

# **Eliminating Riba**

## *The Holy Alliance between Law and Economics in Pakistan*

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### **ABSTRACT**

The Pakistani Constitution requires the state, as part of its principles of policy, to eliminate *riba* as early as possible. A law on the enforcement of *shari'ah* has been promulgated with a view to providing the institutional framework for undertaking, *inter alia*, the Islamization of the economy. Successive governments in Pakistan have taken a number of different steps toward Islamization and the elimination of *riba* from the banking system. Dissatisfied with the results so far, the Supreme Court of Pakistan has directed that necessary legislative and executive measures be taken to transform the current interest-free banking system into a genuine Islamic financial system. The government remains committed to eliminating *riba* and to promoting Islamic banking in the country. It is in the process of taking various measures in line with the guidelines and directives of the Supreme Court. It intends to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors.

### **I. INTRODUCTION<sup>1</sup>**

Pakistan is an interesting case-study for the review of the slow developments that lead to the institution of an Islamic financial system. The Supreme Court of Pakistan is trying to forge a holy alliance between law and economics by seeking to eliminate *riba*. In holding that any excess or increase over principal is *riba*, the Court has decided that *riba* means not usury alone, but includes interest as well. Thus, the Supreme Court ruling has the effect of outlawing all interest-based financial transactions both within and outside the banking sector. Recognizing the broader impact of its judgment on the whole economy, the Supreme Court has dealt not only with legal issues but has proposed economic restructuring as well. As such, it has gone beyond its judicial mandate and instructed that necessary legislative and executive measures be taken to transform and expand the current interest-free banking system into a genuine Islamic financial system.

This holistic transformation of Pakistan's financial system into a purely Islamic system must take place within a specified time frame. The Pakistan Government has been trying to abide by the directives of the Supreme Court, but a complete transformation of the entire financial system does not appear to be possible. It is doubtful whether the Supreme Court directive can be met, at least in the short term. This lack of achievement has little to do with the will of the Pakistani Government, but is reflective of the complexity and near-impossibility of the task entrusted to it by the Supreme Court. Pakistan has been a pioneer in the Islamization process and was one of the first countries to introduce interest-free banking at the national level.

The purpose of this paper is twofold. First, it aims to critically review both the process and substance of the ongoing transformation of the financial system in Pakistan with a view to understanding the difficulties in implementing the Supreme Court directives. Second, it seeks to suggest a viable solution to the problem. Time and space do not permit a thorough identification and analysis of all of the issues involved but I hope these preliminary talks will spawn productive dialogue down the line.

### **II. HISTORICAL PERSPECTIVE**

The 1973 Constitution of Pakistan requires the State, as part of its principles of policy, to eliminate *riba* as quickly as possible. Further, it requires that all existing laws be brought in conformity with the injunctions of Islam as laid down in the Qur'an and Sunna, and instructs that no law can be enacted that contradicts the injunctions of Islam. A law on the enforcement of *shari'ah* has been promulgated with a view to providing the institutional framework for undertaking the Islamization of the economy. Under this law the State is required to "take steps to ensure that the economic system of Pakistan is constructed on the basis of Islamic economic objectives, principles,

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and priorities.” Successive governments in Pakistan have taken a number of timid steps toward Islamization generally, and toward the elimination of *riba* from the banking system specifically.

Pakistan started the process of Islamization in the 1980s, and this effort led to the introduction of an interest-free banking system in the country. At the time there was very little conceptual discussion or debate on the subject; nor was there any change in the goals and objectives of banking, such as the elimination of exploitation. Instead, there was more emphasis on form than on substance. An interest-free banking system was introduced merely by replacing traditional forms of bank financing by twelve specified modes of Islamic financing. There was no corresponding change in either the legal or regulatory framework of banking. There was no consequent institutional restructuring of either bank regulations or operations. Thus, it was pretty much business as usual. The change was superficial, merely a change in nomenclature. Interest was replaced by a “service charge,” “mark-up” or “profit” in lending, trade, and investment. The results have not, therefore, been very different: indeed, the cost of funding has gone up without any corresponding benefit.

