Islamic Banking and Finance Pakistan’s Experience and Skepticism

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Abstract. The rationale of this paper is to review the various aspects of growth of Islamic banking & finance globally and also assess their viability and applicability with respect to individuals and corporate consumers. This study attempts to assess the reasons why no remarkable or visible changes has been witness in the economic system of any Muslim country in spite of that Islamic bank have been working since last three decades. In addition, it assess that despite the climate is more favorable to Islamic banking yet Pakistan’s record in developing its own Islamic banking system has been very disappointing. The main objective of the paper is to focus specifically the development of Islamic Baking in Pakistan, which will enable the readers in understanding the evolution of Islamic Banking and will consequently enable them in evaluating its need in present times.

Keywords: Islamic Banking, Islamic Finance, Economic System, Skepticism Pakistan.

1 Introduction

1.1 A Review of Islamic Banking and Finance

Islamic banking and finance, is a faith-based system of ethical finance, while it is growing at the same time it still continues to struggle for its identity; it is torn between the market success of emulating conventional structures and developing genuinely Islamic structures that reflect its spiritual ethos. This paper reveals the struggle and irrelevant pressures that threaten Islamic finance between the State Bank of Pakistan the ministry of Finance which were never very enthusiastic nor supportive about introducing Islamic banking and finance and the country’s policy makers which constitutes the modern bureaucrats and the successive Pakistan government who are largely responsible for ignoring this important work and have failed miserably to undertake the necessary practical steps to introduce Islamic finance, so that the system could be a genuine alternative to the conventional system (Ayub Muhammad 2002).

1.2 Historical Development

Pakistan was created in the name of Islam in 1947. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba (interest) as an important objective of the State policy. Article 38(f) of the Constitution of the Islamic Republic of Pakistan provides: “The State shall Eliminate Riba as early as possible.” The Objectives Resolution, now a part of the Constitution, as well as principles of policy enunciated in the Constitution also require to establish an order in Pakistan “[w]herein the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and tenets of Islam as set out in the Holy
Quran and Sunnah

In late 1960s and early 1970s when some noble minds came up with the idea of an alternate banking system that would do justice with both the suppliers of capital (depositors and investors) and the recipients of capital (borrowers and investees) which is pure justice so it is rational. Hence the thought of JUST BANKING or RATIONAL BANKING was born which is nothing but an ISLAMIC BANKING. In Pakistan Islamic banking emerged as a response to both religious and economic needs (Manzoor, et al., 2011).

1.3 Islamic Banking & Finance Movement

The conceptual developments of IBF occurred in the late 1940s. The IBF (Islamic Banking & Finance movement that gathered significant momentum in the Muslim world by the late 1970s lead to the emergence of number of Islamic banks in the private sectors of Muslim countries. However, no Muslim country had taken an initiative to establish its national economy and finance sector on Islamic lines. Islamic banking and finance (IBF) is a sub-discipline of Islamic Economics. Its origin, objectives and operative mechanisms are based on Shariah. It is mainly an equity-based system that offers a more ethical and efficient alternative to the interest-based conventional system. At present IBF successfully operates in 70 countries, with a network of more than 300 institutions across the globe (Memon, 2007). Numerous banking services systems or channels were available and can be adopted, such as, Electronic payment (E-payment), Automatic Teller Machine (ATM) bank, m-banking, adoption of internet, and online banking, Wireless application protocol (WAP) services, usage of Islamic financing products, and usage of Islamic automobile financing (Alkhaldi & Al-sa’di, 2015).

2 A Step Forward

A major breakthrough in this regard occurred in September 1977 when the president of Pakistan General Mohammed, Ziaul Haq, expressed an interest in transforming the economy of Pakistan on Islamic lines. He directed the Council of Islamic Ideology (CII) to formulate a blueprint for an interest-free economy within 3 years.

2.1 Beginning of Islamic Banking as a Closely Owned Entities in Pakistan

The mid-80s attempt was a significant step in the evolution of Islamic banking system in Pakistan. In a technical sense it was the most advanced model compared to any other model being practiced anywhere in the world at that time.

The earliest efforts for finding an alternative to the interest-based system could be found in a number of reports submitted by the Council of Islamic Ideology (CII). The process of Islamization of the economy was started in 1980s and mark-up was introduced in place of interest and separate windows were established in all commercial banks to carry out banking practice under profit-and-loss system (PLS). Mudarbah Companies (Floatation and Control) ordinance, 1980 was enforced and more than 30 Mudarbah Companies were launched and enlisted at Karachi Stock Exchange. These companies are still operating and paying handsome dividend every year to their
shareholders. The successful experience of Mudarbah Companies and people’s enthusiastic participation in their equity paved the way for initiation of Islamic banking in Pakistan.

