

CONFERENCE AND WORKSHOP REPORT

ON

“ISLAMIC MODES OF FINANCING”

**HELD AT PESHAWAR
ON
10TH - 11TH NOVEMBER 2000**

**Submitted by: Association for Creation of Employment
To: Swiss NGO Programme Office.**

TRANSLATION OF SURAS FROM THE QUR'AN.
ON RIBA

Those who swallow down usury cannot arise except as one whom Shaitan has prostrated by (his) touch does rise. That is because they say, trading is like usury; and Allah has allowed trading and forbidden usury. To whomsoever then admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it) – these are the inmates of the fire; they shall abide in it [Sura 2:275]

Allah will deprive usury of all blessing, but will give increase for deeds of charity; for he loveth not any ungrateful sinner. [Sura 2:276]

Those who believe, and do righteousness, and establish regular prayers and give Zakat, will have their reward with their Lord; on them shall be no fear, nor shall they grieve. [Sura 2:277]

O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. [Sura 2:278]

If ye do it not, take notice of war from Allah and His Messenger; but if ye repent ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly. [Sura 2:279]

If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew. [Sura 2:280]

And fear the Day when ye shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt with unjustly. [Sura 2:281]

Golden Last Words

Prophet Muhammad's (SAWS) Last Sermon

This sermon was delivered on the Ninth Day of Dhul-Hijjah 10A.H, (632 A.D.) in the 'Uranah Valley of Mount Arafat' in Mecca.

“O People, Lend me an attentive ear, for I know not whether after this year, I shall ever be amongst you again. Therefore, listen to what I am saying to you very carefully and take these words to those who could not be present today.

O People, just as you regard this month, this day, this city as sacred, so regard the life and property of every Muslim as a sacred trust. Return the goods entrusted to you to their rightful owners. Hurt no one so that no one may hurt you. Remember that you will indeed meet your Lord, and that He will indeed reckon your deeds. Allah has forbidden you to take interest, therefore, all interest obligations shall henceforth be waived. Your capital, however, is your to keep. You will neither inflict nor suffer inequity. Allah has judged that there shall be no interest and that all interest due to Abbas bin Abdul-Muttalib (the prophet's PBUH uncle) shall henceforth be waived.

Every right arising out of homicide in pre-Islamic days is henceforth waived and the first such right I waive is that arising from the murder of Rabiya bin Al-Harith (relative of the prophet PBUH). O men, the unbelievers indulge in tampering with the calendar in order to make permissible that which Allah forbade, and to forbid that which Allah had made permissible. With Allah the months are twelve; four of them are holy; three of these are successive and one occurs singly between the months of Jumadah and Shaaban. Beware of Satan, for the safety of your religion. He has lost all hope that he will ever be able to lead you astray in big things, so beware of following him in small things.

O People, it is true that you have certain rights with regard to your women, but they also have rights over you. If they abide by your right then to them belongs the right to be fed and clothed in kindness. Do treat your women well and be kind to them for they are your partners and committed helpers. And it is your right that they do not make friends with any one of whom you do not approve, as well as never commit adultery.

O people, listen to me in earnest, worship Allah, say your five daily prayers, fast during the month of Ramadhan, and give your wealth in Zakat. Perform Hajj if you can afford to. All mankind is from Adam and Eve, an Arab has no superiority over a non-Arab, nor a non-Arab has any superiority over an Arab; also a white has no superiority over a black, nor a black has any superiority over a white except by piety and good action. Learn that every Muslim is the brother of another Muslim, and that Muslims constitute one brotherhood. Nothing shall be legitimate to a Muslim that belongs to a fellow Muslim unless it was given freely and willingly. Do not, therefore, do injustice to yourselves. Remember, one day you will appear before Allah and answer for your deeds. So beware, do not stray from the path of righteousness after I am gone.

O People, no prophet or apostle will come after me and no new faith will be born. Reason well, therefore, O People, and understand my words, which I convey to you. I leave behind me two things, the Qur'an and my example, the Sunnah, and if you follow these you will never go astray.

All those who listen to me shall pass on my words to others, and those to others again; and may the last ones understand my words better than those who listen to me directly. Be my witness O Allah, that I have conveyed Your message to Your people.”

Foreword:

The Supreme Court of Pakistan has decided that July 31st, 2001 is the cut off date for the country to change over to an Islamic Financial system. This is a challenge for the nation as a whole. It was felt that though there is information about various forms of lending in Pakistan, there are no practical models or demonstrations. These models and demonstrations can best be developed by applying Islamic Lending Principles to Micro-Finance first and then scale them up through commercial banks in a similar manner as what happened in the case of conventional Micro-Credit.

To develop a demonstrable model, Association for Creation of Employment held a one-day conference followed by a one-day workshop to achieve this end.

This Conference cum Workshop on Islamic Modes of Financing, supported by the Swiss NGO Programme Office (SNPO) was the first of its kind to be held at Peshawar.

As a result of this exercise not only were Islamic lending principles clarified, but in fact lending models for the most demanded loans were developed. These models were developed for Livestock, Agricultural Inputs and Trading/Shop keeping/Machinery loans.

I would like to extend special thanks to all those who participated and helped us develop these models and to the guest speakers, Mr Salman Syed, Director, International Institute of Islamic Economics and Mr Kaleem Iqbal, Vice President, Bank Al-Baraka to have taken out time from their busy schedules to share their knowledge and experiences with us.

We at ACE are most grateful for SNPO to have made this noble activity possible. I would especially like to mention the names of Mr. Ajmal Malik, Co-ordinator SNPO and Ms. Lubna for their valued support.

My special thanks to the Minister for Industries, Mr Awais Ghani for his encouragement and also to Mr Nauman Wazir of the Sarhad Chamber of Commerce and Industries.

Mostly I am grateful to Allah for enabling us all to serve His command.

We hope to further develop these models on the basis of implementing them at the field level. An indication from the Bank of Khyber that they might test these models is a source of great encouragement for us and we hope to contribute further to developing a truly Islamic based financing system.

Similar such exercises would further reduce the rift between the clergy and NGOs. Demands for more exercises of this nature have been demanded by various segments of society. We hope to continue with this effort InshAllah.

*Muhammad Zahid Elahi.
Executive Director, ACE.*

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INTRODUCTION:

Loans bearing a fixed rate of interest and exchanging like for like with an increase have been strongly prohibited in Islam. The Supreme Court of Pakistan has decided that all forms of lending based on fixed interest (Riba) would be stopped and the country will follow the Islamic Financial system after July 31st, 2001.

There is sufficient material describing Riba¹ and the various instruments that have been allowed in Islam and declared Halal. Unfortunately these descriptions have not been translated into implementable and workable models in Pakistan.

