Submission to Federal Shariat Court
Islamization of Banking System in Pakistan
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Islam provides guidelines to Muslims in every sphere of life including the financial system. Having roots in Shariah principles, the business model of Islamic banking emphasizes on strong linkages between the financial and real sector. The innate strength of being asset backed enables Islamic banking industry to lend prudence and stability to the economic system.

Islamic banking and finance in its modern form started in the second half of twentieth century as a niche market catering only to the faith sensitive individuals buoyed by petro dollar wealth of Muslim countries in the Middle East. Islamic finance industry currently has an asset base of US$2 trillion (World Bank Report on Islamic Finance)[1]. In particular, the global acceptability and recognition of Sukuk in raising Shariah compliant funds is increasing. It is, however, important to note that despite witnessing significant growth, the share of Islamic finance assets in global financial assets is only one percent.

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In terms of geographic outreach, Islamic finance assets are concentrated in the Gulf Cooperation Council (GCC) countries, Saudi Arabia, Iran, and Malaysia. According to Global Islamic Finance Report 2015, Iran has the highest assets in Islamic Financial Services Industry (US$ 530 billion) followed by Saudi Arabia (US$ 339 billion) and Malaysia (US$ 249 billion). However, despite having largest asset size, Iran has not played any significant role in global Islamic financial services industry mainly due to economic sanctions on the country. Moreover, some of the practices in Iranian Islamic banking system like allowing minimum rates of return on time deposits[2] remain unacceptable in other jurisdictions.

Malaysia is generally considered as the market leader and is renowned for having comprehensive regulatory and legal infrastructure for Islamic banking as a parallel system. Due to enabling environment and history of Islamic banking and finance spanning over thirty years, Malaysia's Islamic banking accounts for only 20.7 percent share[3] in the overall banking industry. Moreover, some Islamic finance transactions practiced in Malaysia remain controversial in terms of Shariah permissibility in other parts of the world.

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[1] March 2015
[2] Mehdi Sadeghi Shahdani (2007) "Islamic Banking In Iran From Theory To Practice", Proceedings of the 2nd Islamic Conference 2007 (iECONS2007) organized by Faculty of Economics and Muamalat , Islamic Science University of Malaysia.
[3] World Islamic Banking Competitiveness Report 2014-15

Bahrain also has a history of Islamic banking and finance of more than thirty years. Various international standard setting bodies like Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Liquidity Management Centre (LMC), Islamic International Rating Agency (IIRA) and International Islamic Financial Market (IIFM) are based in Bahrain. Despite this long history and being host to some significant international standard setting agencies, the market share of Islamic banking in overall banking is still 27.7 percent in Bahrain[4].

In case of Pakistan, the country is generally considered as one of the initial countries to have allowed Islamic banking. In order to Islamize the financial system of Pakistan, significant efforts were made during 1980s and pioneering work was done on legal, regulatory and supervisory fronts. However, these efforts could not produce desired results mainly due to the decision of abrupt conversion of the whole banking system in absence of adequate infrastructure and human resource. Consequently, due to concerns about practices of Islamic banking in the country, some products and processes were challenged in the Federal Shariat Court (FSC) which declared those as non Shariah compliant in 1991. FSC further ordered to eliminate Riba from the economy by June 1992. Subsequently, the government and financial institutions challenged the verdict in Shariah Appellate Bench of Supreme Court of Pakistan (SAB), but it re-affirmed the decision of FSC in 1999 and recommended to change the prevailing system by June 30, 2001. Later the time line was extended to June 30, 2002. As a result of review petition filed in SAB, both judgments of FSC-1991 and SAB-1999 were set aside and the matter was referred back to FSC for hearing afresh.

In order to comply with the substance of the judgment it was resolved to introduce Islamic banking in Pakistan in its true spirit. An independent Commission of experts from banking, ulema, Shariah scholars, academics and researchers by Islamic Development bank was formed to advise the Government and the State Bank of Pakistan on the most feasible options to bring about the transformation from conventional to Islamic banking. In the light of the Report of the Commission it was concluded that as Pakistan cannot completely sever its linkages with the rest of the world and would remain part of international trading and financial community for its economic sustenance a sudden knee jerk time bound action to make a complete switch over would be highly detrimental and disruptive to the country's economic interest. The economy would come to a standstill as it is deprived of its financial life line. It was therefore decided that a parallel banking system should be introduced in which both Islamic banking and Conventional banking would be provided a level playing field to offer their products and services. Stand alone Islamic banking

[4] World Islamic Banking Competitiveness Report 2014-15

licenses were allowed although there was a ban on issue of new conventional bank licenses which continues to exist. Conventional banks were encouraged to open subsidiaries and separate windows for Islamic banking making sure that there was no comingling of assets or deposits. Shariah Boards were formed both at the SBP as well as individual banks to guide and certify that the products and services in fact complied with the principles and percepts of Shariah. Infact, the choice was given to 26 million consumers of banking services in Pakistan whether to shift their deposits and assets to Islamic banks or continue with the conventional banks for the time being and making the choice ultimately. There is always uncertainty associated with any new system and the Government and the SBP wanted to ensure that this uncertainty is minimized and the whole financial system does not come to an abrupt halt. The repercussions of this sudden shock to the economy would have been unbearable and the risks to the normal living standard of a common citizen would have been unmanageable. The model of gradual transformation to Islamic banking system over time was therefore adopted as the most feasible strategic intervention under these circumstances.

This approach has proved to be a success since the re-launch of Islamic banking in 2002. As of end June 2015, 22 Islamic banking institutions (IBIs) (5 full-fledged Islamic banks and 17 conventional banks having standalone Islamic banking branches) are operating in the country with a network of above 1700 branches. Asset base (Rs.1,495 billion) of Islamic banking industry constitutes 11.3 percent of the overall banking system while in terms of deposits (Rs.1,281 billion) its share is 12.8 percent.

Despite the fact that the progress has been impressive and the model of Islamic banking provides solutions for fulfilling financial needs of all stakeholders there are a number of challenges that need to be addressed for realizing its true potential. These challenges are complex and suggest continuing with gradual transformation.

Efficient Shariah compliant monetary transformation mechanism at macro level and liquidity management at micro level is constrained due to limited availability of tradable Islamic interbank market instruments in most jurisdictions including Pakistan.

At micro level, issuance of sovereign Ijara sukuk since 2008 has provided some relief to Islamic banking industry by providing an investment avenue. This has also helped Islamic banking institutions by enabling them to invest in Shariah compliant government securities instead of keeping cash in order to meet their Statutory Liquidity Requirement (SLR) by the central bank. However, there has been infrequent and insufficient supply of sukuk resulting in its illiquid secondary market. Due to high level of uncertainty surrounding the availability of sukuk, Islamic banks like to hold sukuk till maturity.

The corporate sukuk market in recent past has started picking up again after 2008 with K-Electric and Engro taking the lead, however, the growth of this market with huge potential cannot be capitalized upon without bringing in desired changes in legal, regulatory and taxation framework. Moreover, heavy reliance on sukuk globally as well as domestically is not ideal since sukuk market globally is witnessing a decline; Standard & Poor's (S&P) has revised its 2015 Sukuk forecast from US$100-110 billion to US$50-60 billion.

Moreover, till now all domestic sovereign sukuk are of three years maturity and the industry has not been able to introduce any short term liquidity management instrument. Resultantly, Islamic interbank money market is grossly under developed forcing Islamic banking institutions to place most of their short term liquidity in conventional banks through transactions like commodity murabaha and sukuk murabaha, which although meet the minimum Shariah requirements, however are not preferred by majority of Pakistani Shariah scholars. Furthermore, like many other jurisdictions, lender of last resort (LOLR) facility is not yet available in Pakistan that forces Islamic banking institutions to maintain larger cash balances. This affects earning ability of Islamic banking institutions and adversely affects the return for depositors. Any other safety net like deposit insurance for Islamic banking is also absent. The need for development of these facilities is becoming critical with the increasing size of Islamic banking.

At macro level, the launch of Shariah compliant Open Market Operation (OMOs) in recent past has extended central bank a mechanism to transmit monetary policy stance to Islamic banks. However, with the growth of Islamic banking industry there will be a significant increase in demand for Shariah compliant securities by the central bank for monetary management. This can be done either by issuance of sovereign sukuk by the government for the central bank or issuance of Shariah compliant securities by the central bank itself. In both scenarios, issues like identification of assets, their valuation, documentation and legal issues need to be addressed.

Furthermore, the issuance of sukuk (both local and international) has helped the government to transform its debt into Shariah compliant financing. However, given the amount of financing required for budgetary needs, sukuk issuance is desired to be of sizable magnitude which require significant assets and prolonged time frame. Moreover, 33 percent of GoP debt is through foreign borrowing (Rs. 6.77 trillion) from institutions like IMF, World Bank and hence the conversion of foreign debt into Shariah compliant financing is highly unlikely in near future.

Compliance with continuously changing international policy landscape, for instance, adoption of Basel-III is one of the key challenges that Islamic banking industry is faced with internationally as well as domestically. This new international regulatory framework has increased the quantity and quality of capital requirement for banks by introducing various capital buffers and instruments with specific characteristics to raise capital. It is imperative to consider that most of the Islamic banks in Pakistan are small and need to strengthen their capacity for further growth in potential. Moreover, liquidity requirements have also been increased under Basel III and the limited Shariah compliant high-liquidity assets (HQLA) accentuates the difficulty that Islamic banks both international and local have with liquidity management.

