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JINNAH, ISLAMIC BANKING AND THE NEW FINANCIAL ARCHITECTURE

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1. Introduction

In his address at the opening ceremony of the State Bank of Pakistan on 1st July 1948, the founder of the country stated that it would be in the interests of the economy to consider an economic and financial system based on Islamic principles, particularly as Western economic thought had brought a spectacularly unsuccessful framework for advancements in the world he knew. Little would Jinnah expect that over 60 years later Islamic banking and finance principles would be the talk of Western economists, bankers and policymakers as a model on which to guide the re-introduction of ethical principles back into collapsed Western financial systems! He would also probably be astonished to know that by 2008 Shariah compliant banks held assets amounting to nearly $700 billion and that Islamic banking and finance activity covers the globe with all major global commercial banks having Islamic subsidiaries and investment banks arranging and issuing *Sukuk* bonds and other *Shariah* compliant investment services.

Islamic banking that started on a modest scale in the 1960s has shown exceptional growth. What started as a small rural banking experiment in the remote villages of Egypt has now reached a level where many mega international banks now offer Islamic banking and financial products. The practice of Islamic banking now spreads from East to West all the way from Indonesia and Malaysia towards Europe and the Americas. Forty years ago Islamic banking was considered not much more than wishful thinking but now it is a reality. It has been shown to be both feasible and viable and can operate just efficiently and productively as Western style financial intermediation. The successful operation of these institutions and the experiences in Pakistan, Iran, Malaysia, Saudi Arabia, Bahrain and throughout the Islamic world, demonstrate that the alternative suggested by Jinnah offers both a viable and successful alternative to Western commercial banking and finance. The fact that many conventional banks also are using

Islamic banking and finance techniques is further proof of the viability of the Islamic alternative. Even though Islamic banks emerged in response to the needs of Muslim clients, they are not religious institutions. Like any other types of banks they are profit-seeking institutions. (Jinnah may have been pleased to learn that one of the most profitable banks in the world, and the most profitable Islamic bank, in 2007 was Habib Bank – a conventional Pakistani bank with an Islamic division!) The big interest in Islamic banks is that they use a different model of financial intermediation and these features have attracted worldwide financiers as well as policy maker's attention. In recent years there has been a new dynamism as this industry has proved increasingly attractive, not only to the world's 1.6 billion Muslims, but also too many others who are beginning to understand the unique aspects of Islamic banking and finance.

2. Key principles of Islamic finance

The main (and most well known) principle of Islamic finance is the prohibition of interest (*Riba*). This means that financial contracts and other activities have to be constructed in a way that omits interest receipt or payment. Probably the second best known principle is the prohibition of gambling and other activities forbidden under Islamic law (this means that banks cannot make loans to casino firms, alcohol producers and so on). Islamic investment funds, for instance, have *Shariah* boards that screen out investments in non-Islamic compliant businesses. A final main principle, the prohibition of *Gharar,* is lesser known (and more complex). This refers to acts and conditions in exchange contracts, the full implications of which are not clearly known to the parties. It is similar to what we refer to as "asymmetric information" – differences in information between contracting parties. When these are large and there is the opportunity for one party to take material advantage of this position then the contract is regarded as anti-Islamic. Islamic jurisprudence relies on the general condition of trustworthiness of contracting parties to take care of this. With regard to the aforementioned three main principles, all Islamic financial firms have *Shariah* boards that oversee activities so as to ensure operations comply with Islamic principles.

The function of financial intermediation requires providing mechanisms for saving and borrowing so that agents in the economy can alleviate budget constraints. This involves creating a variety of financial assets and liabilities with different characteristics that appeal to different savers and borrowers. Conventional commercial banks provide financial intermediation services on the basis of rates of interest (charged and paid) on both the assets and the liabilities side. Since interest is prohibited in Islam, Islamic banks have developed various other modes through which savings are mobilized and passed on to entrepreneurs, none of which involves interest. Similarly, for performing the function of providing other financial services, such as payment services, insurance, fund management etc., Islamic banks have developed alternative contracts, which are compatible with the *Shariah* law. Overall, the core tenets of Islamic finance relate to: a ban on charging interest, a commitment to profit-and-loss sharing (in place of interest-based transactions), and asset-backed transactions.

While types of Islamic banking products and services can vary from country-to-country, as an example, in Pakistan the main lending products offered by banks are as follows:

Murabaha (Sales contract) – this relates to various trading contracts where the sale of goods is specified at a set profit margin. Here the bank purchases the goods desired by the borrower (e.g. a car) and then the bank sells the goods on at an agreed marked-up price. Payment is settled within an agreed time frame, either in instalments or in a lump sum. The bank bears the risk for the goods until they have been delivered to the buyer (borrower).

Diminishing *Musharakah* – this is a profit and loss sharing partnership contract of a particular form. A traditional *Musharakah* contract involves both partners to the contract (the bank and borrower) participating in the management and the provision of capital, and sharing in the profit and loss in the project for which the funds have been lent. Profits are distributed between partners according to ratios set at the onset of the contract, whereas losses are distributed according to the proportion to each partners share in the capital. Diminishing *Musharakah* has evolved from the former and also involves the bank and client participating in either joint ownership of property or equipment, or in a joint commercial enterprise. The share of the bank is further divided into a number of units and it is understood that the client will purchase the units of the share of the bank one by one periodically, thus increasing their share until all the units of the bank are purchased, the client then becomes the sole owner of the property, or the commercial enterprise, as the case may be. Diminishing *Musharakah* can take on different forms in various transactions and traditionally it has been used mainly in housing finance.

Ijarah – these are generally viewed as leasing agreements. Under this concept, banks make the use of various assets / equipment (such as plant, office equipment, cars) available to clients for a fixed period and price;

Salam (Purchase by order) Salam is a sale whereby the bank undertakes to supply some specific goods to the buyer at a future date in exchange for an advanced price fully paid on the spot.

Istina – this is similar to *Salam* but involves a sale where a commodity is transacted before it comes into existence. For instance, it may involve the financing of manufactured goods purchases before they have been fabricated. The price is fixed with the consent of the parties as is the specification of the commodity (intended to be manufactured). The difference between *Istisna* and *Salam* is that in the former there is always a good involved that needs to be manufactured, whereas *Salam* contracts can cover any item. Also, in Salam contracts the price has to be paid in advance, while this is not necessary in *Istisna*. And

Querd-e-Hasnah – these are loans given on compassionate grounds free of any charges and repayable if and when the borrower is able to pay.

According to the State Bank of Pakistan (December 2007) in terms of types of financing, Murabaha was used for almost 45% of total Islamic banking financing followed by

Diminishing Musharakah (25%) and Ijarah (24%). Other types of contracts include: Salam, Istina and Querd-e-Hasnah.

3. Islamic banking in Pakistan

While Jinnah's request for the Pakistani monetary authorities to adopt an alternative to Western style finance and economic management was made in 1948 the process of economy wide Islamisation of the country's banking system was not initiated until 1979. In February of that year the government announced plans to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest activity from various specialist financing firms - the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Soon after, these specialized financial institutions took various steps to adopt their activities to a non-interest basis.

The conversion of the country's commercial banks to Islamic institutions was somewhat more convoluted. In January 1981, separate counters were established for accepting deposits on a profit/loss-sharing basis in all the domestic branches of the main nationalized commercial banks and this system existed up until mid-1985. From July no banking company was permitted to take interest bearing domestic currency deposits (although foreign currency deposits could still earn interest). As from that date, all deposits accepted by banking companies shared in the profit and loss of the bank except deposits in current account on which no interest or profit was given and whose capital sum was guaranteed.

Over the following twenty years or so there was ongoing debate between the monetary authorities, Islamic scholars and banks on the appropriate modes of Islamic structures and the oversight of Islamic banks in general. Typically arguments raised focused mainly on what type of financing arrangements were or were not Islamic compliant. By 2004 some form of general consensus emerged and the government continued to promote a mixed system whereby conventional and Islamic banking compete side by side. All commercial banks are allowed to set-up Islamic windows and licences are granted on a case-by-case basis.

By 2007 out of a total of 46 banks operating in the country there were six fully fledged Islamic banks: AIB Albaraka Islamic Bank B.S.C. (E.C.) (with 12 branches); BIP Bank Islami Pakistan Limited (14 branches); DIB Dubai Islamic Bank Pakistan Ltd (17 branches); DWD Dawood Islamic Bank Limited (1 branch); EGI Emirates Global Islamic Bank Ltd (6 branches) and MBL Meezan Bank Limited (72 branches). As its substantial number of branches suggests, MBL Meezan Bank is by far the largest accounting for 37% of Islamic bank deposits and 34% of assets. In addition, 12 conventional banks had Islamic banking divisions or windows (separate counters) operating with 103 branches. The Islamic banking network has increased rapidly – the total number of branches increased from only 150 in 2006 to 288 in 2007 covering 25 cities and towns in all four provinces of the country.