### III. JUDICIAL INTERVENTION

The Supreme Court of Pakistan has recognized and condemned the superficiality of the change in the banking system in Pakistan, and has thus taken an active role in promoting a purer form of Islamic finance. In its landmark judgment on *riba* in the Khaki case in December 1999, it accomplished two things. First, it specifically declared certain provisions relating to “interest” contained in various laws to be repugnant to the injunctions of Islam, and directed that all said provisions be deleted in those particular laws. Second, it defined *riba* in broad terms that include any element of interest, and declared that all prevailing forms of interest are clearly prohibited by the Qur’an and Sunna. The Supreme Court considered the earlier actions taken by the Government to be inadequate and declared some of the most commonly used interest-free banking practices as a sham. It has, for example, judged the popular “mark-up” system to be a negation of the principles of Islamic finance. The Supreme Court has thus ordered the transformation of Pakistan’s banking and financial system into a purer and more wholly Islamic one.

It is not surprising that the Supreme Court has termed the current interest-free banking practices in Pakistan a sham and has directed the transformation to a genuine Islamic banking system. But in doing so the court has clearly gone beyond its judicial mandate to decide only the cases before it, by also directing the transformation of the entire national financial system. Although it was initially intended to serve merely as a guideline, the transformation directive has a binding effect because of the broad definition of *riba*. It is likely to have a profound impact not only on the banking and financial sectors but on the economy as a whole. Mindful of the economic impact of its judgment, the Supreme Court has suggested the restructuring of the economy.

The extension of the Supreme Court’s jurisdiction raises issues of judicial competence and the separation of powers between the legislative, executive, and judicial branches. It also raises myriad other banking, financial, economic, political, religious, legal, administrative, regulatory, institutional, and contractual issues as well. For example, an unplanned implementation of the Supreme Court judgment may, *inter alia*, not only jeopardize savings and deposits but also adversely affect loan recoveries. Furthermore, it is likely to cause uncertainty regarding existing domestic and international financial contracts.

The Supreme Court definition of *riba* is not universally accepted. For example, in Egypt the Shaykh al-Azhar considers ordinary interest (as opposed to usury) as Islamically permissible. He emphasizes that it is the exploitative nature of transactions that constitutes *riba*. But even if *riba* is deemed to include interest, the question remains as to whether to exclude inflation from the definition of *riba*. The Supreme Court considered the issue of inflation and indexation but has left the determination of this point for later. It has, however, closed the door for accommodation by giving a watertight definition of *riba*.

### IV. GOVERNMENT POLICY

The Government is, as a matter of policy, committed to eliminate *riba* and promote Islamic banking in the country, and has taken various measures in line with the guidelines and directions of the Supreme Court. The Finance Minister of Pakistan made the following commitment to the nation during his budget speech in 2001:

- A legal framework is being designed to encourage practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations;
- Consultations and exchanges are undertaken with other Islamic countries and renowned institutions of Islamic learning, such as al-Azhar University of Egypt, to learn more about their experiences and practices;

- Amendments to the HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC would be a fully *shari'ah*-compliant institution, which will play an effective role both in the promotion of Islamic financing methods and in the development of the important housing sector;
- *Shari'ah*-compliant modes of financing like *musharaka* and *murabaha* will be encouraged so that familiarity with and use of such products are enhanced and their adoption on a wider scale made possible;
- The Transformation Commission established by the State Bank of Pakistan will continue to function and its recommendations, when finalized, will be considered by the government for appropriate action.

