



Development of Islamic Banking in Pakistan: Challenges and Prospects

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Abstract

The study assesses the development and progress of Islamic banking initiative in Pakistan and further attempts to highlight the major challenges faced by the Islamic banking sector to gauge the future prospects of Islamic banking in the country. The research findings are based on qualitative research approach using both primary and secondary data including the historical reports, facts and figures along with the interview data collected from the most important Islamic banking stakeholder groups including the Islamic banking industry regulators comprising of officials from The State Bank of Pakistan (SBP) as well as the Shariah and Islamic banking experts serving at various Shariah Supervisory Boards (SSBs) in the country's Islamic banking sector. The study is undertaken by conducting interviews of nine SBP officials and twelve Shariah supervisors. The study is the first of itself in Pakistan as the previous studies focused stakeholder groups like customers and bankers only but this study takes into account the views and opinions of Islamic banking industry regulators and Shariah scholars serving in the Islamic banking sector. The research findings highlighted that Islamic banking initiative in Pakistan experienced a difficult journey but gained momentum with the passage of time and there are still several challenges that must be aptly addressed to ensure a brighter future for Islamic banking in the country.

Keywords: *Islamic Banking, Islamic Finance, Pakistan, Prospects, Development, Challenges*

Introduction

The system of Islamic banking (IB) emerged on the global financial landscape in the decade of 1970, and with the passage of time, the IB initiative experienced success in the Muslim countries that were mainly located in the Middle East and Asia, while the IB sector continued to grow and progress, its popularity also spread in the non-Muslim states located in Europe, UK and Africa and the global IB and finance industry has recently become a global phenomenon with a presence in various parts of the world covering all major financial markets at the international level. According to a report published by the IFSB in 2019, the overall Islamic financial services at the global level have estimated assets of 1.57 Trillion USD and the share of Islamic banking in these assets accounts for 72%, which clearly reflects the in the late 1970s.

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The IB initiative has had its share of difficulties and hurdles to reach where it stands now. There are presently a total of five fully fledged Islamic banks providing their products and services in Pakistan including MCB Islamic Bank, Al-Baraka Bank, Meezanin the late 1970s. The IB initiative has had its share of difficulties and hurdles to reach where it stands now. There are presently a total of five fully fledged Islamic banks providing their products and services in Pakistan including MCB Islamic Bank, Al-Baraka Bank, Meezan Bank, Bank Islami, and Dubai Islamic Bank. The overall count of branches of conventional banks' Islamic banking branches (IBBs) is 2979 and sub branches including 2850 fully fledged IBBs and out of these 2850 fully fledged Islamic branches, dedicated Islamic banks' branches are 1469 and conventional banks' IBBs are 1381 (SBP, 2019). According to a report of SBP (2020), Islamic banking assets possess a market share of 15.2% whereas Islamic banking deposits have a share of 16.9% in the country's banking industry.

The researchers in the past studies, have discussed at length about the Islamic banking theoretical, ideological, developmental and operational aspects in the past covering several important topics including Islamic banking products and service structures and variations, Islamic banking objectives, Islamic banking strategic and business issues like product development, services acceptance and customer satisfaction etc. This study aims to take into consideration, the complete journey of IB initiative in Pakistan along with the inclusion of perspectives of Shariah experts and IB industry regulators i.e. from the central bank (State Bank of Pakistan) regarding the key challenges pertinent to the Islamic banking industry of Pakistan.

In the past, several studies were conducted to analyze the Islamic banking perceptions, for instance the research studies of Gerrard and Cunningham (1997), Ahmad and Haron (2002), Dusuki (2007), Dusuki and Abdullah (2007), Dusuki (2008), Loo (2010), Rustam et al. (2011), Lee and Shakir (2011), Saeed et al. (2012), Riaz (2014), Ringim and Yussof (2014), Buchari et al (2015), Khan and Ramzan (2015), Akhtar et al. (2016), Shah et al. (2016), and Belwal and Maqbal (2019), all aimed at the assessment of perceptions of various stakeholders regarding Islamic banking. Besides these studies and many others on the subject of Islamic banking perceptions, there remains a significant research gap in the sense that majority of these studies only focused on two stakeholder segments that included mostly customers and bankers. Hence, there is much dearth of research on evaluating and analyzing the perceptions of other stakeholder groups. This study is a pioneering endeavor in this context because in addition to the review of historical development and progress of Islamic banking sector in the country, this study also attempts to address the research gap by analyzing the viewpoints and opinions of Islamic banking sector regulators from State Bank of Pakistan and also assesses the percepts of Shariah supervisors serving at various Shariah Supervisory Boards (SSBs) in the Islamic banking industry of Pakistan.

Review of Related Literature

Islamic banking paradigm is not considered merely a financial proposition; somewhat it also has its ethical and religious underpinning. Hence, researchers have debated about not only the differences in the conventional banking and IB products and services but also about the contrast in the fundamental objectives of the IB system in comparison to interest-based system. With reference to the basic models of IB, there are two viewpoints (Dusuki, 2008); the first one is Chapra's model (Dusuki, 2007; Lewis and Algaud, 2001) asserting that Islamic banks, unlike their conventional competitors should operate with a greater purpose rather than only meeting their commercial objectives of profit and shareholder maximization, the Islamic financial institutions must shoulder the higher responsibility of socio-economic



development and social welfare of the people. On the contrary, the IB schema proposed by Ismail suggests that Islamic banks are like other commercial conventional banks with the exception of doing business in conformity with the Shariah principles and it is not the function of Islamic finance institutions to care about social and economic well being but it for the government to take responsibility to ensure these socio-economic objectives in a society (Lewis and Algaud, 2001; Satkunasegaran, 2003).

Islamic banking entities besides experiencing a formidable competition by the conventional banking competitors as one of their foremost challenges also have to face several other major constraints and challenges which are diverse and multifaceted in nature (Haneef and Mirakhor, 2014). Some of the chief obstacles and challenges include absence of specific regulatory laws and regimes of governance (Nabi et al., 2016); over-reliance on debt-based financing structures like *Murabaha* and *Bai Muajjal* also called BBA or *Bai Bithamin Ajil* (Aqib and Hussain, 2016; Tarik, 2004) and limited equity-based financing offerings structured on the basis of *Mudaraba* and *Musharaka* (Abdul-Rahman and Nor, 2017); scarcity of trained and qualified human resources (Akhtar et al., 2016); lack of understanding and awareness regarding Islamic banking products and services (Aqib and Hussain, 2017; Awan and Bukhari, 2011). Notwithstanding, the difficulties borne by the IB sector, it has consistently showed encouraging growth over the years and promises even better in the future. The challenges faced by the Islamic banking sector of Pakistan are discussed in the context of interview data collection from two vital IB sector stakeholder groups including the SBP personnel and leading members of Islamic banks' Shariah Boards but before moving towards the discussion on Islamic banking challenges based on interview data findings, we will survey Pakistan's Islamic banking sector's developments and progress over the years beginning from its inception till date.

Origin and Progress of Pakistan's Islamic Banking Initiative

Pakistan's Islamic banking (IB) origins may be traced back to the late 1970s. The Islamic banking setup in the country, gained momentum by concurring with global rise of Islamic banking initiative, in the second half of 1970 (Aqib, 2014). In 1977, the IB paradigm was initially considered by the then President of Pakistan Zia ul Haq who assigned to the Council of Islamic Ideology – CII, (an expert body regarding Shariah matters), the task of designing an interest-free schema of economy, a system that may be pragmatically implementable to get rid of *riba* (interest) in financial transactions (Khan and Bhatti, 2008). After the recommendations of the CII, in shape of a detailed report submitted in 1980, some amendments were made in the pertinent banking laws and statutes including the changes to the BCO – Banking Companies Ordinance 1962, State Bank Act of 1956 and The Negotiable Instruments Act 1881, among others; to facilitate Islamic banking from regulatory framework perspective. The efforts for implementation of IB framework faced a setback in 1991 when a Shariah court – Federal Shariat Court (FSC) declared that all banking transactions in the country contain the element of *riba* and the system needs genuine reforms to truly transform its financial system based on Islamic guidelines entailing a interest-free banking sector (Shah and Niazi, 2019). Besides the governmental efforts to structure and operate a viable Islamic banking and finance (IBF) system upon the recommendations put forward by the CII, the legal, tax, regulatory and socio-economic frameworks of the country acted as hurdles in the way of the IBF mechanism which consequently resulted in a failure to endure an immature system at various levels of the economy (Khan and Bhatti, 2006).

The revitalization efforts after the jaded first phase of implementation of IB initiative started after the FSC in its court decision in 1991, asserted that concrete steps should be take to do away with the financial system based on interest. A commission was formed with the



name of Commission for Islamization of Economy (CIE) to lead the reforms regarding the designing, framework and modus operandi of an interest free economy and banking sector. The CIE submitted its report in 1992 identifying the weak links and making recommendations which were not duly considered by the concerned authorities at that time, however, the commission kept operational and submitted another report in 1998 with the assistance provided by the International Institute of Islamic Economics (IIIE). The second report provided pragmatic and practical measures along with detailed alternatives for various banking and financial needs in the perspectives of modern trends and practices prevalent in the banking sector. Besides all these efforts, the report emphasized on finding the conventional alternatives and replacements rather focusing on the Shariah spirit and substance regarding the financial transactions which lead to the lack of a sustainable and stable IB structure, which was needed at that point.

As discussed about the verdict of the Federal Shariat Court (FSC) in 1991, urging the government to purge interest from the banking and financial system of the country, the same was challenged, instead of being implemented, in the apex court of Pakistan i.e. Supreme Court (SC) of the country (Khan and Bhatti, 2008). The SC gave its decision on the issue of interest in its historic judgment in 1999, comprising of about 1100 pages, stating that all kinds of interest is prohibited as per Shariah rules and the financial system of the country must be revamped in consonance with the principles of Shariah. The court ordered the government to formulate a Commission for Transformation of Financial System (CTFS) in the State Bank of Pakistan (SBP) to complete the task of eliminating interest from the banking system. The CTFS also coordinated with other task forces to achieve the goal of an interest-free economy within the time-frame prescribed by the Supreme Court (Janjua, 2004). The CTFS made its recommendations in the shape of two reports proposing the government to initially create various institutional setups for adequate development of Islamic financial system and the CTFS also advised the government to introduce a pertinent legal statute for the governance of interest-free transactions with the proposed title “Islamization of Financial Transactions Ordinance” (Shah and Niazi, 2019). The efforts of CTFS culminated in the year 2001, when the stakeholders from the government deliberated with the CTFS members and SBP officials taking on board the other relevant bodies to contemplate a steady and sustainable IB system in Pakistan.

Consequent upon the fruitful deliberations of various stakeholders from the government, banking and regulatory sectors; the SBP was assigned to craft a multipronged strategy for the development and progress of Islamic banking in Pakistan (Shah and Niazi, 2019). The SBP, with reference to the assigned task, formulated detailed criteria regarding the establishment and structure of a full-fledged Shariah-compliant commercial bank. And resultantly, the first Islamic commercial bank license was issued by the SBP in 2002 to Al Meezan Investment Bank in 2002 that was later renamed as Meezan Bank, being the premier Islamic bank in the country (SBP, 2002).

After the first Islamic commercial bank was established in the country, the IB industry emerged encouragingly with the commencement of several other full-fledged Islamic banks including Bank Islami and Dubai Islamic Bank. The growth of the IB sector continued as the SBP also permitted and encouraged the conventional banks to open their Islamic subsidiaries and separate Islamic banking branches (IBB), parallel to the conventional interest-based branches. Thereby, the growth of Islamic banking is credited not only to the full fledged Islamic banks but also to the conventional banks’ Islamic windows/divisions. The branch network of Islamic banking branches rose rapidly as SBP played a facilitative role for both



Islamic and conventional banks to operate their standalone Islamic banking branches (IBBs). According to SBP (2007), a total of six Islamic banks operated in the country in 2006. The consolidated number of IBBs – Islamic banking branches of all banks operating in Pakistan went up to 1100 in number as on March 2013 in comparison to a meager total of 99 as in February 2006, reflecting a remarkable growth (SBP, 2013).

The present state of Islamic banking in Pakistan is quite good as reflected in the facts and figures of IB industry in the country. Currently, there are five dedicated and fully-fledge Shariah-compliant banks functioning in Pakistan comprising of Al-Baraka Bank, Meezan Bank, Dubai Islamic Bank, Bank Islami, and MCB Islamic Bank. The total number of Islamic banking windows, currently providing IB products and services in the country are 17 in number as well as there are currently 2979 Islamic banking branches (IBBs) and sub branches including 2850 fully fledged IBBs and out of these 2850 full fledged Islamic branches, dedicated Islamic banks' branches are 1469 and conventional banks' IBBs are 1381 (SBP, 2019). As reflected by the above statistics, the expansion of IBDs (Islamic Banking Divisions) of conventional banks is fairly swift as they are making quick progress in order to compete with the full-fledged Islamic banks to attain and retain as many customers as possible. Overall market share of deposits and assets of Islamic banks in Pakistan's banking sector is 16.9% and 15.2% respectively (SBP, 2020). There are currently a total of 3250 outlets of Islamic banking operating in Pakistan, with total assets of PKR 3360 billion (approximately USD 20 billion).

Chronology of Pakistan's Islamic Banking Initiative

The journey of Islamic banking and finance paradigm in the country has seen many milestones and has been an eventful one in terms of its success and sustainability. All the major landmark happenings with reference to Islamic banking setup in Pakistan are mentioned in the following Table 1, which presents these events in a chronological order to comprehensively cover Pakistan's Islamic banking history from developmental and progressive perspectives.

Table 1: Pakistan's Islamic Banking Chronology (Source: Researcher's Compilation)

Year	Developments/Events/Milestones Pertinent to Islamic Banking
1947	Pakistan was established as an independent state on 14 th August.
1948	The State Bank of Pakistan, Pakistan's central bank, was inaugurated by Pakistan's founder Quaid-e-Azam Muhammad Ali Jinnah on July 1 st resolving to form a banking system compatible with Islamic principles.
1949	The adoption of Objectives Resolution took place on 12 th March 1949 by the first Constituent Assembly of Pakistan, asserting that all laws, rules and regulations by the state shall be made in accordance with Quran and Sunnah.
1956	Pakistan's first constitution was enacted on 29 th February and the country was declared as an Islamic republic.
1962	Islami Nazriaati Council i.e. The Council of Islamic Ideology (CII) is formed to offer advice/recommendation to the government on Shariah matters.



1974	Pakistan's banking sector was nationalized and Pakistan Banking Council (PBC) was created.
1977	President Zia ul Haq assigns the task to rid economy of <i>riba</i> (interest) to the Council of Islamic Ideology (CII).
1979	Pakistan's government declared three years timeline to eliminate <i>riba</i> from the country's financial system and economy.
1980	The establishment of Federal Shariat Court (FSC) on 26 th May which was mandated to assess whether any laws are repugnant to the Islamic or Shariah injunctions. CII submitted report regarding implementation of interest-free financial system and recommended amendments in banking laws and statutes including changes to the BCO – Banking Companies Ordinance 1962, State Bank Act of 1956 and The Negotiable Instruments Act 1881, among others.
1981	CII in its meeting on 11 th November lauds the efforts of the government to avoid interest in the business and operations of House Building and Finance Corporation (HBFC), National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP). CII also criticizes the system of mark-up in banking system, declaring it as another name for interest.
1985	Pakistan's government accepts its failure to eliminate interest from the financial system within the declared deadline.
1991	Commission for Islamization of Economy (CIE) was formed to ensure <i>riba</i> is purged from the financial system. FSC declares that the banking practices in the country are against Shariah principles involving the element of <i>riba</i> and announces a deadline to free the economy from <i>riba</i> by 30 th June 1992. The denationalization and privatization process of banking sector also began in this year.
1992	CIE submitted its first report regarding riddance of <i>riba</i> from the economy.
1997	CIE invites recommendations from The International Institute of Islamic Economics (IIIE) from The IIUI – International Islamic University Islamabad regarding IBF system. PBC liquidated.
1998	CIE in consultation with IIIE submits the second report regarding the implementation of a truly Islamic financial system in the county.
1999	The Supreme Court (SC) of Pakistan's Shariah Appellate Bench (SAB) conducted hearings for Pakistan's government's and other parties' appeals against FSC's 1991 verdict regarding interest in economy and declared on 23 rd December, its historic judgment against <i>riba</i> in the financial system of the country, rejecting all appeals against FSC judgment of 1991. The SC sets a deadline for the government to transform the financial system on Islamic lines by 30 th June 2001.
2000	State Bank of Pakistan (SBP) sets up a body within its organizational ambit with the name of Commission for Transformation of Financial System (CTFS) in order to expedite the removal of <i>riba</i> from the economy as per the judgment of the Supreme Court of Pakistan. Government formulates a task force in Ministry of Finance to deliberate and convert governmental finances to Islamic financial framework.
2001	Major modifications were introduced in legal statutes and laws to expedite the Islamic financial system, including amendments in BCO 1962; furthermore Money Lenders Ordinances were also repealed.



	On 14 th June, the government filed a petition in the SC to extend the timeline to transform the economy as per Islamic lines, which was accepted and one year extension till 30 th June, 2002 was granted. On 1 st December, State Bank issues comprehensive criteria for setting-up a full-fledged Islamic commercial banking institution to enact dedicated Islamic banks.
2002	Pakistan's first full-fledged Islamic bank (Meezan Bank) was established. SC admits a review filed from the government and United Bank Limited (UBL), against its decision on <i>riba</i> case and on 24 th June, rules in favor of the government by setting aside the 1999 <i>riba</i> verdict and also declared void, the 1991 judgment of FSC.
2003	The State Bank of Pakistan established its own IBD – Islamic Banking Department to facilitate and promote the Islamic banking initiative in the country.
2004	Dual Banking system continues in the country with several Islamic banking branches (IBBs) of conventional banks in addition to one full-fledged Islamic bank. HBL gets approval for Islamic banking. Moreover, State Bank received 24 applications for more IBBs.
2007	Six purely Shariah-compliant Islamic banks and several IBBs of interest-based banks signaled for positive Islamic banking prospects in Pakistan.
2010	Four Shariah Standards designed by AAOIFI – Accounting and Auditing Organization for Islamic Financial Institutions are approved for adoption by Pakistan to be made applicable to the IB sector.
2020	The State Bank of Pakistan played a supportive role by conducting several Islamic banking awareness campaigns. The IB sector holds a market share of approximately 15% in the country's banking industry. In terms of operational strength, there are currently five fully fledged and purely Shariah-compliant Islamic banks as well as 17 conventional interest-based banks having their separate Islamic Banking Branches (IBBs), throughout the country.

Methodology

The development and progress of Islamic banking was based upon secondary sources of data including the already available literature, records, reports, facts and figures. For the discussion regarding the challenges faced by the Islamic banking sector, primary data was fetched by conducting the interviews. Further details regarding methodology being adopted to undertake interviews, is discussed hereunder:

Data Collection:

The data was gathered by conducting semi-structured interviews with the research participants that included the State Bank of Pakistan (SBP) personnel and Shariah supervisors serving in the Islamic banking industry of Pakistan.

Sampling:

The study employed the purposive sampling technique because VanRijnsoever (2015) posited that purposive sampling technique in comparison to other random sampling methods is especially much efficient in the domain of qualitative research. The choice of purposive sampling is also chosen based on past similar research studies (Ali and Hassan, 2017; Ayedh and Echchabi, 2015; Echchabi and Aziz, 2014; Echchabi and Olaniyi, 2012).

Data Analysis:

The data was fetched from conducting the interviews, in mainly two ways i.e. audio and voice recordings and in the shape of textual content when the researcher was taking notes



during the interview sessions. Subsequently, that data collected was meticulously and carefully reviewed before the transcription of data was undertaken. Afterwards, analysis of the data was done by formulating themes in the context of issues as discussed with the interview participants; the analysis entailed a detailed interpretation of collected data so as to have a holistic understanding regarding the responses, opinions and experiences of interview participants (Echchabi and Aziz, 2014; Lester, 1999).

Ethics:

The data was collected from the interviewees after taking their written consent. All interviewees were briefed about the research aims and purpose and were ensured about their confidentiality and anonymity and use of the information provided by them was being collected only for academic objectives.

Interview Data Findings and Discussion

The research interviewees provided their valuable feedback about various challenges being faced by Pakistan's Islamic banking industry. The researcher delved deep into the discussion with the interviewees regarding various problems and important issues as experienced by the IB sector of the country. There were many important points highlighted by the interviewees in their responses to the questions asked which are categorized under the following sub-themes:

Understanding and Awareness

The interview respondents were quite unanimous upon the issue of limited Islamic banking awareness among the masses. This is why most of the interviewees perceived that spreading the knowledge and understanding about Islamic banking philosophy, products and processes must be the greatest agenda point for all IB stakeholders in the country in order to ensure a progressive and stable IB market in Pakistan. Across both interviewee segments, including Shariah experts and regulators, majority of the respondents concurred that promotion of IB awareness among general public is crucial for a sustainable and successful Islamic banking sector. The interviewees deemed the lack of IB awareness as among the top hurdles in the realization of true IB market potential and suggested an all-out approach to disseminate the true and clear Islamic banking knowledge to the maximum extent among the masses by using all the possible resources to enhance the level of awareness in order to warrant a thriving IB industry. Some of the interviewees even pointed that general people aside, there is lack of understanding of true IB spirit even among the top-tier management of various Islamic banking and financial institutions, hence as the saying goes "charity begins at home"; the drive to inculcate concrete knowledge and understanding to raise awareness about Islamic banking products and processes must start from within the Islamic financial institutions to better equip their management and staff with necessary knowledge to pursue the cause of Islamic banking which will eventually facilitate the greater dissemination of IB awareness to a larger number of people including customers and general public. The matter of IB awareness must be considered at priority-basis, according to the interviewees as it would not only enhance IB products acceptability but would also help to dispel the negative viewpoints regarding the products and operations of Islamic banking sector in Pakistan. The interviewees asserted that all possible mediums and channels of communication must be utilized to spread Islamic banking awareness among the people to make them better understand the Islamic banking offerings and operations, so they accept and adopt Islamic banking products and services instead of going for the inter-based conventional banking products. The views of some of the interviewees with reference to the important aspect of IB understanding and awareness are mentioned as under:



Interviewee 4: “The issue of awareness tops all others because it is indeed the most crucial aspect in terms of acquiring new customers and attaining the confidence of existing customers in order to retain them, the fundamental distinction of Shariah-conformity of transactions by avoiding *riba*-based dealings must be conveyed in a clear manner to the general public to lift the IB market share in Pakistan.”

Interviewee 5: “This is amongst the major challenges faced by the IB sector of the country that there is absence of conviction regarding IB philosophy even among the management of IBFIs [...] and public at large comes later, firstly the IB knowledge and understanding must be diffused effectively within the Islamic banks’ leaderships, staff and personnel to eventually spread the message of Islamic banking in a clear fashion to other stakeholders like customers, competitors and general masses.”

Interviewee 9: “[...] and I think the most pertinent variable to IB growth is the IB awareness, simply put, the greater the awareness of IB paradigm, the more the market share will be [...]; therefore, every possible effort must be made to maximize IB understanding among the people using all available channels of communication including electronic media, social media, press and others.”

Interviewee 12: “The IB knowledge shall be the central focus of Islamic banks and they should ensure that the issue of IB awareness is pursued at grassroots level involving branch-level staff, in order to maximize the impact of IB understanding to the general public.”

Interviewee 13: “[...] and Islamic banks must strive at all levels to spread the knowledge of Islamic banking to their staff and customers as well as they must conduct awareness events, learning sessions and seminars, etc sorts of activities to draw the interest of general public towards the IB paradigm, this must be the focal agenda of all their marketing endeavors to effectively convey the message of Islamic banking model to the stakeholders.”

Interviewee 20: “All stakeholders must play their role to get the message (of Islamic banking) across including academia, mosques, and media in particular. Islamic banks must strive at all levels to spread the knowledge of Islamic banking to their staff and customers as well as they must conduct events and seminars etc. sorts of activities to draw the interest of general public towards Islamic banking services.”

The interviewees discussed various points in connection to the IB understanding and awareness which largely emphasized the significance of expanding the understanding of general public towards Islamic banking services and offerings. This aspect regarding the knowledge and understanding of IB products and offerings has also been elucidated in past literature including the studies by Haron et al. 1994; Metawa and Almosawi, 1998; Ahmad and Haron, 2002; Aziz; 2005; Khattak and Rehman, 2010; Soud and Sayılır, 2017; Riaz et al., 2017; Lujja and Hassan, 2018; and Latif, 2019.

Conventional Banking System

Among other issues, the interviewees underlined the challenge of countering conventional banking setup in the country. The majority of Shariah experts were of the opinion that the authorities including the governmental and regulatory bodies must intervene to support the cause of Islamic banking by putting some sorts of constraints upon the conventional banking sector. The fact that the country operates on dual banking basis apparently provides an open field for both interest-based as well as Islamic banks to compete but the level-playing field is not truly available to Islamic banks because they have a largely disproportional competition with conventional banks who are clearly winners in the race because of their already established organizational and industrial superiority over the Islamic banking institutions. The interviewees from both groups of respondents i.e. regulators as well



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as Shariah scholars emphasized some sort of measures to curtail and restrict further conventional banking growth to facilitate and support the IB initiative. The fact that the competition with conventional banks is an extremely uphill task is ratified by the Islamic banks' fractional share in the overall market share of Pakistan's banking industry which currently stands at approximately 16%. The cut-throat competition from conventional interest-based banks is perceived as one of the key obstacles and one of the biggest threats to the overall growth and progression of Islamic banking sector by the interviewees. Some of the opinions of the respondents are noted as under:

Interviewee 8: "There had been supportive arrangements already done in the past to favor Islamic banks and to discourage conventional banking system somewhat by encouraging them to operate their Islamic banking divisions/windows [...] but more needs to be done to put some type of limits to the exponential growth of conventional banking system to impact the Islamic banking sector in a favorable way."

Interviewee 11: "[...] people at the helm must have to take some tough decisions in order to constrict the conventional banking setup in one way or another to assist the Islamic banking sector because current scenario warrants not much IB success provided there is nothing done to put some reigns on the conventional banking setup."

Interviewee 21: "[...] as this, in my opinion, is not an option but a necessary move to facilitate the slack IB sector and steps to tighten control over conventional banking system would not only serve as a booster to full-fledged Islamic banks but would also send a strong signal to the conventional banks to divert more energies to expand their Islamic banking operations through their Islamic windows and IBDs (Islamic banking divisions)."

The interviewees also talked about developing Islamic banking sector by addressing key challenges including capacity limitations which are discussed in the next section. The capacity expansion is also contingent upon Islamic banks' survival from the fierce competition posed by the powerful conventional banking entities, so this was aptly highlighted by the research participants, and therefore they generally suggested supportive measures by constricting the rampant conventional banking system is quite essential.

Capacity Constraints

The challenges of capacity building and capacity enhancement are among the key challenges faced by the Islamic banks, operating in Pakistan's IB sector. The capacity issues are multi-faceted and varied in nature and magnitude, posing a threat and being cause of disadvantaged position of Islamic banks in comparison to the interest-based banks. The interview respondents noted several relevant issues including dearth of qualified and trained staff, lack of competence of Shariah and managerial personnel, limited financial resources and weak infrastructure among top factors which hinder a stable and sustainable IB set up in Pakistan. The points indicated by the interview participants were also highlighted in some of the previous studies like the ones by Mehmood, 2002; Ahmed et al., 2013; Aqib and Hussain, 2016; Ayub, 2019; Latif, 2019; and Shaikh and Shah, 2019. The viewpoints of the interviewees are given in the following statements as quoted:

Interviewee 2: "One of the obvious issues faced by the industry is the lack of human capital; it includes various aspects including overall competence of Islamic banking branch staff, managers, and executives who have lack of clear understanding about philosophy and processes of Shariah-compliant banking because mostly they come from the conventional banking entities [...] as well as the Shariah board members having a limited knowledge of modern banking and financial issues essentially make them unable to perform their roles in an effective manner."



Interviewee 7: “Poorly trained staff and underqualified Shariah personnel are major problems whereas, on the other end, limited financial resources render the Islamic banks to lag far behind in the competition with their conventional counterparts [...]”

Interviewee 10: “[...] and weak financials and limited physical resources of Islamic banks in comparison to conventional banks presents major challenges also causing setbacks in terms of stiff competition with the conventional banking sector.”

Interviewee 18: “[...] and conventional banks naturally being already established and in operation since a long period undoubtedly puts them at a frontal position whereas Islamic banks are lagging far behind owing to less-developed infrastructure, for instance in terms of several branches, inadequate and less-trained staff [...] all largely because of underdeveloped IB market and restricted financial capability.”

Stakeholders’ Engagement

The interview participants offered their insights regarding the promotion of the IB sector by suggesting various points regarding how to achieve IB sector growth and expand in terms of market share. The interviewees opined that the IB industry must engage in various forms of direct level communication with stakeholders from various walks of life and convey to them the understanding of Islamic banking and its significance in terms of religion and otherwise. The respondents suggested that in addition to addressing issues relating to product designing and development, and delivery of customer-oriented IB services; the Islamic banking stakeholders must adopt a holistic and comprehensive approach to take on board the general masses; this would certainly lead towards favorable interaction with prospective customers who may ultimately become IB customers and would be patronizing the Islamic banks in some way either by becoming clients or by otherwise spreading the message of Islamic banking by word-of-mouth advertising, which is the greatest mean to disseminate the Islamic banking awareness in society. The interviewees especially emphasized that awareness regarding Islamic banking requires an integrated approach and made various recommendations to enhance Islamic banking acceptability by involving general people from different fields of life. The proposals included stakeholders’ engagement through the involvement of academia (colleges and universities), *madaris* (Islamic seminaries), business and corporate entities, as well as members of the society from all walks of life including organizations from the public and private sectors. The community involvement initiatives may also be materialized by involving various institutions of social interaction including mosques, recreational and social clubs, market-places, shopping malls, etc. Apart from business and financial benefits, the interviewees suggested that the religious element is an essential and integral component of the Islamic banking model, and therefore, the same must be stressed while engaging the communities and general people to persuade them to patronize Islamic banking products and services. Some of the pertinent statements of interviewees are noted hereunder:

Interviewee 5: “[...] and a small market share of Islamic banks proves the point that the IB market potential remains largely untapped in Pakistan to a greater extent and thus the situation calls for a coordinated effort to take all the concerned stakeholders on board by community engagement activities at various levels including diverse means like by conducting events and activities at banks, business places, and other public and private sector organizations to spread awareness and offer IB services at the doorstep of the people to win over new customers and maximizing the prospective clients [...]”

Interviewee 8: “[...] and people must be urged to realize that the Islamic banking alternative should be considered as a mandatory choice instead of being an optional one, particularly from a religious perspective because *riba* is one of the most serious sins in the



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Islamic faith, this fact may be reiterated by involving communities and individuals at different social and institutional scales.”

Interviewee 9: “No doubt an integrated and well-organized marketing and awareness campaign to involve general people, to enable them to understand and adopt Islamic banking services, is the need of the hour [...] and various social setups and institutions including mosques, *madaris*, educational institutions, public places like marketplaces, transport centers, shopping areas and corporate and business establishments, etc may be approached for the purpose.”