Moreover, in many countries while the desire for interest-free banking was from the masses, the efforts for its practical implementation did not come from the governments but from individuals or small groups. Kazmi Ali (2001). Since the practical efforts were only from relatively few individuals – i.e., those who could put up large amounts of wealth in establishment of new institutions – Islamic banks tended to become closely owned entities. And in many instances owned and governed by only one or very few wealthy people. This opens them to risks emanating from lack of sound corporate governance and contributes to their susceptibility to financial distress.

2.2 Half Hearted Approach of the State Bank of Pakistan towards Islamization of the Economy and Financial Sector

The State Bank of Pakistan took the first step towards Islamization by directing all banking institutions to open PLS counters in 7,000 domestic branches across the country from January 1981. The SBP instructed banks from time to time to invest their PLS funds in interest-free (cleaned-up) assets, such as commodity operations of the government, Participation Terms Certificates (PTCs), or National Investment trust (NIT units). The SBP advised banks to keep separate accounts of their PLS operations to ensure that returns on PLS deposits were free from interest. Besides, the adoption of Banking Technology (BT) enables banks to make the international market more truthful (Alkhaldi, 2016).

According to Khan (2008), during the period January 1981 to June 1985, depositors were given a free choice to invest their funds either at the conventional banking counter or at the PLS counter at banking institutions in Pakistan. On the first day alone, i.e., 1 January 1981, banks mobilized Rs 92.6 million on a PLS basis (Faruqui and Habibullah, 1983). PLS deposits increased from Rs 6.5 billion at the end of 1981 to Rs 33.3 billion by March 1985 (Ahmed, 1987). The rates of profit on PLS deposits were higher than the returns on interest-based deposits during January 1981 to July 1985.

Foreign banks working in Pakistan also showed a keen interest in adopting the new system. They sent their top officials to overseas Islamic banks for training in, and to gain a better understanding of, IBF practice. It was the prime responsibility of the SBP to transform the economy and financial sector of Pakistan on Islamic lines in the light of the CII’s recommendations. The task of eliminating interest from the economy of Pakistan was highly complex and required radical changes in the financial and administrative set-up of the country. A number of deficiencies and concerns were observed in the adoption and practice of IBF in Pakistan (Khan 2008).

The urge to adopt Islamic finance should stem from a conviction that one should follow Islamic ways in all walks of life. Thus, Islamic restructuring of economy and state institutions should take place at the same time in the Muslim polity. It may be noted that Pakistan inherited a very exploitative socio-political and economic nexus from the British colonial era. The people of Pakistan have dreamed about seeking financial independence and prosperity and sharing the
benefits of growth widely and equitably among themselves since the dawn of independence in 1947. They unanimously and constitutionally resolved that the objective of economic freedom and prosperity would be pursued through the Islamization of the economy of Pakistan. In the given context, the government of Pakistan was required to adopt the Islamization strategy for the entire system of the country. However, this has not happen.

2.3 Early Breakthrough

The Federal Shari at Court of Pakistan which is a constitutionally recognized authority in Shariah matters, was created in 1980 to examine and decide on the question whether any law or provision of law is repugnant to Shariah as enunciated in the holy Quran and Sunnah under a Presidential Order by the insertion of a new Chapter 3A in Part VII of the 1973 Constitution of Pakistan under Article 203D, but it remained incapable of dealing with the case of interest in the early years of its foundation because its jurisdiction of entertaining petition over fiscal laws and banking matters was banned through special Presidential Orders. On 25 June 1990, when the constitutional power of the FSC was restored, 115 Shari at petitions and three suo moto Shari at notice cases were filed with the court between 30 June and 24 October 1991, challenging a host of banking and fiscal laws in Pakistan on account of interest provision in them. A full bench of the FSC, comprising three judges, namely, Chief Justice Tanzil-ur-Rahman, Justice Fida Mohammad Khan and Justice Abaid Ullah Khan, thoroughly considered the views of all parties to the riba case. After lengthy deliberations, the FSC concluded its hearing on riba on 14 November 1991. The FSC announced the following verdict on riba:

A transaction which contains excess or additional over and above the principal amount of loan, which is predetermined in relation to time or period to be conditional on the payment to predetermined excess or addition, payable to the creditor (such a transaction containing the said elements) constitutes riba and any sale, transaction or credit facility, in money or in kind, has been considered to be a transaction of riba, which is unlawful (harm) in the territory of Islam and in Muslim society. There is a consensus (Ijma) of the Muslim jurists on it.

