



ISSN: 2519-707x  
Vol. 1, 2016

# *COMSATS Journal of Islamic Finance*

A Double-Blind Peer Reviewed Research Journal



**Center of Islamic Finance**

COMSATS Institute of Information Technology Lahore, Pakistan.

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# An Alternative to Markup Based Financing Technique

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## Abstract

In a scheme of revamping banking system in Pakistan and to bring it into consonance among with Islamic Sharia, the State Bank of Pakistan, in early 1984 introduced Twelve Modes of Financing and among them financing on the basis of Markup had commonly been practiced. The critiques were of the view that it was merely simplification of the accounting procedure and the concept of money borrowing was disguised in buying of goods on credit. For the time being its use could be allowed to abstain from apparent interest based transaction but this should have been improved with the passage of time. But it could not attract the attention of the people at helm of affairs because of either a mala fide intention or lack of knowledge, skill and even since rityon the part of people who could contribute under the official umbrella state authority. Theorists and jurists agreed with fact that this mode was also based on stratagem and pretexts. In this paper various aspects of Markup based financing had been discussed and Trader's Credit Cheque had been suggested as an alternative to the mode of Markup Based Financing.

**Key words:** Riba /Interest, Mark Up, Opinion of Scholars, Trader's Credit Cheque

## 1 Introduction

Riba is an Arabic term which means "addition" or in excess over the original. In Islamic Economic system this term has been used for the amount, which is paid in addition to the original loan amount. It also stands for the additional quantity returned with the one originally borrowed. Interest is the excess amount paid to the money lender for the use of money over a specific period of time at a predetermined rate.

"RIBA" in true sense is the "Interest" which has taken its terminology from the Arabic language. However, in its real meaning both INTEREST and RIBA are in equation and also synonymous in the matter of their implications. To arrive at correct conclusion we, therefore, first trace the history of interest because the element of interest is found in the business of money dealings as early as 2000 B.C. The Markup financing is in fact a notional sale transaction without involving the actual sale purchase of goods. It is only stratagem purporting purchase of goods from customer and simultaneous resale thereof to the customer on the basis of Markup on deferred payment basis. There is no physical exchange of goods against money. In most cases the stock held by the customer is purchased for granted. This means that paper transaction is recorded which is a pretext to legitimize the transaction. Islam does not recognize any transaction which carries interest in disguise. It therefore necessitated to evolve a system which is immune from any such stratagem. This paper discusses opinions of the veteran scholars on the issue of Riba as well as the existing mode of Financing on the basis of Markup with its implications and finally suggests an alternative in the form of Traders Credit Cheque with its practical application in banking. The paper also suggests accounting procedure pertaining to the newly suggested instrument of TCC. This instrument will effectively replace the Markup Based financing mode without involving the element of interest.

### 1.1 The Origin of Interest

World economy gradually shifted from barter system to monetized exchange transactions. The use of money matter steadily increased economic activities. With ever expanding production and distribution process the need for money also went on rising, which necessitated minting silver and other metals in addition to gold. Increased supply of money added to the income of traders and other asset owners resulting in fund surpluses. To get the surplus money secured these wealthier people made a search for persons of integrity who could ensure safe return of money as and when called.

Tannan (1977) in his work on "Practice and Law of banking" writes that among the people, priest and clergyman were more credible and trustworthy who inclined the rich people to deposit their surplus fund

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with these priests who enjoyed the confidence of the masses of the people. Eventually by 2000 B.C the temple of Ephesus and Delphi became most busy deposit houses (Tanan, 1977).

Goldsmiths were equally considered people of integrity whose worth and value ensured timely return of money entrusted with them for safe custody without depletion. There was still another class of the people who fell short of funds and resorted to goldsmiths for financial assistance. Realizing the ever increasing quantum of deposit, the goldsmiths started making loans to the needy persons who were charged certain extra amount over the principal which was termed "INTEREST". With the passage of time multiple disputes arose with regard to the rate, mode and payment of "INTEREST". To resolve various relative issues, in 1728 B.C the King of Babylonian Empire got a code of conduct designed and inscribed on a block of diorite. There were 150 paragraphs which covered all the important aspects of advancing of money, receiving and paying of interest thereon, guarantees/sureties and securities there against. The enforcement of this code gave legal form to the receipt of "INTEREST" which menace played a very determinant role in dividing the society into "have's" and "have-nots" and eventually resulted in emergence of a capitalist class.

The borrowing business was also organized in Venice and Genoa. Later on, the famous Greek philosopher Aristotle prohibited the transactions based on interest. He was of the view that "a piece of money cannot beget another piece as the sole natural object of the use of money is to facilitate exchange and that money cannot be used as a source of accumulating money at interest. Aristotle, therefore, rejected interest on the basis that money is 'sterile' which lays no eggs.

The followers of Aristotle, accordingly, used to abstain from accepting interest. The Jews accordingly established an interest-free banking institute under the name of "AGIBI Bank" in 700 BC in Babylon (Siddiqui, 1994, p. 2-3).

It was in 340 B.C. when LexGenucia prohibited interest in the Republic of Rome and churches began forbidding clergymen from accepting interest. With the emergence of Christianity, the churches began preaching the prohibition of interest as Jesus had since disallowed any return on the amount lent. By 1311 AD Pope V declared all legislation in favor of interest null and void and prohibited charging of interest/usury absolutely.

Siddiqui (1994) from 'New Testament' has reproduced the following verse on the subject:

"Love your enemies and do good, lend, expect nothing in return, if you lend money to any of my people who is poor, you shall be to him as creditor, and you shall not exact interest from him"

However, with the decline of influence of Orthodox Church secularism again gained ground. Religious values gradually lost their force. At the end of 13th century the interest-based transaction had effectively changed the socio-economic system.

Before the advent of Islam Arabian people were so accustomed to "RIBA" that "RIBA" was considered synonymous to trading. There were, however, different modes of dealing on "Riba" basis. The one most common of the practices was similar to that of today's lending and borrowing on the basis of "Riba". A capitalist used to lend cash money to a needy person and after a specific period of time added certain amount of interest to the principal for repayment.

In the second mode of transaction, the principal plus "Riba" accrued were aggregated for the next term and "Riba" for the subsequent period was used to be applied on compound amount. In the third instance lenders used to obtain ornament, weapons and other precious articles by way of mortgage. The value of mortgaged property/articles was deflated arbitrarily and after a specific period of time "Riba" was applied on the loan amount to confiscate the mortgaged property against the loan plus "Riba" (Siddiqui, 1994).