Despite the number of Islamic banks operating in the country, however, their domestic market share is small. They only account for just over 4% of total banking sector deposits and assets. Table 1 illustrates that in value terms they lend mainly to the consumer and corporate sector, however in terms of their total share of borrowers this is less than one percent!

4. The future for Islamic banking in Pakistan

Jinnah's desire to provide the now 160 million Pakistani populous with an economic and financial system based on Islamic principles is starting from a low base but is gradually gaining credence. The 97% Muslim population offers substantial opportunities for Islamic banking to penetrate deeper into the financial transactions of the economy. In a bold attempt to bolster the sector the central bank has developed a strategy that aims to increase Islamic bank market share to 12% (from its current 4% level). This is coupled with plans to improve regulation and strengthen *Shariah* compliance throughout the banking sector. Areas particularly targeted are the micro finance, agriculture and small business lending sectors – areas that Islamic banks have typically found it difficult to penetrate given the limited product set available. The aim is to encourage banks to rollout a new Islamic compliant products to target these areas. The central bank has engaged in benchmarking exercises comparing products available in other Islamic banking countries and aims to encourage the adoption of best-practice services into the domestic market. It is also likely to encourage the provision of Islamic credit cards and insurance products as well. Overall, the sector is expected to grow rapidly over the next few years.

5. Conclusion

Jinnah's call for a new financial and economic paradigm to complement Western economic philosophy and capitalist ideas has certainly become a reality but it still has a long way to develop, even in his own country, if it is to surpass the importance of interest-based banking on the global stage. Despite their rapid growth in recent years, the assets size of the top 500 Islamic banks (in 2007) amounted to only 0.7% of the total assets of the top 500 Western banks! However, the key features of Islamic banking – no charging interest, profit-and-loss sharing contracts, and the emphasis on asset-backed transactions – have meant that Islamic banks have shied away from the complicated securitized asset business that has collapsed Western institutions. (The most recent estimates suggest that by July 2009 the US government had dedicated around $3 trillion of taxpayer's funds to bailout its banking system). Islamic banks have also relied on abundant Muslim depositors rather than international debt markets to finance their growth, and profits have remained strong. Confidence in the reigning secular financial architecture has also been severely shaken and an increasing number of commentators are looking at the success of Islamic banking to see if lessons can be learned in formulating a new and safer operational and regulatory structure for Western banks.

While the short-term policy response to the Western financial crisis – injecting massive amounts of capital and liquidity into the U.S., UK and other systems - appears to have been effective (so far) in minimizing the likelihood of a deflationary spiral there is still extensive policy debate surrounding the longer-term implications of the crisis for the future architecture of the banking and financial system. When Jinnah gave his speech at the opening ceremony of the State Bank of Pakistan he noted that 'The Western world, in spite of its advantages of mechanization and industrial efficiency is today in a worse mess than ever before in history'. The same can perhaps be said of today given the impact of the credit crunch and collapse of Western financial systems. What will emerge is an new economic environment and financial structure informed by both Western and Islamic ideas that seeks to establish a safer and more equitable financial system founded more (as Jinnah would have wanted) on the principles of social justice and fairness to society than on the capitalist principles of avarice and greed.

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Table 1 Islamic Banking Sector Market Shares

	Banking Industry Of Pakistan		Islamic Banking (IB) Ind. Of Pakistan		Mkt. Share of IB (Percentage)	
Sector	**No. of Borrowers**	**Amount (Rs. Mln.)**	**No. of Borrowers**	**Amount (Rs. Mln.)**	**No. of Borrowers**	**Amount (Rs. Mln.)**
Corporate	26,061	1,520,130	1,959	62,784	7.5%	4.1%
SMEs Sector	185,039	437,351	2,685	12,535	1.5%	2.9%
Agriculture	1,415,353	150,777	159	13	0.0%	0.0%
Consumer Sector (other than staff loan)	3,025,463	371,421	36,533	28,843	1.2%	7.8%
Commodity Financing	2,616	148,447	31	1,118	1.2%	0.8%
Others	126,021	72,758	1,148	2,459	0.9%	3.3%
Total	**4,780,553**	**2,700,883**	**42,515**	**107,752**	**0.9%**	**4.0%**

Source: State Bank of Pakistan (December 2007)