Interest-free Banking

Why in news?

Pakistan has announced that the government would introduce interest-free banking under the Islamic law by 2027.

What is interest-free banking?

- **Interest-free banking** - Interest free banking, a narrow concept within Islamic banking system, denotes a number of banking operations which **avoid interest**.
- **Islamic banking** - Islamic banking refers to banking activity that conforms to laws and values laid down by Islamic law or Sharia.
- The basis of Islamic finance is
    - Rejection of usury (levying of unreasonable high interest rates) while lending money
    - Non-engagement with immoral businesses (Speculative trading, gambling, or trading in prohibited commodities such as alcohol or pork)
- Under Islamic law, a Muslim is prohibited from paying and accepting interest on a predetermined rate.

How can an interest-free banking system work?

- **Ijarah** - In this system, a bank purchases the asset on behalf of the client and allows its usage for a fixed rental rate.
- After a mutually agreed time, the ownership of the asset is transferred to the client.
- **Murabaha** - It means a sale on mutually agreed profits.
- In this financing technique, an asset is purchased by the bank at a market price and sold to the customer at a mutually-decided marked-up cost.
- The client is allowed to repay in instalments.
- **Musharaka** - It refers to a joint investment by the bank and the client.
- The bank and the client both contribute to the funding of an investment of purchase and agree to share the profit or loss in agreed-upon proportions.

What was the Federal Shariat Court's (FSC) ruling?

- In 2022, the FSC said that Riba in all its forms was prohibited by Islam
- It asked the government to replace the conventional banking system by an interest-free one by December 31, 2027.
- The FSC gave the verdict, after the Supreme Court had referred the case back to religious court for its reconsideration in 2002, after the FSC in 1922 held Riba to be inconsistent with Islam.
- The FSC also stated that all forms of interest (in banking or private transactions) are considered Riba, which is against the teachings of Islam.

Pakistan became the first Muslim country to officially declare modern bank interest as Riba.

What about interest-free banking in India?

- Raghuram Rajan Committee in 2008 suggested the need to have interest-free banking in India, without naming Sharia banking.
- The Reserve Bank of India (RBI) in 2016 had suggested that Islamic banking could be gradually introduced through the opening of an "Islamic window" in conventional banks.
- **Need for interest-free banking** – The Sachar Committee Report, 2006 said that Muslims hold 12.2% of accounts in public sector banks and 11.3% in private sector banks.
- The non-availability of interest-free banking products results in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith.
- This non-availability also denies India access to substantial sources of savings from other countries in the region.

Quick facts

Federal Shariat Court (FSC)

- Established in 1980 during the government of General Muhammad Zia-ul-Haq.
- The FSC has the authority to determine whether Pakistan's laws comply with the Sharia.
- It is backed by the provisions of the Constitution of Pakistan.
- There is no court fee payable either on petitions or appeals.
- The Court consist of not more than 8 Muslim Judges including the Chief Justice and not more than 3 Ulema Judges having at least 15 years experience in Islamic law, research or instruction.

Ulema

- A body of Muslim scholars who are recognized as having specialist knowledge of Islamic sacred law and theology.

Riba

- Islamic term for interest charges on loans and covers all interest, and not just excessive interest.

References

1. The Indian Express | What is interest-free banking?

2. Federal Shariat Court | About Federal Shariat Court (FSC)