The FSC further added that any stipulated increase on capital, whether high or low, simple or compound, taken for personal or private or productive or consumption purposes, for short- or long-term, between two Muslims or between a Muslim and non-Muslim or between a citizen and state or between two states, comes under the ambit of riba. The FSC decreed that bank interest falls under the definition of riba. The FSC resolved that the practice of mark-up (Bai Muajjal/Murabaha) with a buy-back arrangement in the banking and financial sector of Pakistan involves excess on the amount of principal and thereby constitutes interest. The FSC adjudged 20 banking and fiscal laws that contained provisions of interest and mark-up as repugnant to the injunctions of Islam. The FSC ordered the government to bring these laws into full conformity with Shariah by 30 June 1992; otherwise they would cease to be effective on and from 1 July 1992.

The FSC judgment brought to the surface the central fact that the Pakistani polity was not ready to make any real sacrifice to establish the Islamic economic and financial system in the country. The matter of abolishing interest from the economy of Pakistan had been delayed for the previous 45
years (1946–92), and by lodging an appeal with the SC the polity of Pakistan further deferred it for the time being (Khan & Bhatti, 2008b).

2.4 Gross Exodus of State Bank of Pakistan from the CII’s Recommendations

The CII had emphasized the need to design a well-integrated plan to evolve full-fledged IBF practice in Pakistan. It recommended that the task of phasing out interest from the financial sector of Pakistan should be started on its assets side and completed on its liabilities side. The CII informed the government that the transformation of the assets side of the banking sector on a PLS basis could not be guaranteed without the introduction of rigorous reforms in the regulatory, legal, tax and accounting systems of the country. The CII advised the government that these preconditions should be satisfied in order to develop a conducive socio-economic infrastructure for ensuring the smooth adoption and functioning of the PLS system. In addition, the CII strongly rejected the proposal to start the task of transforming the banking and financial sector on Islamic lines by opening and running interest-free counters alongside interest-bearing counters at the banking and financial institutions of Pakistan (Khan & Bhatti, 2008a).

The SBP, however, simply ignored all the crucial recommendations made by the CII. On the contrary, it started with eliminating interest from the liabilities side of banking sector, which promoted a parallel IBF system within the conventional banking framework. The SBP advised banks to open PLS counters from January 1981. Since a total of five government-run banks mainly constituted the banking sector of Pakistan, they enjoyed a kind of monopoly over public funds and did not face any problem in transforming their deposit-taking functions on a PLS basis. However, the regulatory, tax, legal and socio-economic frameworks of the country remained seriously at odds with the IBF system.

Due to institutional constraints and high risk exposures, banks did not utilize their funds under the PLS system, and mostly invested them on a mark-up basis. The CII had strongly recommended that interest should be eliminated first of all from government borrowings because this was the most serious obstacle to enforcing Islamic economy and finance in Pakistan. However, policymakers totally ignored the task of eliminating interest from government borrowings, and that eventually led to the failure of IBF in Pakistan.

It is evident from the above disagreement that neither the government of Pakistan nor the SBP was serious about implementing the CII’s recommendations in either the spirit or the letter. They adopted delaying tactics and gradually deviated from the prescribed evolutionary steps for adopting the IBF system in Pakistan. The government did not follow Islamic discipline in its expenditures and borrowings, and largely relied on the banking sector to meet its finance needs. The banking sector of Pakistan remained deeply involved in interest-based government and foreign transactions, which left hardly any scope for it to truly adopt Islamic operations. The SBP successfully managed the status quo in the banking sector of Pakistan by riding on the mark-up mode of financing.

The CII had clearly warned of serious repercussions from using the mark-up (Bai Muajjal) system on a large scale; yet the SBP encouraged and obliged financial institutions of Pakistan to practice
mark-up financing in bulk. The SBP show no enthusiasm for promoting PLS modes of financing in the new system. Due to the lack of a proper Islamic framework and infrastructure, banking operations based on PLS principles did not achieve any real success. Banks largely invested their PLS deposits in interest-based venues and other fixed mark-up investments, and paid almost risk-free and predetermined rates of return to PLS depositors. The government as well as the SPB made frequent moves to impair the growth and development of IBF in Pakistan. In November 1991 the FSC judgment on *riba* confirmed that the IBF system had yet to be adopted in Pakistan.