Islam denounced all modes of "Riba" by the following verse of the Holy Quran:

"Those who swallow usury cannot rise up save as he arise when the devil hath prostrated by his touch – that is because they say, trade is just like usury; whereas ALLAH permitteth trading and forbiddeth usury. He unto whom an admonition from his lord commeth and he refraineth (in

obedience thereto) (he shall keep (the profit) that which is past and his affair is henceforth with "ALLAH" verse 275 Al-Baqra (Picktal, 1994).

Another Quranic verse prohibited the receipt of additional amount on the quantity lent in the following manner – "Do not eat usury by doubling and quadrupling" 130 Aal-e-Imran. However, Allah forbade "Riba" in money transaction and also prohibited other types of lending business in which "addition" in quantity to be returned was pre-conditioned. Quran says "ALLAH FORBIDDETH RIBA 275 Al-Baqra.

This is the final decree and concluding ordinance that "RIBA" of whatever type, nomenclature, amount or mode it is acknowledged is forbidden by declaring it "Haram" once for all. Therefore sale on deferred payment basis at a rate or price higher than the cash price is also nullified and termed illegitimate. Such a transaction is disapproved from the following tradition.

"AbulAalia said, "I was with Hazrat Aisha when a women said, I sold a maid slave to Arqam at Rs.800/- under credit sale. He desired to sell that maid slave. So I purchased it for Rs.600/-. On this Hazrat Aisha told, "How bad this transaction of buying and selling is. Convey to Arqam, if he does not repent then all his "Jihad" he fought under the command of the Holy Prophet will be in vain." The woman said, "if I do not get anything other than principal, then what do you opine. Hazrat Aisha recited the following verse of the Holy Quran. "He unto whom an admonition from his lord commeth and he refraineth (in obedience thereto) he shall keep (the profit for) that which is past and his affair is (henceforth) with ALLAH" 275 Al-Baqra.

The above verse and tradition clarifies that the excess of amount, which is received in addition to the principal or spot value is "RIBA" and not allowed under the law of Sharia.

In other words "Riba" Al-Fazal is the excess of amount paid in hand-to-hand exchange of goods where no time period for liquidation of any liability is involved. However, very commonly transacted business of "RIBA" revolves around loan of currency of which, principal amount is deferred for repayment. Here the rate of "excess" is fixed prior to the taking of delivery of funds. After the expiry of time the "excess" so fixed becomes due for payment to the lender. However, the period of repayment of principal is separately agreed. The core issue of the problem requires intensive analysis as to which of the characteristics renders the transaction to be of "RIBA".

Aljazeera-Sheikh Abdur Rahman (1991) states that RIBA AL NASIA is an interest-bearing loan where "excess" is paid in repayable amount of principal loan for reasons of delay. Thus any "excess" constitute "RIBA" when

- i. Money is paid by way of loan
- ii. Repayment of the loan amount is deferred for a pre-determinable future date
- iii. Deference of repayment is pre-conditioned with payment of extra amount at a pre-fixed rate (Al-Jazeri, 1991).

Rida- Rashid who is one of the keen followers of Mufti Muhammad Abduha of Egypt while discussing the type of "Riba" elaborates that primary form of "Riba" is that one which has been prohibited by Quran, which ordinance is valid and must be maintained for all time. This form of "Riba" he says is also prohibited in Sunnah to which all Muslim Jurists are agreed. This primary form he describes is that of "double and multiplied" which under the conventional economic system is known as "compound interest" in the secondary form of "Riba" he includes the "Riba" prohibited by a text of Sunnah and which can be permitted under the doctrine of necessity (dararah)<sup>1</sup>. Rashid further maintains that "interest" paid by banks on saving deposit or paid to banks in the initial terms does come under "Riba". Rashid Rida by so classifying the "Riba" forgets the fact that the life of Holy Prophet is a model derived from the injunction of the Holy Quran and therefore the "Riba" once proclaimed unlawful in the Islamic Shariah cannot be allowed to be practiced under any circumstances. Rashid is in oblivion because Quranic verses 275-279 of sura ALBAQRA clearly forbid receipt of usury (interest) disregarding the quantum and the period involved. Rashid also fails to conclude that whatever has been prohibited by "ALLAH" cannot be allowed by Sunnah. Similar views have been expressed by Abu Zahrah of Egypt who says that it is the Riba-al-buyn (RIBA-AL-FAZAL i.e. "interest" on sale of Goods, which comes under the Riba prohibited by Sunnah. The argument loses ground in the light of a tradition cited by JABIR wherein the "Holy Prophet" (P.B.U.H) said "It is illegitimate to sell two animals for one credit"<sup>2</sup>.

Rahman- Fazlur-(1992) Ex-Director, Council of Islamic Ideology, had, however, argued that the prohibited

"RIBA" pertains to "INTEREST" on consumption loans. He excluded commercial loans altogether with regard to interest thereon (Siddiqui, 1994, p. 49-50).

1 Institute of Islamic Research. RibaAurMudaribat, (1983) JamiaIslamia, Islamabad, page 139.

2 Institute of Islamic Research. RibaAurMudaribat, (1983), JamiaIslamia, Islamabad, page 139.

A four men mission assigned with the task of study of banking in Malaysia, Egypt and Saudi Arabia reported that Dr. Tantawi, Rector of AL AZHAR was of the view that there was nothing un-Islamic in conventional banking and their transactions were basically business oriented. Mission also quoted the saying of a former Grand Mufti of Egypt Sheikh Muhammad Abdullah that "interest" does not fall under the meaning of "RIBA". Equally thrilling verdict was given by Dr. Muhammad AL JASSER, Vice Governor of the Monetary Agency wherein he pronounced that interest received by banks on loans and advances under conventional system does not fall under the interpretation of "RIBA".

Shahid has quoted Qurtabi saying that "Muslims have agreed on the authority of the saying of the Holy Prophet (PBUH) that a condition for an increase over the amount lent is "RIBA" irrespective of whether it is a handful of fodder or a particle of grain".

