documentation for the new regime.

As the supervisory body set up by the Supreme Court Judgment, it was the job of the Commission to coordinate the extensive work being done by the Task Force in the Law Ministry and the documentation committee and to give it final shape. Never before in the country's history had such a giant administrative exercise been undertaken to uproot the financial system and replace it with interest-free modes of financing. However controversial, the Supreme Court's decision to provide a detailed administrative blueprint for carrying out the reforms by a set date did result in the concerted movement of the different government departments towards a well-defined target. What follows is a discussion of the major policy challenges before the Commission in handling the transition process (including the drafting of a draft Riba Ordinance for the prohibition of interest), the outcome of a review petition filed with respect to the Supreme Court Judgment, and the outlook for future developments for Islamic finance in Pakistan.

A Framework Statute for the New Financial Regime

Given the enormous number of laws affected by the move to an interest-free regime, it is expected that there will be a spate of legislation comprising amending and new statutes. However, at the time of writing, the Task Force in the Ministry of Law, building on the work of the Commission, has only finalized a statute that attempts to provide the basic framework for the new regime. This law, entitled the Prohibition of Riba Ordinance, 2001 (the draft Riba Ordinance), (i) prohibits interest in terms of the Supreme Court Judgment, (ii) bridges the transition period, and (iii) establishes a regulatory body to maintain Shariah compliance. A lot of work has been done by the Commission (especially its sub-committee for standardizing documentation) in developing the essential elements of the Islamic financial instruments. However, this work and consequential amendments to other banking and commercial laws is, at the time of writing, still in the drafting process at the Ministry of Law.

1. Existing Private Financial Arrangements (Domestic and Foreign)

(i) *Domestic Financial Arrangements*

It is a settled principle that a change of law does not affect rights (such as judgments obtained in suits) that have accrued before the effective date of repeal. In Pakistan, the Supreme Court in Sardar Ali v Muhammad Ali[55] has confirmed the validity of this principle for the repeal of statutes held to be repugnant to Islam. But in the banking and financial sectors, sole reliance on this principle of interpretation would have been patently inadequate given the long-term nature of banking agreements and the radical consequences of having an interest-free financial system. It was clear that the new law had to protect current financial arrangements into the future, but the difficulty concerned the cut-off date for protecting these arrangements. It could have been declared the date of the Supreme Court Judgment, given that it authoritatively stated the law on 23 December 1999, but the draft Riba Ordinance fixed the date at 1 July 2001 which is the date up to which all existing contracts, including those with interest provisions, are saved. Because the Supreme Court recently extended the period of implementation of the judgment to 1 July 2002, it is to be expected that the draft Riba Ordinance will make a corresponding adjustment in the law for domestic financial arrangements. However, whether the "effective date" for existing financial arrangements is 1 July 2001 or 1 July 2002, the choice of choosing a date later than the date of the original Supreme Court Judgment raises jurisprudential difficulties which are discussed below.

It was a difficult choice for the Commission to provide for a post-judgment date given that Islamic injunctions do not permit the saving of existing financial arrangements; for that matter neither did the existing jurisprudence in Pakistan. However, expediency dictated that maximum cushioning be provided to financial markets as they absorb the changes, and on grounds of expediency the Supreme Court had not provided any time frame or mandatory order for bringing government foreign debt in line with Islamic financing. Acting on practical considerations and using the analogy of foreign debt as a handle, the draft Riba Ordinance fixed 1 July 2001 (now to be extended by a year) as the cut-off date for protecting domestic existing financial arrangements. The choice of a post-judgment date also receives support on the grounds that as the Commission was developing the new financial instruments, the market could hardly be expected to strike out on its own. In a heavily regulated industry, the banks in Pakistan look to the State Bank for sanctioning their model agreements.

However urgent the need, the saving of "existing financial arrangements" and the choice of the "effective date" will almost certainly be the subject of legal challenge as being unconstitutional and un-Islamic. The Sardar Ali judgment, supra, has encouraged the use of saving clauses[56] in legislation to cater for the transition period, but the extent of the saving envisaged by the draft Riba Ordinance is unprecedented and its outcome in the courts remains to be seen.

(ii) *Private Foreign Financial Arrangements*

In its judgment the Supreme Court gave many illustrations of the supposed economic benefits that the Islamic financial system would likely bring,[57] but no mention was made as to how discordant the introduction of this system would be with the country's liberal foreign investment laws[58] enacted in view of the Government's drive to attract capital from abroad.

