

# Possibilities of Interest Free Banking in Pakistan

Zahid Iqbal<sup>1</sup>, Maria Quibtia<sup>2</sup>

<sup>1,2</sup> Hailey College of Commerce, University of the Punjab

---

**Abstract:** The purpose of this paper is to explore the working in Pakistan made for interest free banking. Interest free banking is the basis of Islamic banking. Islamic banking is growing all over the world in the Muslim countries as well as Non-Muslim countries. Islamic banking is governed by the rules and regulations of Islamic economies with the close monitoring of Islamic Sharia'h principles. Interest free banking is not popular in Muslims but also in the Non-Muslims as well due the benefits provided by it. Islamic banking in Pakistan is at its fastest track and many Islamic banks have been emerged in the last decade and even conventional banks also has opened separate branches to deal with the customer which require Islamic banking services. Islamic banking has two types of major customers. First, the people which are more close to their religion they use Islamic banking. Second, the customers who want to gain the benefits provided by Islamic banking. Demographic composition of Pakistan 2014 shows that 96.40% are the Muslims and remaining are the Christians, Hindus and others. Islamic banking has gained the intention of business class due to its attractive products. In the current paper the literature of Islamic banking has been discussed and tried to bifurcate the difference between Islamic and conventional banking. This model is more effective in the Pakistan due to the more Muslim population.

**Keywords:** Interest Free Banking, Islamic Banking, Conventional Banking, Riba, Gharar.

---

## I. INTRODUCTION

Working of interest free banking system is based upon the principles of profit and loss sharing and according to this Islamic banking model funds are collected from the customer and same used in the real economy for lending purpose and through this channel these funds are distributed to the customer again. Islamic banking mainly based upon the interest free banking. This banking system prevailed under the guidance and supervision of Islamic Sharia'h board and Islamic economics. In Islam collection and payment of interest or Riba are prohibited. Islamic economics system does not allow the trading of financial risks and it is considered a form of gambling and the principles of Islamic economy does not allow investment in the businesses which are considered haraam or unlawful. All the businesses are appreciated in Islam which is not involved in any kind of interest. Working of Islamic banking tools deals in equity financing rather debt financing. Interest free banking is the substitute of fixed interest rates in to the profit and loss sharing saving accounts and returns on these deposits are paid on annually basis. These types of banking activities are operated under the highly ethical and professional standards.

The historical background of current interest free banking is based on the profit and loss sharing. In 1970s sudden increase in the oil prices given birth to an industrial revolution in the Islamic countries and need for Islamic banking enlightened to the Islamic economists to set principles of banking. Interest free banking was introduced in Hammurabi's Codes which explains how loan can be arranged and it was considered first interest free investment model in the history. Concepts of borrowing, leasing, partnership and murabaha agreements has introduced on the wider spectrum at the advent of Islam. Interest free banking and finance system was started in the late nineteenth century at that time performance of Muslims was very well at both economically and politically. Then the establishment of Islamic banks in the major cities of Islamic and non-Islamic countries was made to provide the banking services to fulfill the business needs at large. Since then the growth of Islamic banking and financial institutions is faster than the conventional one's. All the Islamic banks

and financial institutions are providing interest or Riba free services to their customers and the principles of these institutions are harmonized under one shadow Islamic Sharia'h board. Individually the services and benefits of the Islamic banking system may differ from one another on the basis of practices, experience and according to the needs of inhabitants, but, the theme of all the institutions is to provide interest or Riba free services in the economy that fulfills personal and business needs of the public.

In the last few years many Islamic banks have been emerged in the Islamic and western countries and it has become a global trend among the Muslims to a closer observant of their faith. Islamic banking growth is faster among Muslims as well non-Muslims due to the products and services offered by them. Global Islamic Finance Report in 2014 estimated that size of Islamic Banking Industry all over the world near about \$ 1.813 trillion at the end of 2013 that has shown growth of \$ 182 billion in absolute term from the preceding year. State Bank of Pakistan has published at the end of 2015 five full fledged Islamic banks has been operating in the country and seventeen conventional banks are operating in the Pakistan with more than 1700 branched and market share of Islamic has been risen up to 12.80% and predicted that it will be more than 20% by the end of 2020. In the last 12 years the growth rate of the Islamic banking was more than 50% same projected in the future. Financial institutions are trying to capture more market share from the global market under the shadow of Sharia'h compliant products and services to satisfy the need of their customers. Islamic banking is helping the economy to fetch savings from the economy to support the major investment projects.