Discussing "RIBA" Dr. MuahammadSaleem a renowned philosopher has very nicely defined it as "*excess of money generated by money without the involvement of human labor and enterprise*"

ALASAR -Ibn, while defining "RIBA" was of the view that excess in principal without any contract of sale is "RIBA" which is unlawful under Islamic Jurisprudence. The Islamic Fiqqah Academy have also decreed by passing a resolution in December, 1985, that bank interest in its all forms is, in fact "Riba". The academy had therefore, passed on an appeal to the Muslim world for establishing bank which could ensure business transaction free of interest.

The fallacy of distinction between interest and Riba stems from the fact that it seeks meaning from the socio-economic condition prevalent in the early age when money was borrowed for consumption purposes meeting an emergent domestic or personal need satisfaction. The fund owner at that time used this instrument of capital, besides earning a return, for building a social status, which eventually divided the societies into classes.

### 1.2 Islamic Finance Movement

Wilson, (1995) has made very interesting discovery that Modern Islamic Banking institutions first appeared in the financial market in 1950 when farmer's credit union was established in Pakistan. This was beginning of the Islamic Finance movement though with low momentum. The spirit behind it incidentally created awareness and in 1963 MitGhamr saving bank emerged as a small rural institution in Egypt which was eventually converted into a Govt. institution with new name The Nasser Social Bank assigned with the responsibility of collecting Zakat and Islamic wealth tax. About a million customers transacting with this bank showed that the Muslim wished an interest-free financial dealing (Wilson, 1995). It was in December 1970 at a meeting of the foreign minister of Islamic countries held in Karachi when Pakistan and Egypt jointly proposed for the establishment of an international Islamic bank for trade and development. This proposal was again discussed in a meeting at Benghazi (Libya) in 1973, which suggested for constituting a committee of experts for designing and drafting the charter for the proposed bank. It was finally approved to establish Islamic Development Bank in Jeddah, Saudi Arabia in 1975 (Siddiqui, 1994, p. 17). To facilitate the growth of Islamic Banks Muslim countries made amendments in their laws affecting the operations of banks and financial institutions. Seventies decade, however, gave birth to major Islamic banks like Dubai Islamic Bank in 1975, Faisal Islamic Bank in Egypt and Sudan in 1977, the Kuwait Finance House too, in 1977, Jordan Islamic Bank in 1978 and Bahrain Islamic Bank in 1979 (Ahmad, 1985, p. 8). In Pakistan five full-fledged banks are operating under interest free system with 1100 as on end of March, 2013. The financing portfolio of Rs.251 billion out of Murabaha amount stands at Rs. 90.4 billion which is 36 % of the total financing.

In Egypt law was relaxed to exempt Faisal Islamic Bank from the exchange control regulations and nationalization. Bank's assets, profits and all aspects of activities were exempted from all taxes for 15 years. Similar concessions were allowed to Faisal Islamic Bank, Sudan.

In Pakistan too, laws related to profit and loss sharing business particularly deposit obtained under profit &



loss sharing were amended affecting State Bank of Pakistan Act 1956, the banking companies ordinance 1962, the banks nationalization Act (ordinance) 1974, the negotiable instrument Act 1881 & the limitation Act 1908 were amended to accommodate the non interest modes of financing. In Pakistan the movement took a momentum when late General ZiaulHaq asked the council of Islamic Ideology to prepare a blue print on interest free banking in September 1977. The council set a panel of economists and bankers to assist in the process. Based on the interim report of the panel the council recommended in 1978 for a start to eliminate interest from the operation of N.I.T, ICP & HBFC. For the first time in June, 1980 participation term certificates were devised to replace debentures. Simultaneously Modaraba Companies Ordinance was promulgated in June 1980.

In Iran comprehensive legislative amendments were approved by the parliament in August 1983 for interest free operation of commercial banks as well as central bank of the country.

However, living force behind this Islamic finance movement derives its spirit from his Royal Highness Prince Muhammad Al-Faisal-Al-Saud of Saudi Arabia whose sincere urge provided foundation stone for the establishment of many Islamic Banks world over as subsidiaries of the Dar-Al-Maal Al-Islami, which was established in 1981. DMI was formed with a primary objective of encouraging formation and development of Islamic banks by undertaking financial operation on Islamic lines, to invest the funds of Muslims with a view to generate profit in accordance with Shariah and also promote cooperation among the Muslims. The DMI has been successful enough in paving way for the establishment of Islamic commercial banks, Islamic investment banks and financial institutions and TAKAFUL companies.

World's renowned scholar Maududi (1985) very nicely had tackled the most burning problem of banking in Islamic state. Till now fund management agencies have been expressing fear of collapse of banking and financial system if the element of "interest" (which most of the people consider the only incentive at work) is dispense with. Very logically convincing the reader of his book "Muashiat-e-Islam" Maulana Maududi drew the contours of interest free banking in the following manner:

"Abolition of interest will close the door of secured investment at a guaranteed pre-determined rate of return without labor and risk. Similarly application of zakat will also debar them to restrain their capital and keep it piling & in an Islamic state people will not be allowed to squander wealth in luxurious way of life. Then people with surplus funds will have one of the following three alternatives:

- i. If those with surplus of fund are not desirous of adding to the wealth, will spend their surplus money in social welfare activities by either directly incurring through "trust" or releasing as grant and contribution to national institutions. Alternately, they may sincerely deliver to Islamic state for spending on social reforms and welfare infrastructure development. This last option will be preferred particularly provided administrative authority/machinery enjoys public confidence for integrity. This will provide substantial amounts of interest free funds to Govt. and other agencies of public interest thereby relieving the public from tax burden.
- ii. Secondly if they are not desirous of additional income but wishes their wealth to be secured, they may deposit this surplus in a bank. The bank will take it as a loan instead of trust. This way bank will be liable to repay the amount on demand or return at a pre-determined date. Under these circumstances bank will be rightful to use the funds for business dealing and even profit there on. Bank will not be liable to pay a part of the profit to its depositors rather the entire profit will be appropriated by bank. Imam Abu Hanifa's business largely owed to this Islamic principle.

Public for his integrity and honesty, used to deposit their funds with him for security. But learned Imam used to take it as loan and utilized the money in business. Biographies report that after the death of Abu Hanifa it was disclosed that 50 million Dirhams had been invested in his firm under this principle. Under Islamic law trust money cannot be used by the trustee. But burden of loss does not fall upon trustee. However loan amount can be used and benefited and the borrower is liable to return the amount on demand. Bank can exercise this practice.