In fact, the judgment gave a lot of space to discussing the Government's foreign debt problem (infra), but almost completely neglected the impact of the prohibition of interest on private foreign investment. It is clear nevertheless that the prohibition on interest will apply to contracts between Pakistanis and foreign parties:

> The essence of the conclusions, based on the preceding discussion, is that Islam does not permit Riba in any shape or form, whether among Muslims or between Muslims and non-Muslims (other than *harbis*), irrespective of the question where any of such contracting parties is domiciled or otherwise located. The prohibition applies equally to non-Muslims located within the bounds of a Muslim State. The commandments as to Riba, inclusive of the present day practices of interest and usury, being all pervasive, transcend individuals and envelop not only groups of men or their institutions but even geographical entities such as State edifices.[59]

While stipulating that private foreign financial arrangements will have to adhere to the interest-free regime, the Supreme Court Judgment is equivocal about the time frame for doing this. There is a discussion in the Supreme Court Judgment under the heading of "foreign loans" that invokes the doctrine of necessity:

> Therefore, the admitted difficulties in resolving the problem of foreign liabilities cannot be taken as an excuse for exempting them from the prohibition for good or for an indefinite period on the basis of necessity. However, it cannot be denied that it will take more time than the domestic transactions. The doctrine of necessity will be applicable to this extent only.[60]

However, it is not clear whether the foreign element referred to above applies to private foreign transactions; even in the operative part of the judgment, it is only government foreign loans (infra) that are specifically exempted (for an indefinite period) from the operation of the judgment. Given the fact that many companies in Pakistan rely on foreign seller's credit, and large projects often involve foreign funding, the

Supreme Court should have explicitly extended the ambit of the doctrine of necessity to private foreign financial arrangements, or at least have discussed the matter adequately. Unfortunately, there may now be need for further litigation to ascertain the true impact of the judgment on this critical area of the economy.

As regards the draft Riba Ordinance, it has through section 5(b) totally exempted "foreign financial transactions," whether involving the Government of Pakistan or private Pakistani institutions from the scope of the Ordinance.[61] For the reasons discussed above, it is to be expected that the exemption for Pakistanis who have incurred financial obligations to foreign persons will be subjected to legal challenge as being in contravention of Islam and the Supreme Court Judgment.

2. Future Orientation of Banking Practices

The first step in the shift of banks from lending to asset-based activities, as directed by the Supreme Court, will be an amendment or repeal of section 9 of the Banking Companies Ordinance, 1979 (the "Banking Ordinance") which currently prohibits banks from engaging in trading activities. There has been considerable discussion in the Commission regarding the

essential requirements of the different modes of Islamic financing which shall be permitted, and the Commission's Committee on Development of Financial Instruments and Standardized Documents has produced model agreements for the various types of Islamic financing instruments. However, neither the "essential elements" nor the model agreements have been incorporated in the draft Riba Ordinance, and it is to be expected that either the "essential requirements" or the model agreements themselves will form the subject matter of further legislation. The following modes have been endorsed by the Commission as being compliant with the Shariah:

(i) *murabaha* (sale with deferred price)
(ii) *musawama* (similar to *murabaha* but with no obligation on seller to reveal cost)
(iii) *ijara* (leasing)
(iv) *salam* (advance payment-deferred delivery)
(v) *istisna'* (commissioned preparation of plant/ equipment)
(vi) *mudaraba* (investment with one party as sleeping partner)
(vii) *musharaka* (joint venture)
(viii) equity participation in a company

The challenge in developing Islamic financial instruments is to bear in mind historical lessons in Pakistan and to achieve substantial and not merely nominal conformity to Islamic principles. The Islamic banking instruments used by Pakistani banks at the time of the Supreme Court Judgment (especially the buy-back/mark-up transactions) rightfully drew the Court's censure[62] as a cosmetic exercise in documentation in what was otherwise a monetary transaction with built-in interest.

While the charades of the past should not be repeated, it cannot be denied that the available instruments of Islamic financing present some formidable practical difficulties. Of the available instruments, sale with deferred price (*murabaha*) and lease (*ijara*) transactions are the most promising. But in the *murabaha* transaction the banks will now have to take on the risks of ownership of goods and a genuine sale will have to be effected in line with the Supreme Court Judgment.[63] Notwithstanding these serious constraints, the *murabaha* and *ijara* transactions at least remain a credible option for the banks; in fact, the *murabaha* is the most popular instrument in the world of Islamic banking.[64] The attraction of these instruments to banks lies in the fixed returns they offer, giving these transactions a solid familiarity and comfort that is lacking in the other instruments discussed below which are equity-driven profit and loss sharing schemes.