Practitioners of Micro-Finance in NWFP, whether Banks, Leasing companies or NGOs, are faced with the problem that approximately half the population is averse to taking loans on fixed interest. People would much rather remain poor than compromise on their faith. NGOs have particularly been very strongly criticised and attacked for this non-Islamic practice. There is growing resentment against the NGOs amongst the clergy and the rural poor mainly due to the fact that they are promoting un-Islamic practices.

The NGO sector in Pakistan has successfully adopted Micro-Finance models and has demonstrated that the poor are bankable and credit worthy. They have not however been able to develop user-friendly lending models.

Development is all about giving choices and alternatives. Poverty alleviation efforts cannot be effective or have the desired impact unless all or at least a majority of the poor can be reached. Poverty cannot be eliminated under the conventional system under which more than half the population would much rather remain poor than lose their faith.

The Islamic Financial System aims to maximise Social Benefits as opposed to the objective of profit maximisation under the conventional financial system. The Islamic system demands of financiers to have a new role of providing support and being informed about the market and viable businesses that are then closely monitored.

To create awareness and develop a practical model that can be implemented, ACE organised a one-day conference, which was followed by a one-day workshop. Eminent speakers from the International Institute of Islamic Economics and Al-Baraka Bank explained Islamic lending concepts and shared their experiences. During the workshop, the participants applied these concepts and principles to real life situations. As a result, lending models for Livestock, Agricultural Inputs and Trading / Shop Keeping/ Machinery loans were developed.

¹ Riba is the consideration paid either for the use of the money or forbearance from demanding it after it has fallen due. (Source: Supreme Court of Pakistan's judgement on Riba, dated December 24, 1999)

Riba is a discrepancy that results from the contractual obligations of a party in the context of a direct exchange of items of the same general kind between two parties. (Source: Blueprint of Islamic Financial System by the International Islamic University, Islamabad.)

EXECUTIVE SUMMARY:

A conference cum Workshop was held on 10th and 11th of November at the Agriculture University, Peshawar. Representatives of NGOs, Banks, Leasing Companies, Sarhad Chamber of Commerce and Industry, Academicians, Students and journalists attended the event. The Minister for Industries, Commerce, Labour and Mineral Development Mr Awais Ghani was the Chief Guest.

Adequate time was allocated during the conference on the first day for questions and answers so that concepts are clarified, setting the stage for the next day.

As a result of this exercise, lending guidelines on three principles allowed under Shariah² were developed, using the Instruments of Bai-Salam, Murabeha and Mudaraba. The principles were applied to real life situations pertaining to Livestock, Agriculture inputs and Trading / Shop keeping loans. For Livestock loans, existing practices at the village level were adapted on the basis of Mudaraba, Bai-Salam and Murabaha. For trading and Shop Keeping Loans, it was suggested that finances would be attracted on the basis of Mudaraba and then applied using Murabeha principles. Though extensive material is available on the theoretical aspects of Islamic based lending, there is almost nothing on practical aspects i.e. in the form of models as to how these principles would be applied to particular loan cases.

The conference and workshop focused on the lending side only. Details of deposits and other macro issues were not probed into. The main aim was to get models that can be immediately implemented at the micro level and then modified if necessary according to Islamic principles.

Very positive feedback has been from the clergy and Academia after the conference. The clergy have shown their surprise and appreciation that the NGO sector is working in a positive direction. It is hoped that this process would further diffuse tensions and misunderstandings between the clergy and Development workers.

Due to the extensive coverage received in the electronic and print media, people have shown great interest in knowing more about Islamic Modes of Financing. The Sarhad Chamber of Commerce and Industry and the NWFP Micro-Credit Network have also requested for such exercises to be repeatedly held.

A strong recommendation that there must be experimentation of these models and repetition of such exercises came from the participants of the workshop as well as the Minister for Industries. Generally, people have demanded information material to be distributed widely so that awareness is raised amongst the general public enabling the to know what to demand and how to enter into contracts that are allowed in Islam.

² Shariah: Islamic Law.

PROCEEDINGS OF THE WORKSHOP

DAY-1

The Executive Director ACE, Muhammad Zahid Elahi presented his paper in which he highlighted the main differences in concepts and objectives of Islamic Finance and the Conventional system.

He made an interesting comparison between the Labour Theory of Value of Karl Marx and how if Capital is treated as a value rather than a mere factor of production in the same way as Karl Marx treated Labour, this would lead us to an Islamic Financial System.

He explained that the ultimate objective of Islamic Banking was the maximisation of social benefits through creation of healthier financial institutions for the betterment of the masses rather than just a handful. The objective of interest based lending is profit maximisation irrespective of whether someone is made worse off during the process.

He briefed the participants about the current scenario and the difficulties that could be encountered while implementing such a system. He also made a comparison between the definitions of money under Islamic law and the definition of money in contemporary economics.³

Dr. Salman Syed, Director, International Institute for Islamic Economics highlighted the basic principles of lending and conditions that must be met for legitimacy of contracts. He briefed participants on Shariah and conditions for contracts to be legitimate under Islamic law.⁴ He also explained the various modes of Islamic Finance.

In reply to a question as to whether profit and loss should be calculated on the basis of investment, he said that Islam allows profit loss to be negotiated between two parties so that higher productivity of one partner or the additional services one provides could be adequately compensated for. Regarding loss, it has to be calculated on the basis of investment, since loss means the loss of wage for services which has to be borne by both in the shape of no profit.

Regarding how to apply Islamic mode of financing to Micro-Credit and its practicality, He said that this is not the problem of Micro-Credit alone. The interest-based system is simpler, but even with its simplicity it does not appear to be working efficiently. He was of the opinion that something similar to the Grameen Bank model could be applied to Micro-Credit, such as the group based lending system, which provides for internal monitoring. Collection costs could also be reduced this way.

³ Presentation at annex-2.

⁴ Presentation is given at annex-3

Regarding who would be willing to come for profit and loss sharing, he said that successful and profitable businesses might avoid such a contract, whereas on the other hand riskier and less profitable businesses would prefer such a system. Successful businesses, he said could be involved by negotiating the profit ration with them. Regarding the role of banks and fee charged for inter mediation, Dr. Salman replied that this would be allowed, but we need to see what banks are doing and how they are doing it. He cited the example of Estate Agents providing the service of a facilitator. What banks do is, they take money, own it and then lend to the other party. There are two contracts here; one between the bank and the depositor and the other between the bank and the borrower. The fee of investment banks he said is Halal, but banks are not practising this.

In reply to an analogy drawn by one participant between game of chance and profits that are not pre-determined, he said that Islam does not prohibit risks. In interest bearing contracts the bank avoids risk and shifts it to someone else.