Interviewee 15: “A systematic and carefully planned strategy is much required to ensure engagement of the common people to patronize and participate in the Islamic banking initiative of the country, there have been some efforts in this regard from various stakeholder groups including the central bank and other governmental and regulatory organizations [...], rather a comprehensive and well-coordinated effort from all concerned stakeholders including Islamic banks, state-owned governmental and regulatory agencies, academia and business entities is needed to lift the status of IB sector and to ensure a thriving and sustainable Islamic banking industry in the country.”

Operational Obstacles

The interviewees discussed several operational hurdles and challenges faced by the IB sector. These issues as highlighted by the interview participants included the use of KIBOR as a benchmark rate; operational transparency of Islamic banking transactions; issues about Shariah compliance and Shariah spirit of IB transactions; and lack of a comprehensive, standardized, and uniform IB legal and regulatory framework. The issues as described by the interviewees act as irritants and stumbling blocks in the smooth functioning and execution of IB dealings and operations and hence must be addressed aptly by the concerned quarters including the regulatory and banking entities to ensure a progressive IB setup in the country. The opinions of various interviewees are mentioned below to elucidate their views regarding the operational issues faced by the IB sector:

Interviewee 4: “[...] and one of the most pinching matters is one of the benchmark rates, this is high time for all stakeholders including especially the regulators and Shariah experts to devise some sort of alternative which may substitute the benchmark rate to price the IB offerings.”

Interviewee 6: “[...] and this is obvious that customers’ expectations from Islamic banks in terms of operational transparency and accountability concerning the execution of transactions are high, and so this is one of the areas the Islamic banks must look into to enhance the confidence of customers [...].”

Interviewee 11: “There are certain misconceptions and misunderstandings about the Shariah spirit of IB products, but these are not unfounded, there needs to be done a lot to dispel the idea that Shariah is not the top goal of Islamic banks, which requires dedication and honest efforts from all concerned including Shariah board members, the management being decision-makers as well as the IB staff who are responsible to execute transactions as per Shariah parameters.”

Interviewee 12: “Benchmark rate is a chief irritant and a major cause of criticism faced by the Islamic banks, therefore something must be done at a priority basis to look for some alternatives in terms of an index, rate or percentage that may be utilized to replace the KIBOR benchmark [...] and it would not be possible without the interest and involvement of regulators and decision-makers at the top from the government sector to approve and implement the same.”



Interviewee 14: “[...] and from Shariah perspective, both forms, as well as the substance of transactions, must be considered to ascertain whether a transaction conforms to the Shariah guidelines in true letter and spirit.”

Interviewee 17: “There are issues concerning the Shariah and regulatory framework, for instance, partial adoption of AAOIFI standards resulting in a mixed-up legal schema and absence of a uniform code to resolve Islamic jurisprudential differences among others so there is still much progress needed towards the development of a standardized framework to serve as of basis for a stable IB sector [...]”

Interviewee 19: “[...] and Shariah violations in transactions, as well as grey areas in product designing and structuring from Shariah conformity standpoint, are critical issues [...] and these may only be effectively addressed by introducing a standardized system of product development at the central bank level to ensure uniformity and a greater degree of Shariah compliance to avoid the phenomenon of *fatwa* shopping.”

The issues and irritants regarding the Islamic banking operations and processes, as discussed in the context of responses of the interviewees comprising members of the central bank’s staff and members from SSBs of various banks, were also shed some light by being part of the past literature as contained in the previous studies including the ones by Mansoori, 2011; Ahmed et al, 2013; Butt and Aftab, 2013; Oseni, 2017; Majeed and Zainab, 2017; Shakir et al., 2018; Ayub, 2019; Shaikh and Shah, 2019; and Tlemsani, 2020.

Regulatory and Governmental Support

The interview participants were concerned about the lack of adequate facilitation and support from the concerned state-owned authorities including the governmental and regulatory institutions; especially the Shariah experts segment raised their concerns regarding the lack of governmental support towards the IB initiative and urged greater support from the governmental and regulatory bodies to strengthen and promote the IB sector in the country. The interviewees opined that the government’s lack of an honest will and slack regulatory support hinders a fast-paced IB growth and the interview participants also discussed issues of the weak legal and regulatory framework, slack policy formulation and implementation, as well as lack of political will to warrant a prosperous Islamic banking regime in Pakistan against an extremely dominant interest-based banking system at both national and international levels. The interviewees suggested that there must a committed and result-oriented policy shift from the government to lift the IB sector by incorporating modifications in legal statutes as well as by introducing a potent and progressive regulatory schema to enable smooth functioning and regulation of the IB industry in Pakistan. The views of some of the interviewees are discussed as follows:

Interviewee 1: “The governmental support is not where it should have been in terms of legislation and legal framework [...] and therefore it is up to the central bank and governmental machinery to back the IB sector in a true sense to strengthen the IB industry against a mighty conventional banking sector.”

Interviewee 4: “SBP has done very well in facilitating the IB sector and its contribution has been commendable yet the policy-related and legal issues from the government’s end require greater interest and consideration to support the IB industry [...]”

Interviewee 10: “[...] and there are several proposals in the pipeline such as modifications to the BCO (Banking Companies Ordinance) and amendments in other statutes to expedite and facilitate the functioning of IB sector and to ensure effective regulation.”

Interviewee 15: “The SBP as the regulator has played a very positive role to strengthen and promote the IB system of the country and further efforts are underway to contribute even more towards the development of the sector.”



Interviewee 16: “There have been measures taken by the regulatory institutions, especially SBP but there is always a margin for the better [...] and facilitation from the government’s end and other regulatory and policy-formulating agencies may surely be enhanced to lift the IB sector in order to support it to achieve greater potential in order to better compete with the conventional banking system.”

The discussion regarding the regulatory and governmental support that Pakistan’s central bank has certainly played a much favorable role in assisting the IB industry of the country (Siddiqui, 2021), yet the interviewees stressed that a lot can be achieved if the regulator along with the backing of governmental support. There must be improvement in terms of policy formulation and in terms of designing and implementation of effective legal framework to facilitate IB governance and ensure a greater degree of reliability of IB operations in the context of Shariah compliance which is the cornerstone of the Islamic banking paradigm. The endeavor must be to develop a superior system of regulation and control based on focused legislation to promote and strengthen the IB initiative in the country. The need is to involve the corridors of power in the governmental institutions to expedite the necessary statutory amendments in relevant laws specifically the Banking Companies Ordinance as well as the enactment of fresh legal and statutory regulations that must be focused on refinement of the Shariah governance framework and are aimed at assuring a greater degree of operational transparency. The interviewees proposed that there must be separate IB exclusive modus operandi to be implemented by the authorities in terms of policy and regulation to enhance the confidence of the general public at one end and ensure superior regulation of the IB sector on the other.

Summary of Key Findings from Interview Data Analysis

The following table provides the major findings based on the data analysis from conducting the interviews for the study from the two key stakeholder segments including regulators and Shariah scholars involved in the IB sector. The table is followed by the conclusion.

Table 2: Summary of Key Findings from the Interview Data

Challenges Faced by Islamic Banking Sector in Pakistan	
Subject/Theme	Findings
Understanding and Awareness	<ul style="list-style-type: none"> • Almost all interviewees asserted that there is a great need to enhance understanding and awareness of the Islamic banking paradigm in the country. • There must be an all-out approach to disseminate Islamic banking knowledge and understanding among the general public by using all possible communication channels and media.
Conventional Banking System	<ul style="list-style-type: none"> • The conventional banking sector is perceived as the greatest challenge to the Islamic banking set up by a majority of the Shariah supervisors. • The size and share of interest-based conventional banks in the overall banking sector pose a major setback for Islamic banks and put Islamic banking entities in a survival race that eventually acts as a barrier toward a progressive and stable Islamic banking setup. • There is surely a need to somehow restrict and curtail the conventional banking sector to support the Islamic banking



	<p>initiative in the long run.</p>
Capacity Constraints	<ul style="list-style-type: none"> • The capacity issues at Islamic banks are multi-faceted and varied in nature and magnitude putting Islamic banks in a compromising position, especially in comparison to the conventional interest-based banks. • Major capacity limitations and issues include a dearth of qualified and trained staff, lack of competence of Shariah and managerial personnel, limited financial resources, and weak infrastructure.
Stakeholders' Engagement	<ul style="list-style-type: none"> • There is a certain necessity to engage stakeholders at all levels of society to ensure the uplift of the Islamic banking sector. • The approach must be to involve various segments of society including religious, business, public, and private sectors. • The efforts to improve Islamic banking awareness must be well-coordinated and integrated targeting all levels of society by engaging various stakeholders from diverse walks of life including banking and non-banking business organizations, religious institutions, academia, social structures/setups, and the government sector.
Operational Obstacles	<ul style="list-style-type: none"> • Among other difficulties and predicaments, the interviewees also described some key obstacles faced by Islamic banks. • The points highlighted by the interview participants included the use of KIBOR as the benchmark rate; operational transparency of Islamic banking transactions; issues about Shariah compliance and Shariah spirit of IB transactions; and lack of a comprehensive, standardized, and uniform IB framework.
Regulatory and Governmental Support	<ul style="list-style-type: none"> • Regulatory institutions particularly SBP have played a positive role to further the cause of Islamic banking in the country. • There have been favorable progress and good steps taken by the SBP in promoting and strengthening the Islamic banking sector. • There is a need to enhance the level of regulatory and governmental support for the IB industry. • The government must step forward by enacting and introducing new laws as well as amend the existing ones to facilitate better regulation and to ensure the smooth functioning of the IB sector.

Conclusion

The analysis of Pakistan's IB initiative from its beginning to its current state of affairs shows that the Islamic banking setup in Pakistan had a long and difficult journey which had its share of constraints and achievements but as time passed, the IB sector progressed steadily. A breakthrough for the IB sector came in 2002 when the premier and very first fully-fledged Islamic bank was set up in the country which later paved way for stable industry growth. Furthermore, based on the responses of interview participants i.e. Shariah supervisors and SBP staff members, this may be concluded that sustainable success of the IB paradigm is only possible with the coordinated efforts involving all stakeholders including IB regulators, Shariah experts, customers, and bankers. Moreover, the interviewees emphasized that to cope with the challenges and issues faced by the Islamic banking sector, there must be greater support from the government to facilitate the IB industry in comparison to the mighty conventional banking system and there must be dedicated efforts to raise understanding and



awareness regarding Islamic banking products, offerings, and operations, to truly lift up and enable the IB sector to blossom and achieve its true potential. From the assessment of Pakistan's Islamic banking in the past two decades, as well as keeping in context, the recently launched supportive measures from the SBP, in shape of five-year Islamic banking plans, the prospects for the sector look promising. The SBP plans to ensure a one-third market share for Islamic banking by the year 2025, but a well-integrated and coordinated approach from the concerned stakeholders would be needed to achieve the desired growth objectives.

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