These equity instruments where banks enter into joint ventures with clients as passive (*mudaraba*) or active (*musharaka*) partners, will be the hardest to develop and introduce in the market. Firstly, Pakistan (like the United Kingdom and the United States) has a market-oriented financial system in which banks are not equity holders in corporations, unlike the banking-oriented financial system prevalent in Japan and Germany where banks may own equity in non-financial companies. Secondly, even in countries where banks own equity in non-financial companies, this form of ownership only extends to the largest corporations, and small enterprises (because of private holdings and uncertain financial profiles) have to raise loans (as debt) from banks.

Though Pakistani banks may countenance project lending to blue chip public companies on some form of profit and loss basis, this arrangement will not work in the case of the majority of companies which are privately held and about whom financial information is not widely available. For banks to enter into joint ventures there must be transparent and periodic accounting, especially as banks will seldom be in a position to actively manage the enterprises they finance. How are the banks to prevent the sinking of their capital, let alone their profits, by unscrupulous clients who will paint the books of the company red to consistently show losses? Against the backdrop of widespread tax evasion and non-documentation in the economy it remains unlikely that joint ventures on Islamic lines will take off in the country in the foreseeable future. It appears that only a radical transformation of the prevalent business culture would make joint ventures appealing to banks, and such shifts in social norms take a long time to occur.

Although disfavored by the market, joint ventures are considered to be the ideal mode of Islamic financing while the use of sale and lease transactions by banks has been viewed by the courts as borderline transactions to be used sparingly.[65] Given the commercial and legal uncertainties regarding joint ventures, it would be inadvisable to practice legal discrimination against the more popular trade (i.e., sale and lease) instruments. A legal system that alienates the market will be abused to the hilt and will only stunt the growth of

Islamic banking in its infancy. Because the draft Riba Ordinance has not touched on the issue of Islamic financial instruments, it is too early to tell how further legislation will treat the various Islamic financial instruments inter se.

3. Financial Default, Misrepresentation, and Fraud

The issue of compensation to the financier for default by the client came up in the Supreme Court Judgment when it considered whether provisions in the Code of Civil Procedure, 1908[66] which empowered the Court to grant additional sums over and above the decretal amount, amounted to interest. The Court said that it did because, in its words, "any amount over and above the principal amount of debt is Riba, hence prohibited."[67] However, the Court was forced to concede that no banking system could function if clients dishonored their commitments with impunity; it was also urged upon the court that if the past was any guide, clients would in future freely employ frivolous pleas and dilatory tactics in their lawsuits. To counter this, the Court turned to Islamic injunctions which uphold the virtue of honoring contracts and ruled that a penalty system could be evolved as long as it was "not based on a fixed rate to be awarded in each and every case based on opportunity of money. . . ." Instead, the Court stated:

> The legislature can also confer a power on the court to impose a penalty on a party who makes a default in meeting out his liability or who is found guilty of putting up vexatious pleas and adopting dilatory tactics ... from the amount of such penalty a smaller or bigger part depending upon the circumstances can be awarded as solatium to the party who is put to loss and inconvenience .... The amount of penalty can be received by the State and used for charitable purposes ....[68]

Although the matter of penalty clauses was discussed intensively by the Commission, the draft Riba Ordinance has not addressed the vital issue of how banks will be compensated for financial default of customers and for delays (arising because of litigation or otherwise) in the settlement of claims.

With respect to misrepresentation and fraud, all banks—whether conventional or Islamic—face the difficulty of asymmetrical information; in the nature of things, the clients know a great deal more about their enterprises than the bank. However, this problem is much more acute for banks providing Islamic finance on a profit and loss sharing basis and assumes

greater significance in the business culture of Pakistan where sharp practices are rife. Again, the draft Riba Ordinance has not made provisions for misrepresentation and fraud by customers of financial institutions, and there is resulting uncertainty as to whether further legislation will create a regime of civil liability for dishonest trade practices or provide criminal sanctions in this area given the value Islam puts on financial probity.