Mr Kaleem Iqbal, vice-president of Bank Al-Baraka said that the phenomenon of Islamic Banks is not new. There are currently 200 Islamic Banks operating in 48 countries, managing funds amounting to \$120 billion. In Pakistan, he said that the concept of Islamic banks was introduced 20 years back but the level of commitment required is still not there. He explained that the Islamic system is equity based whereas the present system is debt based. He quoted the example of Haji Taboong Company in Malaysia⁵. In the last 10 years, he said conventional banks declared 3 to 4% interest whereas Haji Taboong declared 7 to 8% dividend.

He said that there are more than 10 Islamic banks that are amongst the top banks of the world. Conventional banks, he said are now convinced and are coming towards Islamic products, such as Citibank. Amongst the top 30 Banks of the world, 6 are Islamic Banks.

He said that though Bank Al-Baraka was presently dealing only in Mudaraba financing, its objective is to introduce the ideal Musharika based financing. Presently the bank keeps 30% of the profit for meeting its expenses and the rest 70% goes to the depositors. Before the profit is distributed, the bank gets its accounts vetted and approved by scholars including Maulana Taqi Usmani.

Mr Kaleem Iqbal⁶ explained the conventional model through an equation of Money = Money = Money, where money does not transform itself at any stage during the process of deposit, lending and then recovery. Under the Islamic system, the equation becomes Money = Commodity = Money. I.e. Money when deposited changes its form, the commodity is employed in productive purposes and is then repaid in money.

⁵ Haji Taboong Company was allowed by the Government of Malaysia to take deposits of Hajis and appointed the company as the sole company for sponsoring Hajis. The company invested surplus money into producing goods and providing services.

⁶ Mterial provided giving diagrammatic representation of lending principles is given at annex-4

Towards the end of the first day, Muhammad Zahid Elahi presented a summarised version of the various lending principles⁷

DAY-2:

Muhammad Zahid Elahi summarised the proceedings of the first day in the morning session. The participants then split into two groups to work on the three most demanded loan types, i.e. Livestock, Agricultural inputs and Trading / Shop keeping. The models developed are given below:

GROUP-1:

Case1: Livestock on basis of Mudaraba: {Funds for productive activity on basis of sharing profit / loss}

A buys a cow and gives it to B for maintaining it and sharing produce on 50:50 basis. Expenditure on maintenance is borne by both parties on equal basis. In case of mortality, A would bear all the loss being the owner of the cow i.e. ownership is not transferred but profits are shared.

This system of lending is currently being practised in rural areas of Swabi and Charssada. It is a traditional system based on Islamic principles and is being applied to livestock. The only difference here is that a third party is involved. This calls for incorporating the role of a person (village based activist) for Recovery and Monitoring of the loans.

Functions:

A	B
Investment (cow)	Services and care
Feed cost 50% in case it is purchased	Feed cost 50% in case it is purchased
Shelter construction 50%	Shelter construction 50%
Treatment 50%	Treatment 50%

Profit:

Revenues from the sale of Milk, Offspring and Farm Yard Manure are shared on 50:50 basis.

Risk:

A loses his capital and business in case of mortality.

B Loses his business in case of mortality. In case of wilful default and cheating, he loses his credibility for further loans.

Risk Management:

⁷ Please refer to annex-2

A	B
Purchases good quality cow	Purchases good quality cow
Shares 10% of profit with activist for Recovery and Monitoring	Receives training in care of animal
Purchase of cow through experts in consultation with client	Links up to veterinary hospital
Obtains information on honesty and credibility of client from community members	Obtains market information
Written contract	Written contract

The contract is void if either party fails to abide by it.

Case –2 (a): Agriculture inputs:

A – Murabaha: {Purchase of goods and their sale at a declared profit.}
 NGO purchases seed, fertiliser etc for onward selling to client at a declared profit.
 Repayment time is fixed in the contract (say, 6 months).

Functions:

NGO	CLIENT
Purchase of input from market	Needs agriculture inputs and purchases them from A with repayment at a future date (say, 6 months)
Provides input at cost + profit (say, Rs.100 per bag)	Agrees on rate of profit.
Written contract	Written contract

Risk:

NGO	CLIENT
Delayed Payment	Loss or no profit
Capital gets stuck	Credibility is lost
Default of B	

Risk Management

NGO	CLIENT
Written Contract	Written contract
Feasibility (Land, Crop, Water, Weather, Disease, type of seed used, etc)	Feasibility
Pre-condition for calamities i.e. provision for new contract for refinancing next crop	Market information
Market information	Rate of profit should be realistic
Rate of profit (not principal) should be flexible in case of depressed markets	Clause for new contract in case of natural calamities
Involvement of community group	

Case –2 (b): Agriculture inputs:

Bai-Salam: {Advance payment – forward buying with 100% cash in advance}

NGO provides finance for seed, fertiliser etc to client on basis of return in terms of produce (Wheat, Maize etc). Repayment time is fixed in the contract (say, 6 months).

Functions:

NGO	CLIENT
Cash worth say, 10 bags of wheat at current price	Purchases seed, fertiliser, etc
Involvement of community group	Repays 10 bags of Wheat of agreed quality after determined period.
Written Contract	Written contract
Feasibility (Land, Crop, Water, Weather, Disease, type of seed used, etc)	Feasibility
Pre-condition for calamities i.e. provision for new contract for refinancing next crop	Market information
Market information	Rate of profit should be realistic
Rate of profit (not principal) should be flexible in case of depressed markets	Clause for new contract in case of natural calamities

Risk:

NGO	CLIENT
Delayed Payment	Loss or no profit
Capital gets stuck	Credibility is lost
Default of B	

Risk Management

NGO	CLIENT
Written Contract	Written contract
Feasibility (Land, Crop, Water, Weather, Disease, type of seed used, etc)	Feasibility
Pre-condition for calamities i.e. provision for new contract for refinancing next crop	Market information
Market information	Rate of profit should be realistic
Rate of profit (not principal) should be flexible in case of depressed markets	Clause for new contract in case of natural calamities
Involvement of community group	

GROUP-2:

Trading, Machinery etc on basis of Mudaraba – Murabeha Mix:

{Funds for productive activity on basis of sharing profit / loss collected from investors then Purchasing goods and selling them to clients at a declared profit.}

The group presented this model on the basis that one party has funds and the other has the expertise to invest them. Both these advantages are used to generate profit. The group did contemplate provision of livestock loans using these instruments but found that these instruments were not suited for the purpose since the animal remains the property of the investor. In case the animal is returned, this would result in a loss. It was there fore decided to test the instruments on other businesses where products are bought and sold in such a way that the main commodity gets consumed. It was therefore decided to on-lend on the basis of Murabaha while generating investments according to Mudaraba. Collateral would be taken up to the value of the business.