Most of these actions have already been taken. It is the Government's intention to promote Islamic banking in the country, while keeping in view its linkages with the global economy and existing commitments to local and foreign investors. The Pakistan Ministry of Finance, while being fully committed to the transformation process, is obligated to:

- Promote and protect the stability of the economic system;
- Ensure that there is no chaos in the financial system;
- Promote confidence in the economic and financial system with a view to generating savings;
- Protect depositors, particularly small depositors (poor, pensioners, widows, etc.);
- Ensure that there is no improper benefit or unjust enrichment by loan defaulters;
- Ensure the safety and soundness of the banking industry and the capital markets;
- Ensure that the inherent risks in trade and investment modes of financing advocated by the new system are regulated prudentially;
- Ensure that Pakistan is not isolated in this era of globalization and remains an important part of the international financial system.

The Government is, furthermore, faced with a number of issues regarding (i) the implementation of the orders of the Supreme Court within the time frame specified by it, and (ii) the practicality of transforming the entire economic system. At present, Pakistan has neither the professional and institutional capacity nor a well-functioning legal and judicial system, which are both prerequisites for the introduction and sustainability of an Islamic economic system.

The Government has made reasonable efforts to comply with the guidelines and directives of the Supreme Court. It has taken the required actions, including the establishment of the Transformation Commission in the State Bank of Pakistan, the Task Force on Laws in the Ministry of Law, and the Task Force on Government Borrowing in the Ministry of Finance. So far, only the Transformation Commission has submitted its report and recommendations to the Government. Nevertheless, just like half a dozen other reports commissioned by the earlier governments, the Report of the Transformation Commission does not deal with the critical issue of safeguarding the liability-side of the balance sheet of banks and concentrates instead on the purification of financing modes. The purification process has resulted in the reduction by half of the number of financing instruments available to banks. In this era of financial innovation, this recommendation alone appears to be retrogressive. In short, the Transformation Commission does not provide any meaningful or comprehensive plan for either a holistic or purist transformation of the economic or financial system in Pakistan.

## V. CONCLUSION

This critical evaluation of the substance and process of Islamization in Pakistan is not intended to negate the concept of Islamization. It is only intended to highlight the difficulties in total transformation. Mere transplantation of Islamic modes of financing is not likely to achieve the goal of Islamization. Pakistan, which has so far only gone through the introductory phase of the Islamization process, is now entering the second phase of development. The instant, holistic transformation of the banking and financial system is not possible. Nothing short of a revolution, as in the case of Iran and Sudan, can provide the instant transformation of the whole system, but even that may be devoid of the desired purity. Complete transformation of the financial system is simply not feasible. The purity of the system is only likely to be achieved through an evolutionary process; and only constructing a new system through consensus can do this. The development of a parallel system, as demonstrated in Malaysia, may be the only viable way to go.

The Pakistan Constitution only requires the provision of an enabling environment for Muslims to order their lives in accordance with the tenets of Islam. It requires the elimination of *riba* but does not define the term. Given the fact that it contains provisions regarding interest, it can be safely assumed that it does not consider simple

interest as *riba*. The Constitution obligates the State to eliminate *riba*. This is a collective responsibility of the legislative and executive branches of government rather than the judiciary.

Instant and total transformation is neither possible nor desirable and may not even be necessary. The Supreme Court has been requested to review its judgment and may modify its decision in view of the practical difficulties being faced by the Government and the banking sector to implement its decision. Mindful of the importance of the subject, the Government should seek *ijma'* (scholarly consensus) on the subject not only nationally, but internationally as well. Before eliminating *riba* in its wider manifestations, it would be expedient to introduce an Islamic banking system that parallels the existing system. The alternate system may be allowed to evolve gradually through a viable long-term national plan for the banking and financial sectors in Pakistan.

In the ultimate analysis, the proposed holy alliance between law and economics will only succeed by close cooperation among religious scholars (*'ulama'*), *shari'a* scholars, lawyers, bankers, financiers, and economists. Such cooperation will require an interdisciplinary approach by all these groups rather than independent input from each. The development of such a capacity remains a challenge both for Pakistan and the rest of the Islamic world.

## APPENDIX I: RECENT EVENTS IN ISLAMIC FINANCE<sup>ii</sup>

### A. Review Petition

The Government did not file a review petition and, in fact, started the process of transformation in compliance with the directives of the Court. However, a review petition was filed against the *riba* judgment by one of the aggrieved banks, namely, United Bank Limited (UBL). In its review petition, UBL contended that the judgment was against the applicable law and recorded facts and also not fully in accordance with the injunctions of Islam. UBL further contended that the Supreme Court exceeded its jurisdiction while giving the judgment. It therefore sought a review of the judgment and asked for suspension of the operation of the *riba* judgment.

The UBL review petition was later supported by the Government at the Supreme Court hearing to review the petition. The Government indicated that after trying hard to comply with the Court's directive, it was ultimately unable to transform the entire system as required by the Court. It used reports of the Transformation Commission and the Task Forces to indicate the difficulties faced by the Government in implementing the judgment *in toto*.

### B. Supreme Court Review

The Supreme Court rendered its judgment on the UBL review petition on 24 June 2002—just six days before the extended deadline imposed by it. In this judgment, the Court has done two things: (i) it has negated its earlier judgment of 23 December 1999 on *riba*; and (ii) it has remitted the cases to the Federal Shariat Court for determination afresh. The Supreme Court concluded:

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

Resultantly, ... the Review Petition ... filed by the United Bank Ltd is allowed, the judgment dated 23 December, 1999 passed by the Shariat Appellate Bench of this Court ... and the judgment dated 14th November, 1991 of the Federal Shariat Court ... are set aside and the cases are remitted to the Federal Shariat Court for determination afresh in the light of the contentions of the parties noted above and the observations made which are germane to the controversy. Besides the points raised before this Court, the parties would be at liberty to raise any other issues relevant to these cases and the Federal Shariat Court may also, on its own motion, take into consideration any other aspect which may arise or may be found relevant for determination of the issues involved herein.

### C. Conclusion

This new Supreme Court judgment, while averting an impending crisis on account of the total transformation of the financial system, has reintroduced an element of uncertainty in the financial market. The Court has, by remanding the cases, put the country in the same place in which it had started. The Supreme Court has not fixed any time frame for the disposal of the cases by the Federal Shariat Court. The parties will have to go through the whole process of litigation all over again in the Federal Shariat Court, and perhaps in appeal to the Supreme Court, before the issue of the elimination of *riba* is ultimately resolved.

Despite the reversal of the Supreme Court judgment, the Government has, as a matter of policy, announced its willingness to promote Islamic banking in the country. The Finance Minister of Pakistan in his recent budget speech reaffirmed the Government's commitment and explained its strategy in this regard: "A high level delegation was sent to Egypt, Saudi Arabia and Malaysia to learn from their experience of Islamic banking. Based on the practices adopted by these countries, the government believes that a parallel evolutionary approach would be a proper course to follow. Let me reiterate the intention of the government to promote Islamic banking in the country while keeping in view its linkages with the global economy and existing commitments to local and foreign investors."

The Government, in consultation with the State Bank, is in the process of developing a distinct legislative and regulatory framework for Islamic banking. A licensing framework for the establishment of new Islamic banks in the country was announced by the State Bank of Pakistan and the first license for an Islamic bank was granted to Al-Meezan Investment Bank, which has already begun operations. Furthermore, existing banks are at various stages of starting their own subsidiaries or branches to undertake operations on the basis of principles of Islamic finance.

Although the Government is committed to developing a parallel Islamic banking system in the country, there is no self-imposed deadline for this goal. Further, there is now no compulsion from the Supreme Court for the total transformation of the financial system in Pakistan. Despite the lingering uncertainty about the final outcome, it is expected that Pakistani courts will now perhaps be inclined to accept the evolutionary approach adopted by the Government rather than imposing any revolutionary change.

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<sup>i</sup> The views expressed in the paper are the author's own and are not attributable in any way to the Government of Pakistan or any administrative unit, agency or office thereof.

<sup>ii</sup> The following comments from the author, submitted in spring 2003, are an update on the latest situation in Islamic finance in Pakistan.