- iii. Thirdly if they desire to invest their surplus/savings in a profitable venture then they have the

only option to undertake partnership business either through Govt. or banks. In case with other individuals terms of business contract and operational results must be settled before hand. In case of companies limited by shares one can right away buy shares. But bonds and debentures with pre-determined rate of return will have no place in the market" (Maududi, 1985, p. 289).

Maududi while presenting the above alternatives has, in fact, explained in detail the modes of investment of surplus funds. He has simultaneously presented innovative procedure of bank deposit which has of late been a debatable issue among the economists and Jurist alike.

Interestingly this idea was expounded in 1969 when almost all the scholars had diverging views about the banking practice. Further commenting on the legitimacy of banking Maududi said that banking is one of the essential requirements of modern civilization, which has been infected by the element of interest. He is of the view that bank performs many lawful services which are indispensable for commercial and civic life of the day, like foreign exchange transactions remittances, issuance of letters of credits, safe custody, traveler's Cheques, stocks & shares and other agency arrangements which relieve a businessman, of most perplex problems. Most important of the functions is pooling the surplus funds of the general public in a reservoir for utilization in profitable venture, which may add to further productivity of the economy. It also promotes the skill building process which improves upon the expertise of the banking personnel who can in turn prove more useful for industrialists and trading people to guide them on selecting right venture (Maududi, 1985,).

Maududi's idea was, in fact, eye opener for those who were of the views that banking without the element of interest cannot be thought of. The model later on proved a guide map for researchers and designers of Islamic banking.

Aljazeera(1991) has composed a marvelous collection on Islamic commercial jurisprudence. The literature offers a very scientific and unbiased study on opinions of all the major four schools of thought. The voluminous literature has been published by UlemaAcademy with translation from Mr. Manzoor Ahsan Abbasi and presents sufficient guiding material for researchers on Islamic economics.

Federal Shariat Court in its decision announced in November 1991 held that all forms of "interest" by whatever name they may be called are "Riba". Similar views were expressed by "Advisory Council on Islamic ideology while giving its verdict on 23rd December 1969. This council which later became "Council of Islamic Ideology of Pakistan" consisted of renowned jurists and scholars of all school of thoughts. The council had decreed that disregarding the rate, purpose and tenure any additional amount paid for the use or deposit of money was Riba. In a report of the "working group" which was appointed by the "Commission for Islamization of the Economy" also declared in 1992 that all forms of "interest" are "Riba".

The Federal Shariat Court had, therefore, asked the Federal Govt. to devise new laws to replace the existing ones in the light of Islamic Laws by 30th June 1992.

Niazi - Imran Ahsan (1995) in his work on "the concept of Riba and Islamic Banking" has correctly pointed out the alarming phenomena prevalent in the banking industry with regard to the recovery of bank advances. The situation is gradually deteriorating with ever increasing quantum of the classified portfolio. Niazi feared that the banks are not sure whether they will get their investment back or will be handed over the bare skeleton of a factory that is worth a fraction of the amount advanced (Niazi, 1995).

## **2. Objective of Study**

To diagnose the nature of Markup in terms of Islamic Sharia and suggest alternative which can ensure interest free finance.

## **3. Methodology**

It is a descriptive study based on printed literature on the subject. Research work of various sages of the age has been consulted on the subject. Views of the scholars have been analyzed to draw inferences as to the legitimacy of the mode of financing on the basis of markup and that too on deferred payment basis. Opinions of the public dealing with banks particularly availing finances from banks have been helpful in forming a solid

opinion about the use of this mode. It appears from the respondents that availing finance facility from banks under this mode is a compulsion because of no alternative. Opinions of the bankers as well as those of the public have been obtained through an open questionnaire during face to face interview.

#### 4. Problem Statement

Although financing under Markup based mode is commonly practiced in commercial banks in Pakistan, yet the mode carry interest in disguise and, therefore, abhorred by majority of the business community. To critically analyze the instrument and also suggest an alternative to this mode was urgently felt so that interest free finances could be made available across the country.

#### 5. Financial Instruments

Siddiqui (1969) had already argued for the successful practicability of the instrument of Musharika and Modaraba. Agreeing with Siddiqui who had made remarkable contribution toward interest free banking in 1969, Dr. Zia-ud-din endorsed the mechanism of Modaraba which will operate under two tier contract i.e. a contract between the bank and depositors and another contract between the entrepreneurs who need finance for conducting business and the bank which will provide the finance (Siddiqui, 1982).

In the matter of short term credit Siddiqui (1982) in his work on "Issues in Islamic Banking" observed that it is hardly possible to assess the profitability of very short-term credit intended to meet the emergent business requirements of traders. Such a credit which in the traditional banking terminology is known as "Temporary Overdraft" may make a part of the investment by the traders only when computed on daily product basis by the trader which no businessman will be ready to reckon. The learned author therefore suggested interest-free loans (Qarz-e-Hasana) to be provided to such traders against guaranteed repayment (Siddiqui, 1982).

Usmaniet al. (1984) in "Workshop on elimination of interest from Govt. transaction" organized by International Institute of Islamic Economics Islamabad, on the issue of the nature of return on Govt. borrowings and their alternatives, were found in consensus over the fact that since Govt. borrows from banks who in turn secure the funds by way of deposits from the public, the borrowing and lending between Govt. and banks is, therefore, not in house operation thus the interest paid by the Govt. to the banks is passed on to the depositors.

Al Sadr - Muhammad Baqir (1984) put the responsibility of transforming economies into Islamic system on State. In his voluminous work "IQTISADUNA" published by World Organization for Islamic Services, Tehran in 1984. To him state must undertake upon herself to ensure that every Muslim is leading a life peaceful and satisfactory. The establishment of BaitulMaal and collection of zakat by the state aims at assisting those fallen in need (Al-Sadar, 1984).

Ahmad (1985) in his valuable work on "The Present State of Islamic Finance Movement" was very much optimistic about a number of new financial instruments which had been developed during early 80s (p. 18).

Nevertheless to him, the instrument of Marabaha or Bai-e-Muajjal in practice in Pakistan, which is based on "Mark-up" is no solution to the problem of "interest" as it does not result in a substantive change one can perceive over the philosophy. Chapra (1991) emphasized upon the utilization of resources for achievement of humanitarian goals of general need fulfillment, full employment, and equitable wealth distribution for economic stability. This necessitates humanitarian strategy and important element of such a strategy is the abolition of "interest". Khan (1992) in his work "Islamic Banking in Pakistan" has suggested financing for working capital on Musharika basis. Elaborating the operational mechanism Khan says "The entrepreneur which needs finance agrees with the bank to float a limited period partnership (Musharika) in which the bank provides finance upto 90% and the entrepreneur provides the rest. At the end of the year, the industry's profit is distributed between the bank and the entrepreneur. The partnership then winds up (p. 55).

Hameedullah (1992) in his essay on "Islamic State" while throwing light on administrative and financial management, has pronounced a very interesting decree on the subject of "Qarz-e-Hasana". Hameedullah (1992) has, in fact, manifested the state responsibility towards the development of a welfare society wherein none of the members is compelled to allow the stronger to exploit the weaker. Jomo (1993) commenting on



views of Rodinson on compatibility of Islamic system of economic with socialism has quoted Sukarno of Indonesia as advocate for Muslim co-operation with Marxists in the following paragraph:

"The Muslim with a broad outlook, the Muslim who understands the needs of our Taimur(1993) in his contribution to material on "the economic system in contemporary Islamic thought" has supported the instrument of "Modaraba" as an ideal alternative to interest based lending (p. 165-166).

Naqvi (1993) et al; recommending "An appropriate policy package" has rightly pointed at the gradual change process which may bear positive impact upon the socio-economic life of the Muslim in a given environment. Naqvi (1993) was of the view that practical application of Islamic financial instrument will guide the economists on their actual viability, which may result in the formulation of macro level policies for broadly workable system. He rejects the idea of applying the economic system in piece meal because it does not present the philosophy behind it until the whole host of mal-adjustment including the unequal distribution of wealth is tackled alongside.

Siddiqui(1994) expressing his discontentment over the legitimacy of financing modes introduced in Pakistan since 1981, in his concluding statement, opined that to replace interest, there are only two modes of financing under the Islamic banking system, namely Qarz-e-Hasana and financing on profit and loss sharing basis. Fahim -- Muhammad (1994) in his blue print on "Riba-free alternatives for transaction in Commercial Banking" has divided financial accommodation into following two different modes:

- i. Direct financial accommodation.
- ii. Indirect financial accommodation.

In Direct Financial Accommodation he relies on "profit /loss sharing basis" for financing different project. By linking, the return on finance to risk the learned author ignored the fact that risk is not the only factor, which justifies return, otherwise big risk is there in the gambling, yet the earning from gambling is unlawful because the activity in itself is not legitimate. In Islamic economic system capital is not independently treated as a producing agent rather it is associated with labour to increase productivity (Khan, 1992).

Shah (1999), Director General (Planning) International Islamic University Islamabad while making his submission before the Shariat Bench of the Supreme Court of Pakistan had contended that profit and loss sharing were closest to the Islamic banking system and there was a consensus that the banker need not to inform the depositor where their funds were being invested.

Usmani(1999) while commenting on the proceeding statement recorded in Shariat appeal No.73 of 1992 has quoted Mr. Abbas Mira Khor and Dr. Mohsin H. Khan of International Monetary Fund as strong supporter of equity based banking. He reported them "As shown in a paper by Khan (1985) this system of investment deposits is quite closely related to proposals aimed at transforming the traditional banking system to an equity basis made frequently in a number of countries including the United States" (Usmani, (1999, p. 745).

Justice Usmani has also quoted Philip Moore who, too, agrees with Abbas Mira Khor in supporting the idea of building banking business on equity-based finance. Moore (1999) in his paper on "Islamic Finance" published by Euro money in 1997 writes "Although this long term shift from bond based to equity based financial system accords in many respects with Islamic economic principles, it is a trend which is by no means confined to the Islamic world and which is increasingly being championed globally. The resurgence in Islamic Finance worldwide is seen by simply as a reflection of the global economy's discernible transaction from bond-based to equity-based finance(Moore, 1999).

This two tier arrangement idea has however, been objected by Prof. Khurshid Ahmed who has rightly questioned the right of bank in sharing the profit when bank is not undertaking any risk. And if the financier is to undertake the risk then why go to bank instead of directly negotiating with the Modarab? From the banking point of view too, the arrangement lacks legal support because acting as intermediary between the financier and Modarab for the sake of earning commission does not form part of banking functions under the present law of banking.

Majority of the Islamic economists have been suggesting Modaraba, to which some scholars name "Qirad" as an alternative instrument to interest. However, Qirad i.e. Modaraba in itself does not abrogate or interfere with the actual system of banking. It cannot itself put an end to interest if even employed in the banking industry. As Ahmad (1976) apprehended that those who escape risk will continue to resort to interest-based lending in their private dealings through black market. Islamic Qadir(1994) in his proposal for "interest free Banking" suggested a framework based on profit /loss sharing on the liability side and equity participation of assets side.Ahmad (1991) has introduced a very interesting theory in place of interest bearing loans. In his innovative suggestion he put forward "Time multiple counter loan" arrangement whereby he expected to meet the commercial needs of the bank's clients. In the submission Sheikh Mehmood wrote that "once we come to note that time is as much an ingredient of a loan as the loan itself, only a little concentration persuades us to evolve the concept of loan value. What the lender forgoes and the borrowers receive is not merely an amount of loan, but an amount of loan for a certain period of time. If we multiply the amount of loan by the period for which it is advanced, we get the measure of deprivation suffered by the lender which is also the measure of gain received by the borrower. It is this magnitude that we may call by the name of "Loan value". (Ahmad 1991)

While elaborating the concept he wrote that a loan of Rs.1,000/- for one year has exactly identical loan value of Rs.500/- for two or Rs.250/- for four year or Rs.200/- for five years. By establishing the above identical loan values the author argued the foundational notion for the evolution of "interest free banking". He was of the view that by counter lending the financial needs of the customer can be met without involving the element of interest.

The "Time multiple Counter Loan" Theory of Sheikh Mehmood Ahmed is, no doubt, a remarkable contribution to the work on "Interest Free Banking" yet its application at macro level does not seem feasible. It is because of the fact that borrower can hardly spare funds for placing with bank for a multiple time period and then the banking operation cannot be carried out without substantial earnings taken for granted that the borrower forgoes the utility of funds for the requisite period, still bank will have to find out means for meeting the administrative cost. The model will work well with a level of 33% of current deposit and also a part of saving deposit held by banks return free due to operative rules yet the rest of deposit reposed to banks for income will lose their utility to the owner and may be channelized to alternative lucrative venues putting the bank into liquidity problem. The author has mainly rested on investment where he assumes earning @ 10% which under the present state of economy is a mere myth.

Zaman(1994) has questioned the competence of commercial bank in trading or in entrepreneurship, which is necessary for Musharika" He was of the view that banks are very sensitive about the liquidity, capital position and also rate of profitability. With regard to modaraba business to be undertaken directly by the bank or collecting and accepting funds for use as Modarab learned Professor has objected that bank being financial intermediary does not qualify as Modarab under the law of Sharia because bank itself does not undertake trading or manufacturing and as such its skills do not come under the purview of Modarab.

Zaman (1994) has also been a critic of the "Murabaha" techniques applied in banks since 1984 because it does not qualify the pre-condition of transfer of possession of trading goods from seller to buyer and also from one premises to another. He has therefore, observed that "To ensure that Islamic modes of financing do not give way to the evils that interest is claimed to generate, it is necessary to shun mark-up Murabaha, Buy-Back, Bai-Salam etc. all such techniques ensure a return for the bank without any consideration to the productivity of bank's funds in the hands of the entrepreneur (Zaman, 1994).

Ahmad(1994) has made substantial contribution toward the elimination of "Riba" from the economy. The period after 1988 shows reversion to the old system under new nomenclature. This seems to have given rise to an attitude of passivity on the part of banks and led them to use mostly such modes of financing like "Mark-up" as are more akin to interest based banking and require least modification in the old lending procedure.

The important reason being that of investment/financing by banks was largely on "Mark-up" basis, which failed to build trust. Eventually petitions were moved to the Federal Shariat Court and subsequently to the Apex Court for final verdict.

Ahmad (1993) has placed particular emphasis on "Murabaha" financing technique. He informs that Murabaha has been practiced as Islamic instrument in various financial institutions under different names like "MARK-UP" cost plus financing, production, support programme, short term financing or even simply sale purchase contract. Under Secretariat of the Treasury and Foreign Trade of the Republic of Turkey which governs the ALBARAKA TURKISH FINANCE HOUSE defines a sale purchase contract as "a contract regulating the purchase of raw materials semi-finished goods equipment machinery, land and building from a third party in cash and the selling of these on credit to the applicants. Turkish law permits the simultaneous completion of purchase and sale contracts. Client request the bank for purchase of commodities of his specification the bank purchases the goods and resell it to the customer at price, which includes the margin of profit of the bank. ALBARAKA BANK OF SUDAN also practices "MURABAHA in the manner practiced in TURKEY. These sale/purchase contracts are supported by real estate, or personal guarantee that 5Albaraka and its Role in Islamic banking. Albaraka Islamic Bank, page 8. Islamic Finance Journal 68 ensure timely repayment of sale proceed. Sale price is repaid in equal monthly installment. All disputes are settled by arbitration committee.

Kazi(1994) supporting the principle of profit and loss sharing argued that under Islamic system of partnership the capital owner rightly benefits from the market gains. He, however, opined that entrepreneurial efficiency only could give better results which warrants selection of honest and skillful producers/distributors of goods and services that can ensure better profitability.

Ali (1994) has rejected the entitlement of capital as a separate factor of production. He has observed that capital without enterprise cannot beget wealth. Both enterprise and capital are complimentary to each other and none of them can be excluded while determining the return. To be a factor of production each must combine with the other. In an Islamic economic system where the element of interest does not find its place, capital plays very pivotal role by linking itself to enterprise. Thus the risk, which hitherto is undertaken by the enterprise, equally becomes part of the capital. As such under interest free system of economic all investment are based on risk capital. According to Ali (1994) "where the return on capital is defined as interest but if capital is exposed to risk, then the return is defined as profit" (p. 88).

Discussing the value of capital he observes that although with perpetual losses, the nominal value of capital depletes, yet no protection to capital is available against inflation. This double loss i.e. nominal as well as real loss in value needs to be protected for which he suggests:

Indexation & creation of sinking fund on the basis of opportunity cost.

Ayub(1998) has also put forward a similar idea under the concept of "ISTISNA'. In his presentation the leaned author suggested financing of projects of industrial nature. For the completion of work he also involves a third party which might be a contractor who will carry out the construction work and will then hand over the project to the banks client when ready for commissioning. Here too, the author suggests undertaking of project at a fixed cost including the profit of the banks (Ayub, 1998). However, the rate of bank's profit has not been specified nor the mechanism through which the rate of profit can be worked out, has been suggested. Thus the dilemma still remains unresolved. When the terms profit sounds it immediately reminds a sale-purchase transaction. In the absence of such a transaction the amount received in excess over the cost may be attributed to any head of income account but other than profit. (Ayub, 1998)

## 6. Model Derivative

Voluminous business transactions of the day can hardly be conducted with equity contribution. Present economic scenario warrants injection of more and more capital into the production and distribution ventures so that the process may continue unhampered. Ever increasing demand for capital funds rightly justifies introduction of new financial derivatives which can supplement the capital base for steady economic growth. The existing "cost plus sale" (i.e BaiMuajjal) mode of financing which is commonly known as "Mark-up" financing has turned out a revamped form of interest based lending due to its operational will always attract criticism for lacking legitimacy under the law of Sharia mechanism. The system, therefore, is subjected to a variety of limitations.

The legitimacy of "Bai Muajjal (Financing on Mark-up)" has been questioned by every nook and corner. Nevertheless, no practicable modality has so far come up which proves the test of Sharia. Commenting on the

"Mark-up adopted in Pakistan as substitute for interest is really a mix up of the prohibited Bai-ul-Muajjal with equally disapproved Bai-al-Inah. The device adopted is that a fictitious deal is entered between the borrower and the bank, in which the bank purchases certain goods from the borrower, thus lending money to him at the expiry of a certain period during which the price of the goods will be marked-up" (p. 46).

Among modern economists Ahmed (1991) has made significant contribution by expounding the concept of "Time Multiple Counter Loan" (TMCL) which although lacks practical value because counter loaning again emerges out of the original loan amount and does not come out of the spirit of Al-Ihsan, yet the derivation of the instrument in a quite different way adorns the learned exponent with all appreciation. However, our dilemma still stands unresolved.

The concept of "Mark-up" has, in fact, been put forward to merely compensate the capital owner for parting with the liquidity. It, in a way, offers an incentive to the fund supplier for creating a surplus for investment with no idea of Al-Ehsan. It equally does least care for productivity of the funds allowed under the system. The earlier economists have innovated other alternatives like that of Sheikh Mahmood Ahmed who introduced "Time Multiple Counter Loan" theory which although is not only impracticable but also lacks immunity from the element of exploitation under fiat currency. Again the mechanism cannot adequately reward the principal financing institution due to ever rising rate of inflation both at national and international level. In the absence of proper indexation simple or nominal increase in the long run results in negative value of the money lent to day but to be repaid at a future date.

The mechanism of "Mark-up" was derived from the instrument of "Bai Muajjal" which no doubt implies credit sale but does not allow a price which contains a margin for the time period between the date of issue and the date of repayment. The Federal Shariat Court in its judgement announced on 7-12-1991 had concluded "that it (Mark-up) is nothing but interest and should be abolished". The court quoting from Usmani (1984) extensively argued that "the mark-up is the price of time allowed on a debt which is interest pure and simple.

Khan (1995) while discussing the issue has expressed disagreement with people who argue that the difference in the cash price and credit price is allowed since the Sharia recognizes Bai Muajjal by a consensus. Khan says "In fact this argument is misplaced. Bai Muajjal means that the sale can take place on the condition that the buyer will pay later on. It does not necessarily mean that the seller has a right to sell the commodity at a price which is higher than the price he is charging for a cash sale" (Khan 1995. p. 16).

It is also appropriate to quote discontentment of Dr. Munawwar Iqbal on the legitimacy of "Mark-up". He says:

"Strictly speaking, the mark-up scheme being used by Pakistani banks is not the mark-up which the Sharia allows. The banks are just using the name of mark-up and doing what is almost akin to Riba" (p. 4).

The defense wall erected by a renowned banker of not less than ex-chairman of Pakistan Banking Council Mr. Abdul Jabbar Khan is not only interesting but worrying enough also when he says that:

"The Sharia court's criticism of the Mark-up is about the buy-back system that we are following. I am making this point because if the mark-up is abolished altogether, certain transaction may not consummate in the bank."

The apprehension of the learned banker exposes the inability in finding out permissible alternative which can replace the interest based system. That is why they intend to advocate the mark-up scheme to continue with, regardless of the fact that the mode carries the element of interest. A report of the International Institute of Islamic Economics, Islamabad disclosed that none of the efforts have so far been materialized in finding out a practicable alternative to interest based lending for short and medium term working capital financing. Whatever derivatives are suggested out of BAI-MUAJJAL, they ultimately lead to creating a debt for future payment. The debt results from credit transaction. The value of debt is always more than the value of goods

sold on cash. For instance, the report says, "The deferred price would be debt against the buyer."<sup>6</sup> The report further says, "The A`hkam of `Riba' would apply to the debt created in lieu of the transaction. Thus while bank may not seek compensation for delays in repayment of the principal, the buyer too, may not seek early retirement of the debt, be it cash or credit"<sup>6</sup>.

In a discussion with Dr. Sayyied Tahir, Director General of the institute, it transpired that Marabaha (cost plus sale) has been derived from the major instrument of Bai-Muajjal. This instrument was recommended by Council of Islamic Ideology in the scheme of Islamisation of Economy. The instrument of Bai-Muajjal was accordingly introduced as Non-Interest Based mode of financing on the basis of Mark-up under chosen circumstances.

The Council of Islamic Ideology had, in fact, given a qualified approval to the use of "Mark-up" based Bai-Muajjal as means of financing which aimed at replacing the interest based lending. The approval of this device was allowed to be used in rare cases where no other mode could be used. The council wrote:

"However, although this mode of financing is understood to be permissible under the Sharia, it would not be advisable to use widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to inescapable cases" (Ahmad, 1985).

Incidentally, banks in Pakistan adopted it as the most practicable instrument of financing. Its large scale applicability is evident from the fact that the finances previously allowed to housing sector on rent-sharing and to corporate sector on "Musharika" basis was also substituted by financing on "Mark-up" basis.

The financing on the basis of "Mark-up" practically did not change the mechanism of interest based lending. Mere change of nomenclature does not affect the illegitimacy of "Riba" as it still continues with the concept of lending and borrowing. Obviously the daily turnover in the account represents disbursement and repayment of sale/purchase prices which prima facie tells that on each disbursement the bank makes a fresh purchase of stock from the customer which cannot satisfy a sound judgement. In practice the customer requests for a finance facility either to expand business or meet an emergent business requirement. In each situation the customer would be holding stock for sale to the financing bank which even, as per agreement on form No. IB-6, must occur before availing the finance from bank. In reality the mechanism has been developed on the basis of mere stratagems and subterfuges instead of actualities.

Even if we take for granted that the financing under mark-up scheme is a sale/purchase transaction (which is a notional transaction under the circumstances) the sale price is arbitrarily fixed by the bank which is always much higher than the market price of the stock. The customer purchases at a higher price because he lacks funds to purchase in the competitive market. The customer is, therefore, exploited for fund deficiency.

The mode, therefore, does not commensurate with the test of Islamic Sharia. Islamic laws are characterized with the clarity of purpose. 'Adl' is, in fact, the beauty of our economic system. Its intrinsic quality may, therefore, not be altered with pretext and subterfuge in order to suit to a specific situation. Rather the acts and perception be revamped in line with the law of Sharia.

In order to find out the views of the scholars and also people involved in financial matters on the legitimacy and acceptability or otherwise of the existing system and seek suggestions for alternative instruments, (if the present state of affairs is found non-commensurating with the tenets of Islam), a sampling based research had been carried out. During the exercise, individual opinions were sought on the basis of a questionnaire. Among the respondents included 10 economists, 10 scholars on Islamic jurisprudence, 15 traders, 15 bankers and 1 bureaucrat. Expressing their contention, majority of them severely criticized the existing "Mark-up based financing". They held that the change merely replaces compound interest based lending with simple interest which, too, increases with every increase in time span. The informative questions were answered as shown in Table-5.1

Table 1.