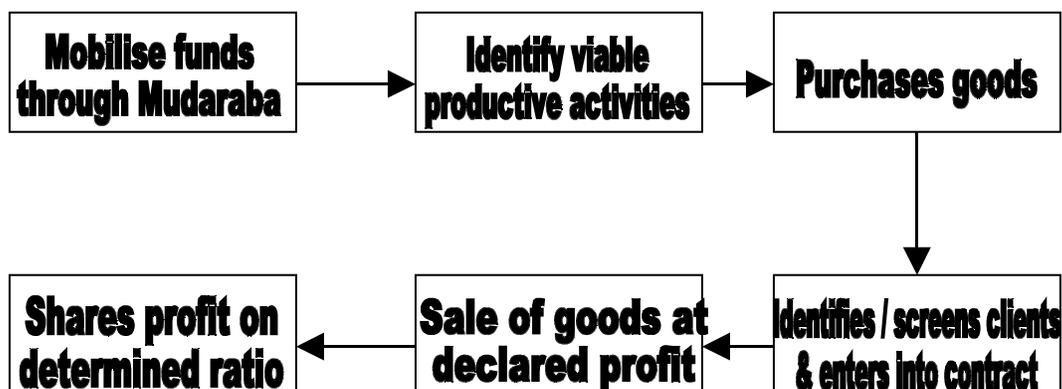
Mudaraba – Lending institution collects funds on the basis of Mudaraba from investors willing to invest their money on profit and loss basis. These funds are then provided to clients, where the lending institution provides a service of intermediation and the client contributes his / her expertise.

Profit between Rab-ul-Mal (one who contributes funds) and the lending institution are shared on agreed upon ratio (say, 30% to intermediary and 70% to Rab-ul-Mal).

The role of the lender is discussed and clarified to Rab-ul-Mal and demand for productive activities assessed by intermediary.

Here we assume the demand is for Machinery, Equipment, Finished goods (for trading) and manufacturing. Goods and equipment are provided on credit.

The role of the intermediary would be to:



CONCLUSION:

This activity was the first of its kind in NWFP. According to a survey and need identification conducted by Bank Al-Baraka, NWFP is a market most suited for introducing Islamic lending. It is for this reason that NWFP is a priority for the Bank to extend its branch network.

Similarly, Islamic based lending is a dilemma for most Micro-Finance Institutions who do not have instruments to target the poor. The instruments that are being used are based on conventional principles and have been replicated in the local environment. A natural adaptation to the local situation and demand would be to make amendments according to the Islamic system. NGOs practising Micro-Finance have developed models of lending to the rural poor based on community participation and social collateral. This aspect of lending has been incorporated in the models suggested here.

The challenge now is to implement these models and further develop them on the basis of action research. This would require educating clients on Islamic lending principles and gaining their trust that these instruments are truly Islamic.

Presently some of these lending principles are already being practised in NWFP. Other principles that have been dubbed Islamic are not so. These include usurious loans from bargain centres⁸ and loans taken from arthis⁹.

In summary, the system is usurious and requires revamping by those in a position to research and implement. Some large NGOs have shown little interest in Islamic lending since they do not believe they would receive donor support for it. This is a weak case since the development of Micro-Finance models is a dynamic process and will continue its transformation until majority of the rural are serviced and poverty alleviation efforts are earnestly targeted.

⁸ Cars are sold to persons requiring a loan. The car is then bought back at a higher rate resulting in a loan. If payment is not made within the required period, there is another sale and the loan is thus marked up.

⁹ Arthis are market dealers that provide loans for agriculture and consumption purposes. In return they purchase agriculture produce at lower rates.

LIST OF PARTICIPANTS

NAME	ORGANISATION
1. Qaiser Butt	Daily Mashriq
2. Muhammad Riaz	Daily Dawn
3. Ms Attiya Rashid	First Women's Bank Limited
4. Ms Bushra Ehsan	First Women's Bank Limited
5. Javed Akhtar	SWSS Swabi
6. Mr Adeel	Swiss Development Cooperation
7. Liaqat Ali	SBRC Swabi
8. Khurram Nawaz Saodzai	Agriculture University
9. Muhammad Tayyab	Agriculture University
10. Imran Shamsi	Agriculture University
11. Waqar Ahmed	IUCN – SPCS Support Unit
12. Mushtaq Yousafzai	The News
13. Abbas Jan	Agriculture University
14. Muhammad Idris Qazi	Director Research Planning
15. Sajjad Ahmed	Institute of Business Management Studies
16. Amjad Zeb	Trust for Voluntary Organisations
17. Shakeel Mir	Orix Leasing Corporation Limited
18. Raja Sohaib	The Bank of Khyber
19. Aamir Saleem	The Bank of Khyber
20. Arif Yousaf	Khwendo Kor
21. Iftikhar Ali	Environment Protection Society Swat
22. Nabeela Ghani	Sarhad Rural Support Corporation
23. Sultan Tiwana	SMEDA
24. Mr Sultan	MD Small Industries Development Board
25. Ms Abida	De-Las Gul
26. Dr Rasheed Farouqi	Dean, Islamia College Peshawar
27. Faheem Afridi	Agriculture University
28. Mufti Fasih-ur Rabi	Agriculture University
29. Waseem Farouq	Agriculture University
30. Muhammad Amir	Agriculture University
31. Shehnaz Arifullah	Institute for Development Studies
32. Siddique Akbar	Institute of Business Management Studies
33. Suleman Aflatoun	Institute of Business Management Studies
34. Amir Usman	Institute of Business Management Studies
35. Shabir Ahmed Khan	Institute of Business Management Studies
36. Javed Akbar	Institute of Business Management Studies
37. Sajjad Ahmed	Institute of Business Management Studies
38. Ashfaq Ahmed	Institute of Business Management Studies
39. Saif-ullah kahn	Institute of Business Management Studies
40. Qasim Jan	Institute for Research and Development Studies

ANNEX-2

Presentation of Muhammad Zahid Elahi. Executive Director, ACE

Ultimate objective

of

Islamic Financing

is

Social Benefit Maximisation

through

Creation of healthier financial institutions

to

serve the needs of the masses,
rather than just a handful.

Manage rather than avoid risk

SCENARIO

Investment in productive sector is declining whereas that in non-productive sector is rising. Investors invest in stock exchange, property, real estate, etc.

Skewed distribution of income.

In a culture of speculation, manipulation dominates the minds of people rather than hard work. This leads to a financial and social crisis.

Finance houses have little information and are not equipped for advisory and support services that would enable accurate identification of viable enterprises and support Business Management and other functions.