Banking sector in Pakistan has largely inclined towards lending to government and corporate sector. Significantly important sectors like Agriculture and Small and Medium Enterprises (SMEs) are largely ignored by conventional industry. While theoretically Islamic banking and finance is able to cater to these sectors owing to intrinsic strength of financing ventures on the basis of their feasibility rather than mere collateral, Islamic banks have been more reluctant than their conventional counterparts to penetrate to these sectors mainly because of low economies of scale, dearth of skilled and trained human resource, high probability of moral hazard and adverse selection. Given the growth trajectory and presence of conducive regulatory regime Islamic banks will likely reach out to these strategic sectors in the long run.

One of the major criticisms on Islamic banking industry is the use of conventional benchmark. Shariah though allows the use of conventional benchmark, however, this is one of the leading reasons for increasing misperception about Shariah compliant banking in the country. Issues such as relatively small size of Islamic banking industry and overwhelming use of debt based products have led to lower acceptance level of Islamic interbank rates. This also demands for ensuring standardization and harmonization with international regulations and best practices and also for transparency through broadening financial reporting and effective monitoring.

The sustainability of growth of banking is subject to the development of its complementary capital market. Islamic banking in Pakistan though has shown considerable growth since the start of this millennium, however, Islamic capital market remains largely underdeveloped. Over the last one and half year, Securities & Exchange Commission of Pakistan (SECP), the regulator of capital market, has been proactively developing Islamic capital market. Following the gradual approach adopted by SBP, SECP is focused on building sound foundations and creating conducive environment for growth of Islamic capital market in the country. However, the work in this regard is at very initial stage.

One of the lessons learnt from the experience of 80's is acceptability of importance of adequate infrastructure being in place for a financial system to work efficiently. Availability of skilled human resource remains central to this. One of the key challenges facing Islamic banking today is lack of trained Islamic banking and finance professionals. Majority of the human resource associated with Islamic banking industry have had their prior experience and training in conventional banking system. As a result majority of banking professionals are are not aware of Islamic banking products/Shariah injunctions. Further complexity is created by dearth of Shariah scholars having expertise in Islamic banking and finance, which puts pressure on existing fraternity of Shariah scholars and may affect the level of Shariah compliance within existing Islamic banking institutions.

There has been growth in number of institutions offering Islamic banking and finance certifications including leading business schools and training subsidiary of the SBP. Despite these efforts human resource remains one of the key challenges faced by all stake holders. Recent establishment of Centres of Excellence in Islamic Finance Education (CEIFEs) in three reputed universities will enhance the number of training programs related to Islamic banking offered by private sector; going forward in the long run a stable stream of trained and qualified HR will be available for the industry.

Despite the increasing popularity of Islamic banking both globally and at the domestic level, the industry represents a relatively small portion of the overall banking sector. There seems to be a disconnect between the theory of Islamic finance and prevailing practice as the current model of Islamic banking internationally and locally remains short of meeting aspirations of Islamic moral economy.

Constrained by issues such as low economies of scale, limited product menu, issues related to Fatawah standardization and harmonization, challenges in the context of dynamic international regulations, lack of awareness across the spectrum including policy makers and demand side, Islamic banking has a long way to go to achieve the mainstream status.

Despite the issues facing Islamic banking industry it has gained attention by offering itself as a realistic alternative to the interest based capitalist system. Going forward with a balanced and gradual approach with focus on setting sound foundations, Islamic banking will be able to address the issues/challenges that are associated with early stages of development.

To conclude, one of the strong planks of Islamic banking that makes it so attractive for financial stability is that it is based on risk sharing rather than risk transfer. Investors, account holders and depositors entrust their money to the banks so that they can manage it on their behalf and deploy it in economic activities that generate a stream of returns. If the underlying business in which the money is deployed is doing well these individuals or institutions get a pre agreed share of the profits or otherwise a share in loss. In a perfect Islamic society complete integrity and trust in the "mudarib" and the "operator of business" would drive this transaction. In Pakistan where all kinds of deceptions, frauds, cheating and greed prevail so widely and Modarabahs and Islamic finance companies have disappeared and run away with the poor people's hard earned savings this plank of Islamic banking has not yet found an anchor to rivet. The transaction costs of Islamic banking would have been much lower compared to other modes if trust had prevailed and Islamic values were practiced in true spirit and obligations assumed by each party were carried out diligently. The entire Pakistani consumers of banking services would not have hesitated for a minute to exercise this choice and we would have only one system of banking in the country i.e. Islamic banking system.

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