## 2. UNIQUE FEATURES OF ISLAMIC BANKING AND FINANCE

### A- Zakat:

Zakat is an essential religious payment or rich's wealth tax which is payable to the poor. Islam has developed this mechanism of redistribution of wealth for the protection of poor people standard of living. Zakat is the one of the five important pillars of Islam. Zakat is an additional payment than a conventional tax payment as in non-Islamic countries. Muslims are not allowed to invest in the enterprises which are involved in the production, consumption or distribution of prohibited items such as pork, gambling, illegal drugs, alcohol etc., even though these enterprise are more profitable. Financing to such enterprises is illicit in the Islam. Islamic Banking and Financial Institutions are allowed to invest in the activities and items which are Sharia'h Compliant. The restriction on investment and financing are also extended to the activities which are harmful to any individual or society at large. Hence investment and financing for production, consumption and delivery of alcohol, tobacco or pornography is also not allowed.

### B-Riba:

The word Riba means that the amount over and above charged against the principle amount. Payment and receipt of interest which is the fundamental concept of conventional banking and finance, this is explicitly forbidden in the Islamic banking and finance. The nucleus of Islamic banking and finance in their financial products and services is the prohibition of receipt and payment of the interest, which is the core of conventional banking and finance. Interest is charged in different types as loans, advances and leasing. Islamic banking is purely interest free banking and also helps to resolve the economic issues from the economy. Riba or interest, its receipt, payment and even witnessing is prohibited in Islam, due to which Islamic Banking system does not receive or pay any Riba or interest to their depositors and not also receive interest or Riba from the borrowers. The primary concern of conventional banking is the capital guarantee, however, in Islamic Banking and Finance it is not possible in some cases, while opening profit and loss sharing saving accounts, if profit earned from investment then profit is paid to the depositors and if loss has been occurred due to any uncertain hazard then the borrower also bears the same. Money is only medium of exchange and it values the thing, itself it has not any value, so, it cannot be used to raise more money. Money in Islam is not considered as an asset and it is not permissible to earn direct return on the use of it. Muslims believe that all the things provided by God are for the use and well being of human being except those which are expressly prohibited in Quran and Hadith, in some cases where guidelines and practices are not clearly given in the Quran then guidance can be sought from fiqa.

### C- Gharar:

Gharar is simply uncertainty or lack of knowledge that can result detrimental to one party. This lack of knowledge as well as lack of knowledge of the outcome of a transaction may stem from mistake, misrepresentation, duress, fraud or terms and conditions of a contract beyond the knowledge of one party.

In practice Gharar relates to the potential issues to a transaction such as quality, quantity, pricing and delivery of an asset that would effect to the quality or degree of consent of the parties to the contract.

Prevention of Gharar is intended to save the weak from being exploited, in Gharar one gains at the loss of another. Gharar is the gambling or speculations and are prohibited in Islam. Islam favors risk taking business transactions but does not allow the speculative and gambling. Any transaction which contains the ingredients of speculations as buying of share at a lower price and sells it at higher price in the future is considered as illegal activity. Speculation is the part and parcel of conventional banking system in the form of hedging, futures, forward contract etc.

### 3. MAJOR DIFFERENCES BETWEEN ISLAMIC BANKING AND CONVENTIONAL BANKING

Before the interpretation of strengths and weaknesses of Islamic banks with respect to their performance it is provided that the environment should be discussed in which Islamic Banks operates. Performing environment makes Islamic banks distinguished and unique from the conventional banks. According to the Sharia'h, basis of Islamic Financial Institutions must follow four basic principles: -

- All the transactions must be free from Riba (interest or usury).
- All the transactions which involve Gharar (speculations or gambling) should be avoided.
- Implementation of Zakat is compulsory as a support to upgrade the poor. Zakat makes the society equal and poor persons support to the society.
- All the transactions which involve the production, consumption or distribution of goods or services which are prohibited in Islam (like Alcohol, tobacco, pornography etc.).