Musharakah financing is applicable to and is capable of bringing benefits to the rural community.

Large numbers of rural poor do not take loans bearing fixed interest.

WHAT IS MONEY

Traditional Economists have defined Money as a commodity and a factor of production.

Karl Marx distinguished Labour Value from labour as a mere factor of production.

The same way that Labour Value embodies itself in a product, so does money.

In Capitalism, Exploitation is caused by Capital.

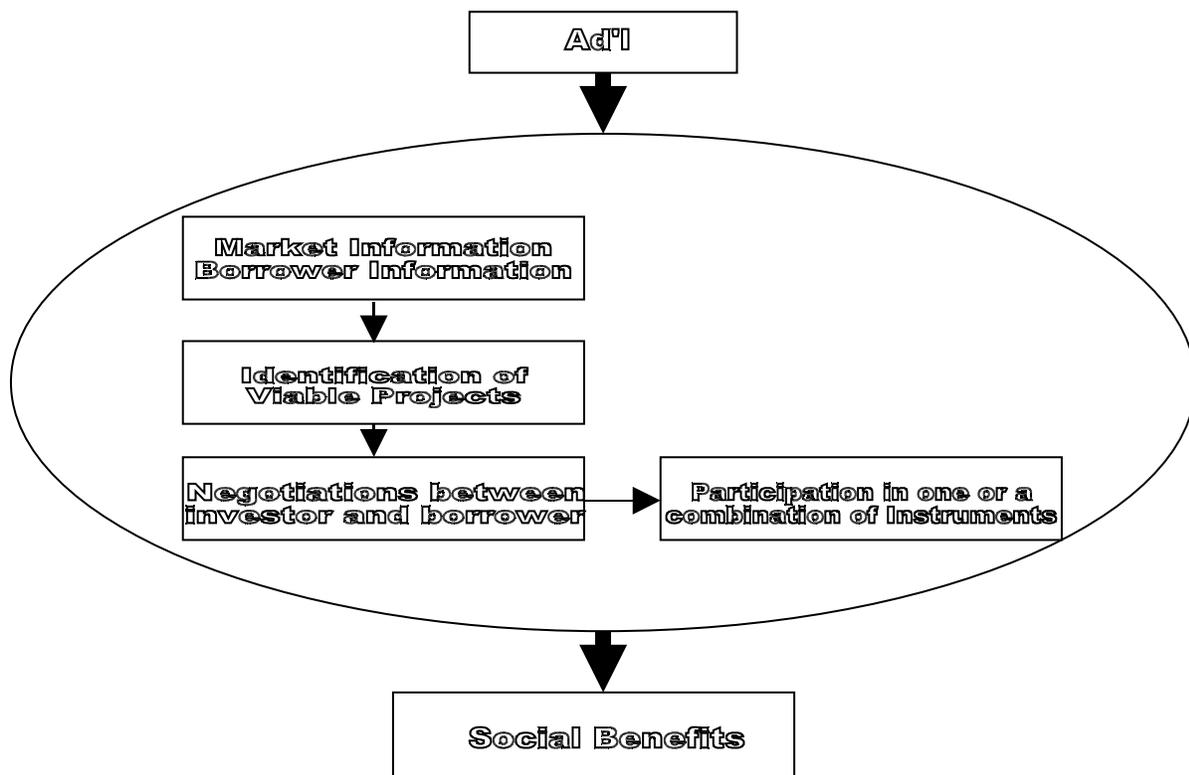
In Islamic Finance, Money is treated as value and not a commodity.

Islamic system prevents exploitation of Human Beings by treating money as a value and not a commodity. Thus also resulting in even distribution of wealth.

Profit is generated under the Islamic system when something having intrinsic utility is sold or offered for use.

MONEY HAS NO INTRINSIC VALUE

<u>Islamic System:</u>	Relation of Investor – Partner
<u>Conventional System:</u>	Relation of Creditor - Investor_



RISK AND UNCERTAINTY

Risk in both the systems can be calculated and uncertainty exists in both the systems also. In the Islamic system, risk is borne by both, but risk of finances is borne by the investor alone.

Risk	Uncertainty
If randomness facing an economic agent can be expressed in terms of specific numerical probabilities	Situations where the agent cannot or does not assign actual probabilities or alternative possible occurrences are said to involve uncertainty.
Can be calculated from experiences	Cannot be calculated from experiences.

SHARIAH COMPLIANT RISK MITIGATING FACTORS

1. By agreement the lender would have a priori right in profit sharing up to an agreed upon ratio.
2. Profit will be paid on monthly basis as provided in projected accounts.
3. Final accounting and settlement at the end of term of instrument when profit and loss accounts are finalised.
4. In order to mitigate the risk a term is included in the agreement for establishment of a takaful fund for the term of the instrument
5. Investor earmarks a part of reserves for the takaful fund (1% advance on future expected / projected profits)
6. In case of loss, the loss will be adjusted against the takaful fund; balance will be distributed between investor and borrower at the end of the term.
7. Through a valuation, value of the investment would be established for the purpose of exercising the put option.

MUSHARAKAH

A person has initial investment and additional finance is provided to the party on the basis of sharing profits from the business.

The ratio in which the finance provider shares the profits of the business with the borrower is fixed and predetermined and is made known to all in advance.

The loss will be shared in the exact proportion of the capital invested by each party.

The profit sharing ratio is left to be mutually agreed between the two parties and may be different from the ratio in which the two parties have invested in the total capital of the project. This difference would be due to management functions of the project performed by each party e.g.: marketing, management etc.

Musharakah and Mudarabah are similar because investor shares in profit and bears the losses (if any), to the extent of his investment. Repayment therefore depends directly on the productivity of the enterprise.

This mode is not preferred because:

- Return is not predetermined.
- Investor has to study and evaluate proposals which requires highly qualified personnel
- Investor has to find adequate measures for protection against manipulation of profits
- Investor needs to identify viable projects with quick break-even and profitability.

Salient Features:

1. Short term financing
2. Investment in form of sanctioning funding limit to the client. Degree of employment of funds is determined on basis of daily product of outstanding balances due to the investor.

MURBAHAH

This is a cost plus financing contract. A person wishing to purchase equipment or goods, requests the investor to purchase the items and sell them to him at a cost plus declared profit. Purchase and delivering is a service which can be paid for and whose value is pre-determinable.

i.e. Cost of product + Credit price + Service for purchase and delivery

The mark-up is not related to time. If payment is not made on time, the mark-up still remains fixed as in the contract. There is no increase due to delay.

Interest does not vary at all. It is independent of the monetary value of the transaction and independent of the goods and services transacted.

The inherent risk is that the borrower may not accept quality or price of items purchased.