S.No.		Answer/ Response	No. of respondents
1.	Is the interest charged by banks is allowed by Sharia?	NO	41
2.	Are the NIB Non-Interest Based used ascending modes in Pakistan free of interest?	YES	10
		NO	45
3.	Will you like to place your surplus money in interest free accounts?	YES	6
		NO	3
4.	Will you undertake risk bearing business as partnership Which one of the following will you prefer?	YES	48
		NO	12
	(a)Modaraba	YES	39
	(b)Musharika	All the three	8
	(c) Leasing	are good.	19
			12
5.	Are the present Modaraba or leasing companies operating on Islamic Sharia basis?	NO	32
		YES	19
6.	Will you indorse Mark-up based financing under law of Sharia?	NO	43
		YES	8

It is really interesting that while responding to the questions, neither reasonable arguments were given in support of the answer nor any of the respondents suggested practicable mechanism.

### 6.1 Trader's Credit Cheque

In order to get rid of the "interest" we may recognize the flaws and grey areas in the system based purely on stratagem, assumptions and pretexts. Islam being the religion of natural justice exerts the lesson of cardinal virtues. Instead of putting the society into a quagmire of suspense, let us be honest and deny the false incandescence of any "interest" in disguise. Why not resort to actual Islamic Modes of financing which carries the authenticity of Islamic Shariah beyond any suspicion?

At present major portion of banks finances are being utilized for meeting short term working capital requirements of trade and industry. In order to cope with the emergent need of the market and also mitigate the strain on liquidity position of the financing agencies I suggest that the bank may adopt "Traders Credit Cheque" system instead of directly allowing financing on the basis of "Mark-up".

### 6.2 Operational Mechanism

The bank will sanction a finance limit at the request of the qualifying customer. The customer will open an account (if not already maintaining) with a specific branch. After completing the necessary documentation formalities in respect of the securities offered to the bank, the customer will be eligible to avail the facility. The limit of finance facility will be for a particular period after which the customer will not be entitled to avail the limit. However, this facility will, in no way, resemble with loan. Here the customer will purchase Trader's Credit Cheques (TCC) of various denominations. Therefore, the account of the customer will not be debited till the TCC are presented for payment. On issuance of TCC customer will pay a commission @ 2% of the face value of the TCC. This commission once charged will not be refundable. The customer can use the TCC by delivering in exchange for required commodity in the open market after discharging the same on the back of the instrument. The TCC will also be cashable at any branch of the bank or financial institution with which the customer is maintaining the finance facility.

Each branch of the bank will open a new column on the asset side of the general ledger cum cash-book for TCC paid. The TCC will be stamped with date of payment. All the honored TCCs be sent to the issuing branch the same day for obtaining credit. The issuing branch on receipt of the honored TCC, will debit the account of the customer and afford corresponding credit to the paying branch. After having debited the customer's account the issuing branch will immediately send a demand notice to the customer to liquidate his liability within 30 days from the date of encashment. The customer will be charged nothing if he liquidates the liabilities within grace period of 30 days. On adjustment of the debit balance the customer will be entitled to



purchase fresh TCC. However in case of his failure, the bank or financial institutions may immediately resort to the securities/collaterals for appropriations of the same by disposing off the securities after issuing recovery notices. The residual amount out of the sale proceeds of the securities will, however, be paid to the customer after satisfying the liabilities against him/her.

### 6.3 Documentation

- i. An undertaking be obtained from the customer wherein he promises to pay/adjust the liability arising out of the encashment of TCC already issued or likely to be issued to him, within the stipulated period of 90 days. He may further undertake and promise to pay the liquidated damages (if incurred by the bank) which the bank may impose from time to time on account of nonpayment of the amount of TCC availed of by the customer.
- ii. An indemnity bond be obtained from the customer wherein he indemnifies the bank from any losses which may occur to or be sustained by the bank due to the fraudulent or unauthorized use of TCC by the customer himself or any other person.
- iii. Muqqadam Agreement (Custodianship Contract) directly with the customer to ensure authority/responsibilities/obligations of the customer towards bank for proper safe keeping of the stock pledged or property mortgaged, its utilization and repayment of the facility amount financed thereon.
- iv. a. Letter of Hypothecation/pledge of stock.  
b. Mortgage of property.  
c. Lien on deposit Receipts (When limit is secured against any of these items.)

### 7. Conclusion

Financing under sale/purchase transaction i.e., purchase of goods from customer and simultaneous resale thereof to the customer on the basis of "Mark-up" on deferred payment basis has been the most commonly used mode in the banks and financial institutions. The mechanism, however, failed to meet the approval of Islamic Jurists due to its dubious character. Obviously the bank and customer take a deal of sale/purchase and bank charges mark-up on the amount of purchase price but in reality there is no such transaction taking place because neither possession is delivered to the bank nor the quantum of "Mark-up" is fixed. (The amount of "Mark-up" varies with the length of period). The amount of Mark-up is, in fact, interest in disguise. I have, therefore, suggested this alternate model which will fulfill the business requirement without violating the law of Sharia.

Under the suggested model, a credit worthy customer will be sanctioned a certain limit of financial assistance and he will be issued "Trader's Credit Cheques" of different denominations. The TCC will be valid for the period of finance limit for encashment. The customer will pay fee on purchase of TCC. This fee is not refundable. The customer will deposit the amount of TCC encashed or dealt within a maximum period of 90 days. The customer will continue purchasing fresh TCC within the approved limit.

Delay in timely repayment will deprive the customer of his stock of securities offered to the financing agency who will rightfully appropriate these securities towards the adjustment of liabilities of defaulting customer.

For the financing of industrial and agricultural machinery, building or other long term fixed investment, the instruments of Musharika, Rent-Sharing and Leasing will be applied with appropriation from case to case basis.

### 8. Recommendations

Based on some 34 years banking experience and looking after the desk of Non Interest Banking Modes for twelve years in a big commercial bank I had the opportunity to intensively study the conventional banking operation in relation to Islamic Fiqqa (Jurisprudence). I am of the opinion that the existing Markup Based Financing carries interest and must be replaced with an instrument immune from the element of interest. The proposed TCC as financing instrument for commercial and short term credit needs will eliminate the interest. This instrument is already being practiced in the form of Travelers Cheque issued to those travelling abroad. The basic difference one can find is that a traveler's cheque is issued against cash while this instrument will, instead, provide cash facility to the holder without first paying cash.

It is recommended that the banks while allowing running finance and cash finance facility may issue TCC and follow the operational procedure described above.

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