4. Government Debt (Domestic and Foreign)

(i) *Domestic Debt*

As the Government dominates the capital markets in Pakistan, accounting for nearly one hundred percent of the debt securities markets, no transformation of the financial system can be completed without providing for an adequate mechanism to meet its funding needs. The essence of Islamic finance is that it must be backed by real assets and it is expected that at some indefinite time in the future a mutual fund will be set up in the State Bank or a subsidiary thereof and shares will be sold in it for both existing saving schemes and future funding streams. To support this new system credible criteria for assessing the fair market value of these assets would have to be developed along with dependable and frequent financial reporting. There is flexibility for both fixed income and variable income securities in Islamic financing, with sale and lease transactions catering for the former and joint ventures catering for the latter. However, with the Government's privatization drive in high gear, it may be difficult in the future to find profitable public enterprises that can provide credible vehicles for the variable income schemes. It is unlikely that privatization will be reversed to accommodate the needs of Islamic banking, given the high burden of foreign debt which has to be repaid with the sale of these assets. Therefore, it appears that even in the area of government debt, it is the fixed income instruments of *murabaha* and *ijara* that will prove to be of greatest benefit.

Regardless of the future shape of government domestic borrowing, it is important that it makes the requisite effort in the direction of Islamic financing. Any attempt at exemption by the Government will do great damage to morale and create further distortions in the economy. Unfortunately, in its judgment the Supreme Court has ordered the Government to tailor domestic borrowing on Islamic lines, but has given no time frame in this regard.[69] Moreover, the Court

has not ordered the amendment or repeal of the Shariah Enforcement Act, 1991, which protects government financial agreements until a future economic system is established. The danger is that the weak legal imperative will only lead the Government to perpetuate its past practices of exempting itself from the operations of Islamic finance. In fact, the draft Riba Ordinance has not fixed the effective date for government domestic transactions; as of now the Supreme Court has extended the date of implementation of the judgment to 1 July 2002, and we will have to wait for the promulgation of the draft Riba Ordinance to see if government domestic transactions are protected beyond the new date of implementation.

(ii) *Foreign Debt*

With regard to the Government's foreign debt, the Supreme Court's directions are of a merely exhortatory nature; in the operative part of its judgment the Court stated that:

> 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 should also be made to structure the future borrowings, if necessary, on the basis of Islamic modes of financing.[70]

It would have been idle for the Court to suggest a drastic realignment of foreign debt to Islamic financing, given the country's precarious economic situation and its dependence on foreign aid. The bleak prospects for the Government in this area are summed up in a lecture delivered in March 2001 by Dr. Tariq Hassan, the Advisor to the Finance Minister of Pakistan, when he stated:

> The Islamization of the financial system will certainly be hampered because of the precarious foreign debt problem faced by Pakistan presently. The Government may succeed in reducing its reliance on foreign exchange borrowings if it limits such borrowings on development expenditure. However, there is little or no chance of it being able to renegotiate its existing foreign loans or structure its future foreign loans on the basis of Islamic modes of financing .... Pakistan cannot and should not attempt to build the Islamic financial system in isolation.[71]

The Advisor goes on to state that the IMF is currently creating an architectural design for a new international financial system which would include internationally accepted debt management guidelines, and Pakistan should participate in this process in concert with the Islamic bloc of nations to make Islamic financing a

part of this new order. It is difficult to disagree with the Advisor's assessment that Pakistan will have to wait for Islamic financing to be recognized by the creditor community as part of a global process before it can align its foreign borrowing along Islamic lines. For the Government to meet its future financing needs, it seems that the doctrine of necessity will have to be stretched very far in time. As noted above in the discussion of private financial arrangements, the draft Riba Ordinance has exempted for an indefinite period both private and government transactions involving foreign persons from the prohibition of *riba*. While this may be a victory for pragmatism in the face of the grave danger that an interest-free regime will effect by alienating foreign investment and lending, the grounding of this policy decision in the Supreme Court Judgment and the jurisprudence of Pakistan is uncertain and could well be the subject of further legal challenge in the country.

5. Shariah Board

In order to provide the necessary Islamic expertise in state institutions, the draft Riba Ordinance sets up in Section 6 a seven-person Shariah Advisory Board (including religious scholars and other professionals) that would guide the Federal Government, the State Bank, and the Securities and Exchange Commission of Pakistan in the transformation of the financial system. Apart from the role of guiding state institutions, the Board has been given the mandate to "ensure" that financial and investment modes are "not in conflict with the injunctions of Islam as laid down in the Holy Quran and Sunnah." Unfortunately, the draft Riba Ordinance is silent on the composition of the Shariah Board (as regards the ratio of religious and other professional members) and also does not provide whether the Shariah Board shall give binding orders and what the scope and procedure of appeals from the decisions of the Board will be.

In addition, an affirmative decision for female inclusion on the Shariah Board would have thrown a favorable spotlight on the progressive role of women in the Islamic world. In fact, as a member of the Commission, one of the authors of this booklet proposed the specific inclusion of female representation on the Shariah Board, but the consensus was that the use of the word "person" read with the General Clauses Act, 1897 included women; it was further contended that even the term Ulema-e-Din was gender-neutral. The

matter ended there, but though the participation of women has not been excluded, a specific provision in this behalf would have been an important symbolic victory. Also, its practical implementation would not have been a problem given the large number of women in Pakistan who are properly trained and are making their mark in the fields of law (including Islamic jurisprudence) and finance.

Review Petition

While the Commission and the Task Force in the Ministry of Law were busy finalizing the draft Riba Ordinance before 1 July 2001, one of the country's major banks, United Bank Limited, filed a review petition against the Supreme Court Judgment. On merits, not much could be expected from the review petition, because under Section 114 (read with Order 47) of the Code of Civil Procedure, 1908 an application for review can only be accepted if new and important evidence has been discovered, or if the mistake or error is apparent on the face of the record, or if there is other sufficient cause analogous to the previous grounds. Given the lack of substantial grounds for review, all the petitioners could hope for was an extension of time, which the Supreme Court is authorized to grant under Order 33, Rule 3 of the Supreme Court Rules, 1980. Although the Attorney General had asked the Court to delay implementation of the judgment to 31 December 2005, the Court extended the period of implementation only by one year, to 30 June 2002. In granting the extension, the Supreme Court stated that the Government was well intentioned, its bonafide intentions being demonstrated by the work already undertaken by the Commission and the various Task Forces including the preparation of a draft Riba Ordinance. For critics who feel that the implementation of an interest-free regime should take place in a very gradual manner, the brief extension given by the Supreme Court to its original time frame, which was short to begin with, will be a very unsatisfying development.

Conclusion

After more than fifty years of independence, Pakistan is now moving rapidly towards a wholly Islamic system of banking and finance. The impetus for this change has come from a special judiciary which was created through the reforms of the Zia regime to

implement his conservative agenda. Instead of merely "packing the courts" with his appointees, Zia ensured the momentum of his movement by creating ideological courts in the shape of the FSC and the Shariat Appellate Bench of the Supreme Court. As a result of the Zia reforms, these courts possess both the constitutional high ground as well as the ideological expertise to rid the statute books of un-Islamic provisions. In other nations, too, it is not uncommon to find large-scale social engineering being done through the medium of the courts where the political will has lacked vitality or cohesiveness. This has happened intermittently in the United States, for example. Although in a very different (non-secular) context, and to a different degree, the development of Islamic law in Pakistan fits this general pattern. To what extent these ideological courts in Pakistan reflect the aspirations of mainstream society and are susceptible to democratic control is, however, difficult to gauge. Policy issues which involve religious strictures are not easily susceptible to vigorous and open public debate, no matter how far reaching the ramifications may be for society as a whole.

Within the growth of Islamic law in Pakistan, financial reforms have proved to be the most labored, complicated, and slowest of exercises as an important pillar of the modern economy of the state has had to be broken and shaped in the Islamic mould. With the stakes so high, it is up to the policy makers to give the country both a viable system and one that will truly conform to Islamic principles as laid out by the superior courts of the country. The Pakistani chapter in the story of Islamic banking will certainly yield some important lessons for the viability of a wholly Islamic system of finance in the modern world. Failure of the interest-free experiment in Pakistan could be catastrophic for economic growth if financial markets become inefficient and for social stability if the middle class, widows, and pensioners flock to black market financial institutions that provide fixed returns in contrast to the profit and loss scheme of Islamic finance.

The legal challenges for the future, though, are many and varied. A large amount of legislation will have to be brought to cater inter alia for Islamic financial instruments, contract liability for banks as traders of goods, fair trade practices on the part of borrowers, and tax and accounting standards reform. It is to be expected that for some years there will be a spate of constitutional litigation on the attempt to protect existing financial arrangements well past the date of re-

peal of the concerned laws. The courts will also be involved in developing a jurisprudence on damages that are to be awarded for default of financial obligations. The challenge will be to devise a system of compensation that will insulate the creditors from inevitable delays in the adjudication of disputes while steering clear of any formula that involves the opportunity cost of money. In fact the pervasiveness of interest as a yardstick of value in financial transactions means that financial institutions will face difficulties in charging commissions for financial guarantees, letters of credit, forward contracts, and underwriting activities, all areas that have been neglected by the Supreme Court Judgment but which are vital financial services.

Turning to state institutions, the role of the Shariah Board as an umpire of Islamic financial arrangements is also presently unclear as the draft Riba Ordinance has not clarified its composition and jurisdiction. Financial arrangements involving a foreign party form another area of future uncertainty. Although the draft Riba Ordinance has indefinitely exempted these arrangements (whether government or private) from the prohibition of interest, it is difficult to square this practical approach with the Supreme Court Judgment. Given the size of the Government as an economic player, failure to re-align government debt on Islamic principles may become a serious drag on the Islamization process. While there may be little room to maneuver in the case of foreign debt, the Government should lead by example for transactions within the country and make a serious effort to transform future domestic borrowing on the asset-backed model of Islamic financing.

Finally, the training of bank staff and a campaign of public education on Islamic finance should be priorities of the first order. Because of the cosmetic nature of past attempts at introducing Islamic finance in the country, the level of general cynicism at the process is at flood tide. Policy makers should never forget that the success of Islamic finance will not be accomplished by the enactment of laws, but will depend in great measure on ensuring the commitment of the citizens through an understanding and acceptance of the new paradigm.

Endnotes

[1] Dr. Parvez Hassan, LL.B. (Punjab), LL.M. '62 (Yale), S.J.D. '69 (Harvard); Senior Partner, Hassan & Hassan (Advocates), Lahore (Pakistan), is a member of the Government of Pakistan's Commission on Transformation of the Financial System. The views expressed herein are personal to the author and in no way reflect the thinking of the Commission. The second author of this essay is Mr. Azim Azfar, B.A '92 (Virginia), LL.B. (Hons.) '98 (Wolverhampton), Associate, Hassan & Hassan (Advocates), Lahore.

[2] See Supreme Court Judgment, PLD 2000 Supreme Court 225.

[3] All references to the Constitution in this booklet are to the Constitution of the Islamic Republic of Pakistan, 1973 unless the subject matter or context indicates otherwise.

[4] Article 198(1) of the 1956 Constitution, Article 8(1) of the 1962 Constitution, and Article 227 of the 1973 Constitution.

[5] Article 29(f) of the 1956 Constitution, Article 8(18) of the 1962 Constitution, and Article 38(f) of the 1973 Constitution.

6 Articles 197 and 198 of the 1956 Constitution, Articles 199–206 of the 1962 Constitution, and Articles 227–231 of the 1973 Constitution.

7 In Article 198(3) of the 1956 Constitution, the period was five years and in Article 230(4) of the 1973 Constitution, it was seven years. The 1962 Constitution did not provide for any report by the Council.

8 In the original 1962 Constitution, framed by a moderately secular military regime, the country's name was declared to be the "Republic of Pakistan" but the title "Islamic" along with the original text of the Objectives Resolution were brought back through the Constitution (First Amendment) Act, 1963. This brief episode shows the resilience of Islamic doctrines in Pakistan.

9 Articles 25 of the 1956 Constitution, for example, stipulated:

> 25 *Promotion of Islamic Principles*—(1) Steps shall be taken to enable the Muslims of Pakistan individually and collectively to order their lives in accordance with the Holy Quran and Sunnah;
> (2) The State shall endeavor, as respects the Muslims of Pakistan—
> (a) to provide facilities whereby they may be enabled to understand the meaning of life according to the Holy Quran and Sunnah;
> (b) to make the teaching of the Holy Quran compulsory;
> (c) to promote unity and the observance of Islamic moral standards; and
> (d) to secure the proper organization of zakat, wakfs, and mosques.

See generally Article 30 of the Constitution and Hakam Qureshi v Judges of the Lahore High Court, PLD 1976 SC 713 where the Supreme Court expressed its inability to examine any action or law on the touchstone of the principles of policy on the basis that these were not rules of law under the Constitution. In contrast, the Fundamental Rights have been the subject matter of a legion of constitutional cases.

1 See PLD 1973 Supreme Court 49.

2 PLD 1980 Central Statutes 89.

13 PLD 1985 Central Statutes 456.

14 See Federation of Pakistan vs. Public at Large, 1988 SCMR 2041.

15 See Pakistan and others vs. Public at Large, PLD 1987 SC 304.

[6] "The Objectives Resolution and its Impact on the Administration of Justice in Pakistan," a lecture given in 1987, PLD 1987 Journal 186, at 194.

[17] See supra n. 5.

[18] Article 3 of President's Order No.1 of 1980, PLD 1980 Central Statutes 89.

[19] Article 42 of President's Order No.14 of 1985, PLD 1985 Central Statutes 456.

[20] See PLD 1987 Karachi 466.

[21] PLD 1987 Karachi 612.

[22] See Muhammad Bachal Memon v Government of Sindh, PLD 1987 Karachi 296.

[23] See supra n. 20, at 651.

[24] See Hakim Khan v Government of Pakistan, PLD 1992 Supreme Court 595.

[25] Asif S. Khosa, "The Ineffective Effect of Article 2-A Constitution of Pakistan," PLD 1990 Journal, at 50–63.

[26] An amendment in the Banking Companies Ordinance, 1962 (Section 26-A) amended the charter of banks to allow such deposits.

PLD 1980 Central Statutes 140. The *mudaraba* is an instrument of Islamic financing in which one party provides the capital and the other provides the managerial services. The profit is to be divided in strict proportion agreed at the time of the contract, but all losses are to be borne by the investor.

[28] Although the PTCs linked return to the profitability of the projects and thus were a step in the direction of Islamic finance, they were in essence preferred capital instruments. The priority accorded to the return on the PTCs was at variance with the Islamic injunction that called for loss sharing in accordance with the ratio of capital and barred prior claims in any form.

[29] A *musharaka* is an instrument of Islamic financing akin to a joint-venture. The profits are to be divided in proportions agreed at the time of contract but the losses must be shared in strict proportion to capital invested.

[30] See supra n. 28.

[31] PLD 1991 Central Statutes 373.

[32] Section 18 of the Enforcement of Shariah Act, 1991, id., provided that "Notwithstanding anything con-

tained in this Act, or any decision of any Court, till an alternative economic system is introduced, financial obligations incurred and contracts made between a National Institution and a Foreign Agency shall continue to remain and be valid, binding and operative." Section 19 extended this protection to the fulfillment of all financial obligations of the Federal and Provincial Governments and of financial or statutory corporations.

[33] See supra n. 19.

[34] Section 8(4) provided that "The Commission shall oversee the elimination of Riba from every sphere of economic activity in the shortest possible time." As events would tell, this statutory optimism was not justified.

[35] See PLD 1992 Federal Shariat Court 1. This became colloquially known as the Tanzil ur Rahman Judgment, after the Chief Justice of the Federal Shariat Court who wrote the opinion for the unanimous five-member bench. In fact, it was Justice Tanzil ur Rahman who, as a member of the Sind High Court, had given the interest judgments in supra nn. 20 and 21 and had authored the 1980 Report of the Council of Islamic Ideology. As a result, the major work on the elimination of *riba* in Pakistan until the early 1990s was attributable to him, almost a one-man Islamization squad in Pakistan.

[36] The court observed that "not only exorbitant or excessive rate of interest is prohibited but it includes a small percentage also. The word Riba as used in the Quran is absolute in terms, and no attribute or qualification as to its quantity is to govern it...." See id. at 73.

[37] Observing that the Arabs always used to give loans for commercial purposes, the court held that "Riba forbidden in the Quran includes interest due on the loans taken or given for commercial and productive purposes by banks and financial institutions." See id. at 74. The court reasoned that "the difference between interest on consumptional loans and interest on productive loans is a difference of degree and not of kind since interest is nothing but an addition to the borrowed capital on deferred payment basis." See id. at 78.

[38] Id. at 110.

[39] Id. at 144.

[40] In fact, the FSC dishearteningly noted that senior Government counsel rendered no assistance in the deliberations of the court. See id. at 188.

[41] For the popularity of this instrument with Shariah experts, see infra n. 65.

[42] See generally Chapter 4 of "The Report on Bank and Financial institutions" (1992).

[43] Id.

[44] The Shariat Appellate Bench set up under Article 203(f)(3) of the Constitution consists of two Ulema judges who are appointed on an ad hoc basis by the Government, which can, therefore, easily influence the constant formation and dissolution of benches. Justice (Retd.) Tanzil ur Rahman (see supra n. 35) makes the point that the non-permanent nature of both the FSC and the Shariat Appellate Bench and the attendant manipulation by the Government has emasculated the role of these courts in the Islamization drive in the country. Tanzil ur Rahman, "Islamic Provisions of the Constitution of the Islamic Republic of Pakistan, 1973, What More is Required?," PLD 2000 Journal 66.

[45] PLD 2000 Supreme Court 225, hereinafter referred to as the Supreme Court Judgment.

[46] Of the four-member bench, which delivered the unanimous verdict, three of the Justices wrote separate opinions.

[47] Supreme Court Judgment, at 464.

[48] Id. at 470.

[49] Id. at 311.

[50] The Court stated that "the concept of Islamic banking cannot be translated into reality unless it is realized that the banks are not meant to deal in money and papers, but their financing is based on and firmly related with real business activities," id. at 336.

[51] See generally id. at 344–347.

[52] Id. at 346 and 347.

[53] Id. at 346.

[54] See Fuad Al-Omar and Mohammed Abdel-Haq, *Islamic Banking. Theory, Practice and Challenges*, Zed Books (1996) at 96.

[55] See PLD 1988 Supreme Court 287, at 316 where the Court noted that the Islamic provisions of the Constitution provided for gradual Islamization and that decrees obtained before the old law ceased to have effect would be upheld and their appeals decided under the old law.

[56] Id. at 316.

See for example the following passage. "If, however, interest is prohibited and banks are required to share in the risks and rewards of financing, they will be more careful in lending. Wasteful spending will decline and more resources will become available for productive investment and development. This will lead to higher growth, a rise in employment opportunities, and a gradual decline in unemployment." Supreme Court Judgment, at 542. This is facile reasoning and is one of many examples of the judgment where the Court has dilated on the economic consequences of interest. It may perhaps be wondered why the courts do not leave economic forecasting to those trained in the discipline and limit themselves to the legal realm.

[58] The current Investment Policy of Pakistan allows foreign investment in virtually all sectors of the economy without government permission, which is required only for ammunitions, radioactive substances, security printing, currency, and mint. Moreover, the Protection of Economic Reforms Act, 1992, PLD 1992 Central Statutes 250, protects operation of foreign currency accounts (sections 4 and 5) and secrecy of banking transactions (section 9) and prohibits nationalization of private (domestic and foreign) investment. The above measures provide for a liberal foreign investment regime that has survived the frequent changes of governments in the 1990s.

[59] See Supreme Court Judgment, at 655.

[60] Id. at 757.

[61] Section 5(b) provides as follows: "5. Continuance of existing and foreign financial arrangements: For removal of doubt, it is hereby declared that notwithstanding anything contained in the foregoing provisions or a decision of any court-...(b) the financial obligations incurred or which may be incurred and contracts made before or after the

commencement of this Ordinance between the Government or any financial institution, statutory corporation or any other institution and a foreign person shall continue to remain in force and all obligations, promises and commitments made thereunder shall be valid, binding and operative." The definition of "foreign person" in Section 2(g) of the draft Riba Ordinance includes natural and juristic persons but excludes such foreign persons who are doing business in Pakistan.

[62] Supreme Court Judgment, at 311.

[63] See supra n. 50.

[64] The *murabaha* is one of the most popular modes of Islamic financing both in Pakistan and abroad, see Supreme Court Judgment, at 308. But see infra n. 65.

[65] As stated by the Court, "The Murabaha when used as a mode of trade financing is a borderline transaction with very few lines of distinction as compared to an interest-bearing loan ... Notwithstanding the permissibility of the Murabaha transaction, it is susceptible to misuse and keeping in view the basic philosophy of an Islamic financial system it is not an ideal way of financing. Hence, it should only be used where Musharaka and Mudaraba are not applicable," Supreme Court Judgment, at 751.

[66] See Supreme Court Judgment, at 328 and 329 where Sections 34 and 34-A of the Code of Civil Procedure, 1908 have been examined.

[67] Id. at 328.

[68] Id. at 330 and 331.

[69] The relevant part of the Order only states that "The domestic inter-government borrowings as well as the borrowings of the Federal Government from State Bank of Pakistan shall be designed on interest-free basis."

[70] Supreme Court Judgment, at 347.

[1] Lecture at the National Institute of Public Administration, Lahore on 19 March 2001, in "Reflections on Transition to a Riba-Free Financial System," Business Recorder (Karachi), 5 and 12 May 2001.