Four conditions have to be met for charging a higher price for a credit sale:

1. The buyer must be told that the price is a credit price.
2. Difference between credit and cash price must be made known to him.
3. Buyer must be given the option to buy at either price.
4. Transaction must be a trade transaction as distinct from a purely financial one.

BAI-SALAM

Advance payment or forward buying. I.e. sale of a good delivered to the purchaser at a future date {Date must be set in the contract}.

Conditions:

- Goods are not available or cannot be delivered at the time of contracting.
- Consideration in lieu of advance payment must be paid or the rate of it fixed at the time of the contract.
- Salam is void if the buyer's consideration is in the form of a set off or negation of an existing debt.
- Allowed only for Fungible objects {Non-fungible objects are precious stones, paintings, and antiques etc, which are unique and by their nature cannot comply the condition of determination, and are therefore not allowed}.

- Risk stays with the seller until the time of delivery.
- Purchaser has a right of inspection and may reject on sight if they don't agree with the description as specified at the time of contract.
- The price agreed in the contract must be paid immediately and in full in cash at the time of contract.
- The delay after which goods are delivered must be a defined period.
- Goods must be of a type commonly available at time of delivery. {Contract must not specify delivery from a location or plot}.

ISTISNA

This is a contractual agreement for processed goods and commodities, allowing cash payment in advance and future delivery, or a future payment and future delivery.

Such an agreement allows investors to pre-sell to clients for future delivery on cash-on-delivery basis and then negotiate purchase.

It is currently being used as short-term working capital finance.

This instrument has the potential to replace Murabaha.

LEASING PRINCIPLES

1. Asset based Finance
2. Assuming a risk element connected to ownership of the asset.

Basic rules of Leasing:

1. Contractual agreement
2. Has to be a valuable use of the asset and transferability of *Usufruct*.
3. Ownership retained by lessor throughout the lease period. Consumable items cannot be leased.
4. Risk and ownership lie with lessor. Except in the case when loss is caused by misuse or negligence by lessee
5. Risk and liabilities with the use of the asset are borne by the lessee (Taxes & other government levies, such as utilities etc.)
6. Term of the lease, its period, renewal or early termination must be stipulated.
7. Purpose of use – Cannot be used for any other purpose than that leased for.
8. Commencement from date of delivery and not from the date of contract
9. Rent must be determined for the entire period at the time of the contract
10. Different rates during different periods are permissible.

ISSUES PERTAINING TO LEASING

1. Joint ownership is permissible
2. Insurance – Islamic Takaful to be established by owner
3. Renewal or variation in Lease period is permissible only if mutually agreed upon.
4. Lessee can acquire asset on part of lessor as agent. This way two relationships are created one after the other.
5. Rentals:
 - i. Advance rentals are permissible subject to adjustments against actual rentals when due.
 - ii. Unilateral increase by lessor not permissible even if provided under contract
 - iii. Adjustment of inflation etc is permissible, if clearly stated according to state figures.
6. Penalty for late payment is not permissible. In case of unscrupulous elements a penalty can be fixed but cannot be retained by the lesser. This penalty must then be given for charitable purposes.
7. Premature termination is allowed if terms of lease have been contravened, or through mutual agreement.
8. Asset reverts back to lessor. It can be gifted to the lessor in the end. No lease amount beyond the contract is permissible.
9. Transfer on the basis of residual value is not permissible. However, scholars are debating this point. Gift or token price separate to the lease agreement can be binding on lessor on the option of the lessee.
10. Leasing and sale purchase are two separate transactions and should not be mixed in one contract.
11. Sale and lease back are allowed as two separate transactions.
12. Sub-Lease is allowed subject to the consent of the lessor and can be expressly outlined in the lease agreement. There is some controversy on proceeds from the sub-lease. Some say residual value can be retained by borrower; others say surplus goes to investor.
13. Lessor can sell the leased asset to a 3rd party. Relationship between lessee and lessor will be determined between new lessor and lessee. Lease cannot be assigned to a 3rd party without transferring ownership for a monetary consideration or without.
14. Rent alone without ownership cannot be secured. Lease can be made wholly to one party or partly to a number of persons.

PRE-CONDITIONS

- ❖ Close Monitoring and Follow up
- ❖ Partner – Client Relationship for problem solving {Human resource at Universities could be utilised}
- ❖ Close proximity of business location for supervision, easy contact and regular deposit of sale proceeds
- ❖ Islam encourages us to go into the business arena and manage risk rather than avoid it.
- ❖ Bond of brotherhood – family
- ❖ There must be risk
- ❖ Losses be shared in proportion to capital contribution
- ❖ Liability not to exceed the amount of capital invested
- ❖ Loss in one period may be offset against profit in subsequent periods until entire loss has been written off and capital sum restored to its original level.
- ❖ Definite or indefinite period
- ❖ Clear contractual agreement

The issue of bank deposits, distribution of profit amongst depositors or management of balance sheets, role of judiciary etc will not be covered in this workshop.

DIFFICULTIES ENCOUNTERED IN ISLAMIC FINANCE

- 1) Absence of legal framework
- 2) Lack of adequate infrastructure in investment field.
- 3) Concept that money should be treated as any other factor of production and earn a return over time.
- 4) It is argued that establishment of Large Scale Enterprises is not possible unless finances can be mobilised on the basis of paying interest. {Argument: The more profitable businesses will be inclined towards conventional banking}.
- 5) Banks in Pakistan were legally prohibited from entering into trade or industry.
- 6) Mudarabah degenerated into lending on mark-up since banks limited most of their financing to buying and selling through prospective buyer as agent. They did not assume the role of trader.
- 7) Lack of seriousness and dedication.
- 8) Depositors accustomed to keeping their money safe and earning known return... morality issue.
- 9) Changing system requires sacrifice
- 10) Difficulty of investing surplus cash
- 11) Government or political leaders have not been able to create a proper environment based on *Ad'l*.

An inflation free economy is required. Printing notes to meet budgetary deficit is an injustice to the public and government borrowing at high interest rates has taken domestic and foreign debt to a level that cannot be sustained.

DEFINITIONS

Leasing:

Financial claim of monetary value with recourse to underlying durable assets and related cash flows. There is a predictable future income stream and is marketable, with the option of being discounted, but the transfer is of the title and not of the debt.

Ijara, mudaraba, musharaka mix:

It is a financial claim of monetary value and is partly backed by durable assets. The income stream is not predictable and is evaluated through an asset valuation process at the end of an agreed and declared duration. Debt may be traded in the secondary market at its fair market price acceptable to parties involved but not discounted.

Mudaraba, Istisna mix:

It is purely a monetary claim to an expected income stream forthcoming from an underlying commercial transaction. Income is evaluated through an asset valuation process at the end of an agreed and declared period. Cannot be discounted but may be traded at the end of each accounting period. These are debt claims against 3rd parties in respect to actual commercial transactions.