### 4. LITERATURE REVIEW

Literature review on Islamic banking may be divided into two parts one is the theoretical and another is empirical. Formerly researchers work on the availability of institutions to the Islamic banking for support and supervision and the bifurcation of Islamic banking theme, concepts and governing principles Mannan (1968), Siddiqi (1983b), Ahmed (1984) Iqbal and Mirakhor (1987), Khan (1987), Ahmed (1987), Zineldin (1990) and saeed (1996). Comprehensive working on documentation of Islamic laws and Sharia'h of interest free banking in different Islamic countries like Pakistan, Iran, Malaysia, Sudan, Saudi Arabia and Turkey has been made by Haron and Shanmugam (1997) and interpreted the Islamic banking products in details as mudaraba, musharaka, murabaha and qarz-e-hasna and problems faced from the monetary policy previously developed to run the conventional banking system. Murabaha is not pure Islamic instrument, but, it is developed just to replace interest based discount rate that is an essential tool to run the monetary policy. Financial instruments that are in practice of Islamic banks has been reviewed by Aggarwal and Yousef (2000) and they established that long term loans to seek entrepreneurs capital has been rarely issued by the Islamic banks. Most of the Islamic banking transactions are trade or retail financing related and the Islamic banking model lucidly supports these types of transactions. Islamic banking found viable with respect to the theory and practice a better replacement to the existing conventional banking system Zineldin (1990). Some empirical studies show that comparatively Islamic banking is more efficient than conventional ones in the Bangladesh Ali (1996). Comparative study has been made in Egypt and found that Islamic banking is more innovative to introduce financial products Kazarian (1993). Arif (1989) studies found that performance of Islamic bank in the first six years from its establishment was quite impressive in the Malaysia and suggested that Islamic banking should have research and development department, so that, new products should be introduced to fetch the market share from the conventional banks, to serve the Ummah in a more efficient way. Samad (1999) rose that Islamic banks are comparatively more efficient position in the 1992-1996 in the country. Further, he explored that Bank Islam has better efficient management than the conventional banks. Hassan and Samad (2000) examined inter-bank and inter-temporal performance for the period 1984-1997 and they found that the liquidity position of the Bank Islamic was more liquid due to which it was less prone to the liquidity risks. Hassan (1999) performance of Islamic bank in Bangladesh shows that basic concepts musharaka, mudaraba and murabaha were not developed.

### Execution of Interest Free Banking in Pakistan:



Figure No. 01:- Execution of Riba or Interest Free Banking System (Clock wise rotation of funds)

### Interpretation of terminologies w.r.t. Islamic Banking:

**Loan:** It means Islamic Institution will arrange all kinds of raw material such as goods and semi-finished goods, equipment and machines, real estate items required from abroad to the business enterprises, bank pays the cost of such assets as ordered by the enterprises to the seller and against this account of respective enterprises debited until payment is not received.

### Profit & Loss Sharing in Partnership:

It means customer shares profit or loss from the transaction of purchase and sale of goods or any activity as pre agreed proportion between bank and the customer or the purchasing enterprises.

### Cash Against Documents:

In such type of transactions banks pay cash against the transactional documents it means bank has purchased the imported goods and later on bank sells these goods to the buyer at a higher cost, the time for which buyer used the asset without payment bank will charge rent for the use of such asset.

### Leasing:

It is an agreement between the bank and the customer to use the asset of the bank. Bank takes some down payment and pays remaining amount from own funds and creates partnership with the customer. Customer uses such asset and pays rent to the bank against the share of the bank for which at the time of purchase cash is paid by the bank. If customer pays some extra amount to the bank with same ratio share and rent of the bank in that asset decreases.

## 5. BENEFITS OF THIS MODEL TO THE ISLAMIC BANKS

It is confirmed that from the last two decades in the interest free banking system money never lost from the banking investment. Profit and loss are the part of trade as they are natural and inevitable, it does not mean they never lost money it means they support major projects in the economy. Some of the projects are more profitable than the projected figures and some of the projects may not perform as well as projected and even some of the projects may face loss, but, consolidation are ever profitable to the bank as well to the customer and thus, the banks avoid to distribute loss and pay profit from the more profitable projects that may be very high at the well performing days and may be some lower at the normal performance days. However, it is also mentioned that loss can also be distributed in the days when invested funds are not managed properly by the institutions or during the global market crises. Above all, interest free organizations are working on the principles of profit and loss sharing basis and customer should be ready all the times for the both possibilities.

This question cannot be raised that the profit paid by the Islamic or interest free banks is nearer to the profit of the conventional banks, because profit paid by the conventional banks is also different among them it may be slightly different or more. This marginally different amount in percentage can make a higher amount at a wider level. Interest free banks are operating in this market are mainly contributing to the production activities of the economy. Their contribution enables the trade enterprises to purchase raw materials, semi-finished and finished goods from the local as well as international market. On the contrary, conventional banks specify the amount of mark up when it is deposited to the bank, however interest free banks do not do so, they deposit the amount on the profit and loss sharing basis and same will be decided and credited in the customer account at the time of profit disbursement on the deposits.

## 6. LEGAL ASPECTS OF INTEREST FREE BANKING

At the start of interest free banking practices it was very tough to segregate the interest free banking and conventional banking. The need for Islamic banking rules and regulations separately from the conventional ones was necessary with the inception of this concept. In the Objective Resolution it was requested that Islamic banking should prevail in the country. In the article No. 01 of the constitution of Pakistan 1956, its name was declared as "Islamic Republic of Pakistan". In the Islamic Provisions of Constitution of Pakistan, 1973, it was mentioned that "the state shall eliminate Riba as early as possible". In 1980 Islamic Scholars prohibited the bank to accept any deposit in the interest based accounts and at that time a new terminology was introduced that bank shall accept deposit in the profit and loss sharing accounts and the same deposit shall be used in the new projects in economy and if profit earned from the investment that will be distributed as per their proportion after the bank profit and if loss occurred, it will also be distributed among the investors. At July 01, 1985 all the commercial banks in Pakistan was made to deal interest free deposit in Pakistani rupees that is declared as Un-Islamic by the Federal Sharia Court (FSC) later on, in 1991. Main causes of this failure was that at that time there was neither any Supervisory Sharia Board specifically for the supervision of interest based banking system nor the audit team for these institution along with non availability of Sharia'h based audit of financial institutions, lack of research and development in interest free banking system, lack of training at both in the banks and SBP as well.

To provide the solution against the interest based conventional banking Federal Sharia'h Court in 1999 that pure Islamic banking system should be introduced in the country and for this purpose a commission was constituted named "Commission for Transformation of Financial System (CTFS)" in January, 2000, in State Bank of Pakistan.

In September 2001 government has decided to make the economy as interest or Riba free banking and financial institutions without disturbing the conventional financial institutions. Specifically, SBP has given this task to introduce a system which should replace the interest based financial institutions with the Islamic Banking System. Then, the central bank had made three major strategies to upraise Islamic Banking in Pakistan. Firstly, decided to establish fully Sharia Complied Islamic Banking System in private sector. Secondly, interest free subsidiaries were made in the existing commercial banks. Thirdly, some of the stand alone conventional banks branches were transformed into the Islamic Banking.

In January, 2002 first license was given to the Meezan Bank Limited as full fledged Islamic Bank in Pakistan. All the products and services of Meezan Bank Limited were Sharia'h complied, since then; performance of the Islamic banks in Pakistan is improving day by day.



To provide separate protocols to Interest free or Islamic Banking a Sharia'h Board has been established in 2003 that comprises minimum five members from the fields as Islamic Sharih, banking, law, accounting and relevant fields that are supportive to the Islamic Banking System. The Sharia Board has minimum two Sharia'h Scholars, one is lawyer, one Chartered Accountant and one is the representative of the bankers and State Bank and he is the director of Islamic Banking department in State Bank of Pakistan and he also provides services as the secretary of the Sharia'h Board. Chairman of the Sharia'h Board was to be among the Sharia Scholars and technical members to the Board such as Accountant, Lawyer and banker provides expert opinions in the relevant field to the Sharia'h Board for making rules and regulations under consideration for interest free or Islamic Banking. The prime duty of the Sharia'h Board is to formulate rules and regulations and to introduce new products / instruments or services which are Sharia'h complied and their monetary management functions are under the Islamic modes.