### 3 Reintroduction of Islamic Banking

The initiative to re-introduce Islamic Banking in Pakistan was launched back in 2001 when the government decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the decision of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach. Furthermore it aims at building a broad based financial system in the country to enable all segments of the population to access financial services. In this context SBP worked on a three divided strategy for promotion of Islamic Banking (Usmani, 1998)

- Allow new full-fledged Islamic banks in the private sector,
- Allow the conventional banks to set up Islamic banking subsidiaries
- Allow the existing conventional banks to open Stand-alone Islamic banking branches.

This time there has been a shift in the approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue. As compared to our past experience our new approach provides flexibility to the IBIs (Islamic Banking Institutions) as regard to products, instruments and Shariah compliance methodology. This new initiative has witnessed a very encouraging response.

As at end of the year 2003 only one bank operated as a full-fledged Islamic bank and three conventional banks were operating Islamic banking branches. Currently there are six full-fledged licensed Islamic banks (IBs) and 12 conventional banks have licenses to operate dedicated Islamic banking branches (IBBs). All of the five big banks in Pakistan are providing Islamic banking services. The total assets of the Islamic banking industry are over Rs. 313 billion as of June, 2009 which accounts for a market share of 5.1% of total banking industry assets. The market share of deposits stands at 5.2%. Total branch network of the industry comprises of more than 528 branches with presence in over 50 cities & towns covering all the four provinces of the country.

The industry over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy. Also it has been noticed that the industry has a good financial performance. Foreign investment in Pakistani Islamic banking industry is giving the industry a unique look through which success transfer is taking place as experiences are being shared leading to the
development of the local industry. SBP has over the years attempted to develop a supportive Regulatory and Supervisory Framework having special emphasis on Shariah Compliance that is in line with the best international practices.

This model was a winner in every sense except for four basic issues.

- First it failed to recognize the process as evolutionary, it took the revolutionary approach.
- Second the system was too rigid and did not offer the flexibility to cater to the ever changing needs in a dynamic market.
- Third, there was no appropriate mechanism to ensure Shariah Compliance.
- Last but not the least, all the stakeholders involved, were not ready to roll when the time came to launch.

4  The State Bank of Pakistan’s Current Policies regarding Islamic Banking

The basic difference, in SBP’s current policies regarding Islamic banking and the previous efforts, is the approach adopted by SBP wherein the introduction of Islamic Banking is being viewed more as a change management issue rather than as a religious or a legal issue.

The present re-launch of Islamic Banking in Pakistan by the State Bank of Pakistan has been based not only on the lessons learnt from the history of Islamic Banking efforts in Pakistan but also on the experiences of other countries in the world that are currently known for their leadership role in this banking sector.

It was decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Thus could align our industry with the international best practices so as to enhance the credibility and international stakeholders’ confidence in Islamic banking, which in turn will not only boost the image of our country but will also be instrumental in attracting foreign investment. But the SBP did not provide the banking and financial institutions of Pakistan with sufficient resources to learn and practice the Islamic system. It purposefully encouraged the predominant use of conventional mark-up modes in the banking and financial sector of Pakistan.

5  The noncommittal attitude of Bureaucrats SBP and the Government of Pakistan

The bureaucrats in the Ministry of Finance and SBP were made responsible for overhauling the Pakistani banking sector on an Islamic basis. They found that Islamization worked against their vested interests. Therefore, instead of implementing the IBF system in the spirit and the letter, they devoted all their efforts to practicing the conventional banking system under an Islamic label. The CII criticized bureaucrats in the Ministry of Finance and SBP for adopting measures that handicapped the growth and development of IBF in Pakistan. The absence of a fair and expeditious judicial system also discouraged banking and financial institutions in Pakistan from adopting Islamic modes of finance, which run a very high risk of default as compared with conventional lending (Uzair, 2001)
The government of Pakistan has proactively followed the increasingly pro-Western agenda in sociopolitical and economic institutions of the country in recent years. In view of the Westernized Pakistani political leadership, the liberal-leaning polity and the increasing globalization and integration of economies and financial markets at the present time, the real scope for breakthrough developments in IBF in Pakistan has been shrinking (Yaqoob, 1993)

6 Bleak Prospects

Despite rapid expansion in industry, the share of Islamic banking in the total banking system is a modest 4.0%. Moreover, it only caters for around 32,000 borrowers through around 300 branches relative to the country-wide 5 million borrowers (or 4.8 million excluding microfinance borrowers) tapped through 7,700 branches by conventional banks. Financing and investment levels of Islamic banks barely range around Rs77 billion, which is below 3% of the total banking system’s advances. On the product side, Islamic banks so far offer about 75% of products currently available in conventional banking while clean lending for consumer financing products, like personal loans and credit cards, still pose a challenge.

Islamic banks operate exclusively in large cities with some now venturing into secondary cities but they are absent from rural areas where there is great potential for business growth. Global interest in Islamic finance industry and Pakistan’s success in laying basic foundation and core infrastructure of Islamic financial system lends confidence that the country has good potential and prospects to further exploit this industry. Going forward, however, it is important that Pakistan adopts a more calibrated and coordinated approach and strategy for the development of Islamic finance industry (Zaidi, 1991)

7 Recent Effort

A recent effort by an individual Br. Akif Saeed in filing a case in the Supreme Court of Pakistan to look into the matter of reviving interest free banking against the government’s claims that interest in financial transactions was not riba, which is prohibited by the holy Quran, because it did not involve any exploitation and was, rather, the backbone of modern economy, although the economic events around the globe over the past five years have revealed one important fact that present conventional banking system is fundamentally dysfunctional. Banks commit fraud when they take your deposits, tell you that you can come and get them any time, and then lend them to other people. Does this surprise you? It should not. It has been this way since 1844. In that fateful year, the British Parliament passed the Bank Charter Act, an attempt to bar commercial banks from engaging in fractional reserve lending. The solutions are relatively simple to enumerate -- but harder to implement. He has also appealed in the Supreme Court to dismiss the contention that the global economy is based on interest, so that any departure from it would cause the economic collapse of Pakistan, quoting Henry Ford who said once: “If the people knew how our banking system functions, there would be a revolution overnight.”
8 Is Islamic Banking Flawed?

So, is Islamic finance a failure? No; it is never fair to blame a discipline for the failures and shortcomings of its adherents. Yes, the industry has to evolve, but it is only 40 years old and its competing with a conventional finance system that is over 800 years old. The Islamic finance industry is reported to be valued at over $1 trillion, with an estimated annual growth rate of 10 percent. The industry is continuing to grow despite its inherent problems, and some market analysts’ project it will be valued at anywhere from $3 to $5 trillion by 2016.

It also give a convincing explanation to the many critics who see Islamic finance as an industry more driven by cultural identity than practical problem solving: as a hodgepodge of incoherent, incomplete, impractical and irrelevant ideas. However, for it to continue to grow in a correct way, it must come back to its spiritual underpinnings best reflected by the motto: "Principle before Profit" (Zarqa, 1983).

8.1 How to Fix it?

By all means, the conventional system favors a handful of people, corporations and nations, maximizing their gains at the cost of humanity as a whole. Therefore, they continued with the same conventional lending, investment and profit distribution operations in the name of Islamic banking. Pakistani bankers are trained in the conventional banking and capitalist environment, they have a conventional mindset, which holds that lending and borrowing operations cannot be performed on a risk-sharing basis because the announcement of a loss may cause a run on the bank since the nationwide Islamic banking initiative was launched in Pakistan without any proper education and training for the bankers who were supposed to act as traders, businessmen, stockists and lessors in the new set-up had no vision of IBF theory and practice. For ostensibly good reasons, they showed purely financial transactions as trade-based activities on paper only. Thus, the bankers did not allow IBF a chance to become established in Pakistan (Khan & Bhatti, 2008 a).

Nowadays, Islamic finance is beset with problems including those relating to credibility, regulatory, enforceability, uniformity (including Shariah issues), lack of scholarship/training and being fundamentally out of sync with its spiritual and ethical mandate. The imposition of the Islamic system by force and in superficial ways is absolutely against its own true spirit. Shariah compliance is the most important aspect of Islamic finance. The credibility of Islamic Banking Institutions (IBIs) not only depends on the financial health of the institution but also on its adherence to the Shariah Ideologically speaking, Islamic financial institutions are far and wide integrated into the entire system of Muslim polity. They need genuinely strong support from all state institutions if they are to survive and succeed in their objectives (Nomani, & Rahnema, 1994).

9 Conclusion

The findings of this paper may be useful for the policy makers, researchers, academicians, financial experts, Islamic Shariah scholars, bankers, regulators, Islamic financial institutions and those Muslim countries who wish to undertake a similar kind of experiment as was attempted in Pakistan.
This paper may also help the Western economist to think and debate about an alternative interest free economic and financial system of Islam.

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