Qrad-e-Hassana:

Purely financial claim of monetary value but with recourse to certain precious metals or commodities quoted on the exchanges. Does not carry an income or revenue stream except that its price is pegged to the price of metals or commodities. It can be traded but not discounted.

Provided to a client having cash flow problems either to protect investment or boost investors' image and reputation at no great risk.

ANNEX-3
MODES OF ISLAMIC FINANCE
ORIENTATION SEMINAR ON ISLAMIC ECONOMICS, BANKING AND
FINANCE

By: Dr Salman Syed

PURPOSE OF SHARIAH

1. Protection of life
2. Protection of wealth
3. Protection wisdom
4. Protection of faith
5. Protection of Nasal

VALIDITY OF SHARIAH

1. Free will
 2. All contracts are permissible unless prohibited
 3. Should not be against the objective of Shariah
 4. Free from riba
 5. No Gharar
 6. Free from Khalaba
 7. Free from Jalal
- Principles more specific to Financial contracts
8. Al-Kiraj-u-Bidaman (Right of benefit goes with responsibility of liability)
 9. Prohibition of sale of debts with debt
 10. Prohibition of contingent contract
 11. Prohibition of combining two mutually inconsistent contracts
 12. Prohibition of element of gambling in contract
 13. Debt is settled only by its payment or forgiveness from the creditor.

MUSHARAKAH (PARTNERSHIP)

<p>Mufawadah: All partners are treated equally Profit sharing ratio is predetermined All partners are trustees of each other</p>	<p>At conclusion / winding up of Musharakah all assets / liabilities are distributed according to each partner's share in investment Any change in investment shares or mergers allowed only with the permission of all partners</p>
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MUDARABAH

It is of two types:

1. Limited to purpose or period

2. Open.

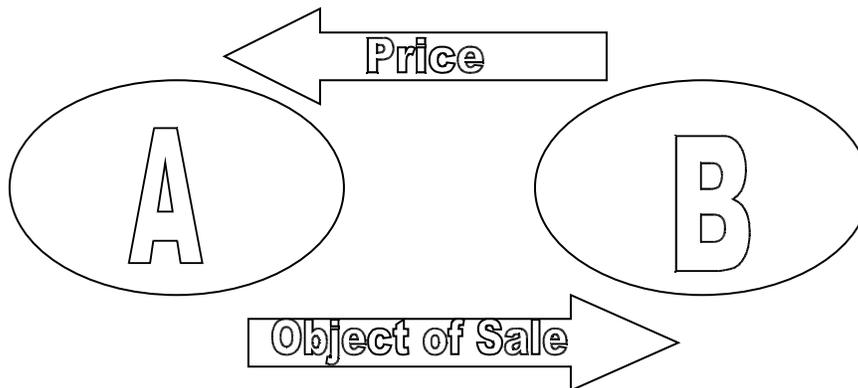
RULES RELATED TO MUDARABAH

- All rules of shirkah carry over to Mudarabah
- Normally, Capital comes from one party and work / effort from the other (executive partner)
- An executive partner can also put-in his capital if others agree
- Profit can be shared on any pre-negotiated ratio, but loss is distributed according to the investment share
- Mudarib can enter into sub-mudarabah, re-mudarabah or musharakah with a third party with prior approval.

TRADE RELATED MODES

- Bai-Muajjal
- Bai Salam
- Bai Istisna
- Murabaha

BAI-MUAJJAL



RULES FOR BAI-MUAJJAL

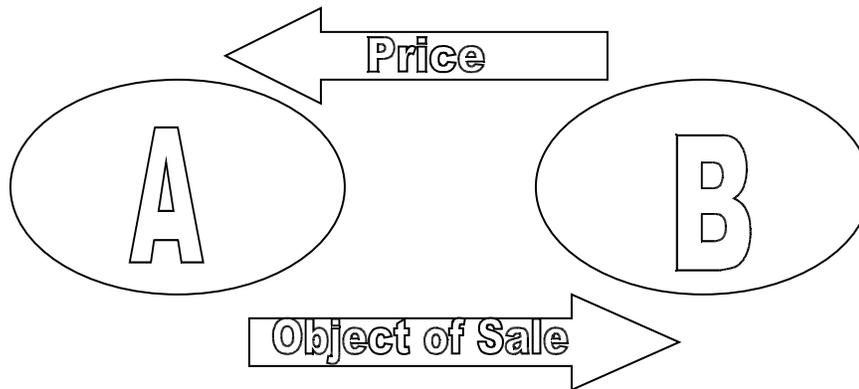
Price is deferred

Due date of payment has to be fixed with certainty not with reference to some event based on probability

Deferred price can be more than spot price but should be fixed at the time of the contract

Once assigned no adjustment in price is possible relating to early or delayed payments

BAI-SALAM



RULES FOR BAI-SALAM

- Spot payment of full price
- Detailed specification of the subject
- Time and place of delivery are specified
- Sold commodity must be found in the markets throughout the period of Salam
- Resale without accepting delivery is prohibited (*)

BAI-ISTISNA

- Applicable to manufactured items
- Price and the commodity can both be deferred; it can be made in instalments
- Price is known and the subject is specified in detail
- Sale is binding. Buyer can exist the contract only if manufactured item is not according to the specifications.

MURABAHA

- Originally a spot sale
- Seller declares his cost
- Asks for a marked up price
- Therefore, Murabaha is only valid when exact cost can be ascertained

MURABAHA PROCEDURE

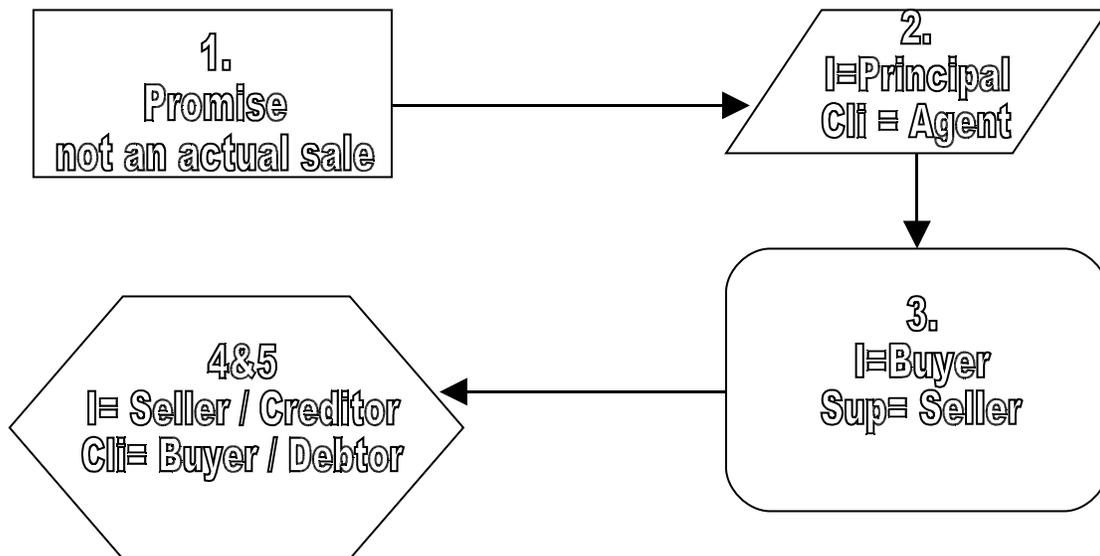
1. Sign an agreement of promise to buy and sell a specified commodity at an agreed marked up price
2. Client can be appointed as agent
3. Client can purchase commodity on behalf of the institution