Further, a body has been established in 1990 named "Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)" in Algiers for the formulation of rules and regulations regarding accounting and auditing to the interest free institutions.

## 7. CONCLUSION

Interest free banking in Pakistan is its fastest pace. Many of the new Islamic banks have been emerged during last decade and they fetched remarkable market share from the conventional banks. Now, the conventional banks have also opened the Islamic banking branches to retain the market share. Interest free banking is growing because major portion of the population comprises on the Muslims. Muslims in Pakistan as they are Sunni or Shia both are vigilant about the religion and they are moving towards the growth of Islamic economies.

Interest free banking is not only providing services to the Muslims but also to the non Muslims. Most of the customers of Islamic banks are that who are more close to the religion and they even consider it sin to deal with the conventional banks in the availability of the Islamic banks and they solely deal with Islamic banks for all domestic and business needs as well. Other customers are those who are attracted toward the Islamic banking due to its comparative benefits which Islamic banking more than the conventional banking.

As per demographic composition the Muslims are 96.40% and remaining are the Christians, Hindus and others. Growth of Islamic banking in the world is up to 12.30%. However, growth of Islamic banking in the Pakistan is fastest pace approximately 50% with the 12.80% market share in the last 12 years that is predicted to be at 20% by the end of 2020.

Government in now a day is projecting to use the Islamic bond and other funds to start new projects like dams, roads, new hospitals, more education universities in the country. Interest free banking creates real assets and generates new employment opportunities and it is expected that the Islamic banking will be the market leader in Pakistan in the near future.

## REFERENCES

- [1] Aggarwal, Rajesh K., and Tarik Yousef. "Islamic Banks and Investment Financing". *Journal of Money, Credit and Banking* 32.1 (2000): 93–120.
- [2] Ahmad, Ziauddin. *Concept and models of Islamic banking: an assessment*. International Institute of Islamic Economics, 1984.
- [3] Ahmad, Ausaf, Islamic Development Bank. Islamic Research, and Training Institute (Jeddah). *Development and problems of Islamic banks*. Islamic Research and Training Institute, 1987.
- [4] Akkas, Ali. "Relative efficiency of the conventional and Islamic banking system in financing investment." *Unpublished Ph. d. Dissertation, Dhaka University* (1996).
- [5] Ariff, Mohamed. "Islamic banking in Malaysia: framework, performance, and lessons." *International Journal of Economics, Management and Accounting* 2.2 (1989).
- [6] Haron, Sudin, and Bala Shanmugam. *Islamic Banking System: Concepts & Applications*. Pelanduk Publications, 1997.

- [7] Iqbal, Zubair, and Abbas Mirakhor. "Islamic Banking. International Monetary Fund." *Occasional Paper* 49 (1987).
- [8] Kabir Hassan, M. "Islamic banking in theory and practice: The experience of Bangladesh." *Managerial Finance* 25.5 (1999): 60-113.
- [9] Khan, Shahrukh Rafi. *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking*. Oxford University Press, USA, 1987.
- [10] Kazarian, Elias G. "Islamic versus traditional banking: financial innovations in Egypt." (1993).
- [11] Mannan, M. A. "Islam and Trend in Modern Banking: Theory and Practice of Interest Free Banking." *Islamic Review and Arab Affairs* 56 (1968).
- [12] Saeed, Abdullah. "Islamic Banking and Interest." *A Study of Prohibition of Riba and its Contemporary Interpretation* (1996).
- [13] Samad, Abdus. "Comparative efficiency of the Islamic bank vis-à-vis conventional banks in Malaysia." *IJUM Journal of Economics and Management* 7.1 (1999): 1-27.
- [14] Samad, Abdus, and M. Kabir Hassan. "The performance of Malaysian Islamic bank during 1984-1997: An exploratory study." *International Journal of Islamic Financial Services* 1.3 (1999): 1-14.
- [15] Siddiqi, Muhammad Nejatullah. "Issues in Islamic banking." *The Islamic Foundation, Leicester* (1983).
- [16] Zineldin, Mosad. *The economics of money and banking: A theoretical and empirical study of Islamic interest-free banking*. Coronet Books Incorporated, 1990.