4. Client informs the institution that purchase has been made on its behalf, and offers to buy for himself
5. The institution accepts the offer, and the sale is complete

MOST ESSENTIAL ELEMENT:

Commodity must remain in the risk (property) of the institution during the period between the 3rd and the 5th stage.

VARYING NATURE OF RELATIONSHIPS



Annex-4

ANNEX-5
SWOT ANALYSIS

STRENGTHS	WEAKNESSES
<p><u>Lender:</u></p> <ul style="list-style-type: none"> • Fulfilment of aspiration of Islamic code of conduct • A very high rate of return as compared to fixed rate of interest. • An equitable way of supporting businesses and productive activity. <p><u>Intermediary:</u></p> <ul style="list-style-type: none"> • Role not only of on-lender but that of a business house providing services • Can have a high service charge without fear of loss because there is no liability of assets as such. <p><u>Overall:</u></p> <ul style="list-style-type: none"> • A less frustrated and less exploited society • Positive Macro-Economic effect with more loans and less collateral • More effective mobilisation of excess resources. 	<p><u>Investor:</u></p> <ul style="list-style-type: none"> • Without fixed return and fear of losses, savings rate may fall and money put to less productive uses. • Relies on honesty and morality
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Employment generation • Greater trust of the public and payment of zakat • Greater social benefits • Voluntary resources may be provided for Qard-e-Hasana • Equal distribution of wealth • Development and strengthening of community groups • Social benefit maximisation against sole objective of profit maximisation • Change in Capitalist approach • Concept of equality according to Islam can be developed • There is more Barkat 	<ul style="list-style-type: none"> • Implementation not easy initially • Banks can not enter into agreements quickly (timely provision of loans) • Certain instruments may not be offered due to constraints of prudential regulations • Financial constraints – Finances may not be available for such lending • Opposition from traditional system • Difficult to explain to layman i.e. more awareness is required • Little time to implement • Imperative to get it right the first time around. Mistakes would be fatal for longer-term adoption of the system.

Speech by Mr. Awais Ghani (Minister for Industries, NWFP)

Informal credit system in rural areas is without question unfair and unjust. It has played and will continue to play a vital role in forcing rural and urban migration.

So..... do we blame the informal sector, or the formal one? Well, both! Because the informal system is exploitative and the formal system is meant to serve the needs of the urban society only.

Project financing requires hard work, commitment and responsibility in identifying viable projects to bring a real change in the society, in both the urban and rural areas. Banks were until 1984 not allowed to participate in Trade and Business. The necessity to do so was further reduced as the Islamic lending instruments were misinterpreted and were not applied in their true spirit. The experiences and expertise of Banks therefore requires strengthening. One way to do this is to establish strategic alliances with the more flexible and innovative NGO sector.

Is it fair that farmers work very hard for survival and yet are taken advantage of and left in debt all their lives?

If we are responsible people who understand our mission as vicegerents of God on earth, then we should not leave matters to worsen, but create an alternative system based on practices that are just and fair.

Rural communities are our partners in development since the participatory community development approach is based on the principle of mutual trust. Communities are entrusted with funds for infrastructure and other development schemes as partners.

Why is this then not so in the case of Micro-Finance? Where a partnership of financier and investor could be established and must be according to the teachings of Islam.

Delays and defaults are penalised rather than understood. As long as the client is paying, all is well. Irrespective of how he or she is managing the payment. While approving loans, alternative sources of income are the main consideration rather than viability of the business.

The system of Islamic Finance will reduce exploitation and if widely implemented will also stop inflationary pressures on the economy.

Economists term profit maximisation as the sole objective of corporations. This view however can neither be supported nor defended since profit maximisation may lead to perverse outcomes. When financial operations are removed of moralistic tone, competitive markets fail to achieve the efficient allocation of a country's resources.

Profit Maximisation irrespective of whether earning profit has made someone else worse off should not be our objective as Human beings and Musalmans.

The focus of this Conference cum Workshop is to work on developing models for Micro-Finance. Such a model I trust will be tested and hopefully replicated for national interest.

I urge all those agencies present here to try and test the models developed here and further refine them for replication at a larger scale. It is our National commitment to remove all forms of usurious lending in the country by June 2001. There are rulings of the Federal Shariat Court and the Supreme Court of Pakistan on this. We have to face the reality and contribute to this noble cause.

Speech delivered by Muhammad Zahid Elahi

Ladies and Gentlemen.

I am most grateful to all of you that you have taken out time to be with us today and be part of a team that would InshAllah carve a new dimension in the field of development in Pakistan. I am confident that we will all be here tomorrow as well, even though Saturday is not a working day for many of us.

People have doubts and arguments regarding interest.... So did I. I have studied and probed into this issue in depth and arrived at the conclusion that no matter how we justify fixed term and fixed rate of interest, it has been clearly and strongly disallowed in Islam.

NGOs have the credit of introducing Micro-Finance in Pakistan, which has now been adopted by the Government of Pakistan and many Commercial Banks. I strongly feel that a model of Islamic Micro-Finance can also be developed through a similar strategy, on the basis of the innovation and flexibility demonstrated by NGOs in the past and present.

The purpose of the conference is to create awareness and clarity about the various instruments used in Islamic Finance. Hopefully the information and knowledge gained today will be sufficient for us to develop an initial draft of a model on these underlying principles in tomorrow's session.

We are not here either to argue on riba or to develop an overall banking model. We just want to be able to lend money on Islamic principles. Development is all about giving choices and alternatives. During the course of today's sessions it will be clear to you that riba is prohibited and what we charging is riba, no matter what name we call it or how we justify it.

I will now take a couple of moments to introduce some concepts to you. You will find reference material in your folders: