



LISBON
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MASTER OF FINANCE

MASTER'S FINAL WORK

DISSERTATION

The Case of Islamic Banking in Pakistan

BY: SADAF RIAZ

OCTOBER-2018



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**SUPERVISOR: RITA DA CONCEICAO CARDOSO MARTINS SOUSA
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ABSTRACT:

The purpose of this thesis is to explain why and when the Islamic banking was introduced in Pakistan and how the Pakistani governments established and promoted this system. In 2001, State Bank of Pakistan issued detailed criteria for setting up of Islamic Banks. The policy given By the state bank described that the Islamic banking should be promoted side-by-side with the conventional banking. As a result of this Policy, Al-Meezan Investment Bank limited was issued the first license to operate as a full-fledged Islamic bank in January, 2002. In Pakistan, people appreciated Profit and loss sharing System.

In this paper we analyze the progress made by Pakistan in developing Islamic banking system. It is noteworthy that Pakistan, despite all of its political , social and economic problems , never stopped the process of developing Islamic Finance and Banking system in the country.

This thesis also explains briefly the introduction of Islamic Banking and its importance in the present world.

Key words: Financial System, Islamic Banking, Pakistan.

Resumo:

O objetivo deste estudo é explicar por que e quando o sistema bancário islâmico foi introduzido no Paquistão e como os governos paquistaneses estabeleceram e promoveram este sistema. Em 2001, o Banco do Estado do Paquistão emitiu critérios detalhados para a criação de bancos islâmicos. A política adotada pelo banco estatal descreveu que o sistema bancário islâmico deve ser promovido lado-a-lado com o da banca convencional. Como resultado desta política, o Al-Meezan Investment Bank Limited obteve a primeira licença para operar como um banco islâmico de pleno direito em janeiro de 2002. No Paquistão, o sistema de compartilhamento de lucros e perdas é apreciado. Neste trabalho, analisa-se o progresso realizado pelo Paquistão no desenvolvimento do sistema bancário islâmico. É digno de nota que o Paquistão, apesar de todos os seus problemas políticos, sociais e económicos, nunca interrompeu o processo de desenvolvimento do sistema islâmico de finanças e bancos no país.

Também-se explica, brevemente, a introdução do Banco Islâmico e a sua importância no mundo atual.

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LIST OF ABBREVIATIONS:

PLS: Profit and Loss Sharing

ICP: Investment Corporation of Pakistan

NIT: National Investment Trust

HBFC: House Building Finance Company Limited

INTRODUCTION:

Islamic banking is now almost 30 years old. Most of the literature confirms that Islamic banking was started in Egypt in 1963 but most of the countries in the world accepted and developed Islamic banking in their countries during 70s and 80s.

Islam believes that income or wealth should be equally divided among all classes of the society and wealth should not stay with the rich only. Islam also provides a very effective system of banking and finance as discussed in this paper and the purpose of the paper is to create awareness about Islamic banking and finance system.

The topic of the paper is mainly on the evolution of the Islamic banking system in the Muslim countries considering specially the case of Pakistan. The topic seems important because Islamic finance is growing rapidly all over the world as described by many authors like Siddiqi(2006), Iqbal and Mirakhor, Ariff (1988), Khan and Mohsin(1989). It also seems important to write about this topic because today the world is looking for methods and strategies to minimize the effects of excessive leverage and to eliminate inequality in the economy especially after the crisis of 2007- 2008. Islamic principles are found more compatible and helpful to handle these problems as confirmed by the World Bank's recent reports on Islamic financial system.

<http://hdl.handle.net/10986/25738>

<https://openknowledge.worldbank.org/handle/10986/25738>

Recently, World Bank issued a detailed report and explained its objectives to be achieved in next 30 years. These objectives are to reduce inequality and make the society more prosper and it is said in this report that Islamic financial system can be very helpful to achieve these goals as compared with the conventional system. There is only a need to develop strategies based on true

principles of Islam because without using the real essence of Islamic laws these goals are difficult to achieve.

Many authors wrote about the evolution of Islamic banking in the world but only a few papers are considerable and if we discuss about Pakistan the number of the papers is very low. The reason to choose this topic is to combine the literature by extracting the most important and useful information about the evolution of the Islamic banking system in the Muslim countries and also in Pakistan and to create awareness about ethical and moral concepts of Islam regarding Financial and Banking systems. The paper is divided into four chapters or parts. First chapter describes the history and evolution of the Islamic banking in Muslim countries all over the world and tries to find out the answers of a few questions that are important to understand while discussing about Islamic banking and finance system. The questions included are:

1. What is Islamic Banking?
2. What is meaning of Riba?
3. What are the principles of Islamic banking system?
4. What is the history and evolution of Islamic banking?

Then in the second chapter, the evolution and development, features and principles of Islamic banking in Pakistan are discussed and there is also a brief comparison of the system with Iran and Malaysia. It also tries to explain briefly if the Islamic deposits in Pakistan are actually interest-free or not? Chapter three consists of the analysis of the data and chapter four is the conclusion.

Chapter 1

The Evolution of Islamic Banking System in Muslim countries:

Before describing the evolution of the Islamic banking it is important to understand what Islamic banking is and what are its principles or features.

1.1) What is Islamic Banking?

Islamic Banking is banking or financing activity that is based on Shariah (Islamic Law) and all the financial activities are made according to the Islamic rules and regulations. Collecting interest or 'Riba' is not permitted under Islamic Law.

According to the Institute of Islamic Banking and Insurance, Islamic banking refers to a system that works in accordance with the Islamic Principles and these principles have wide universal acceptance due to their moral and ethical concepts about all dealings. Shariah prohibits the payment or acceptance of interest charges (riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims although Islamic banking is not restricted to Muslims.

Islamic banking has the same purpose as conventional banking and the principles used in this system are not new because they are commonly accepted all over the world for centuries rather than decades but possibly their original state has been altered over centuries. It is better here to explain or discuss some of the modes of financing under Islamic law so that it becomes easy to understand how the Islamic banking and financing system works without riba or interest.

Therefore, some modes of financing under Islamic law are as follows:

Mudarabah:

Mudarabah is an Islamic contract in which one party supplies the money and the other provides the management expertise to undertake a specific trade. The party supplying the capital is called owner of the capital and the other party is referred to as an agent who actually runs the business. Mudarabah is also called profit – sharing because in the type of financing profits are shared according to a predetermined ratio and the investor is not guaranteed a return and bears the risk of loss also.

Murabaha:

Also called cost-plus financing or cost-plus sale. In this mode of financing the purchase of an asset is financed for a profit margin. First, the asset is purchased on behalf of client or customer and then resold at predetermined price. Payment could be in lump sum or in installments and ownership of the asset remains with bank till full payments are made.

Musharakah (Partnership):

Musharakah is a joint enterprise or partnership structure with profit and loss sharing implications that is used in Islamic finance instead of interest-bearing loans. Musharakah allows each party involved in the business to share in the profits and risks. Instead of charging interest as a creditor, the financier will achieve a return in the form of portion of the actual profits earned, according to a predetermined ratio. However, unlike a traditional creditor, the financier will also share in any losses.

Ijara:

Ijara are the operational or financial leasing contracts. Bank purchases assets on behalf of client

and allows usage of assets for a fixed rental payment. Ownership of the asset remains with the financier but may gradually transfer to the client who eventually becomes the owner. Ijara is generally used by Islamic banks for financing consumer goods, equipment and vehicles, home financing. It has also found its way into project and transportation financing and into asset-based financing in larger and more complex transactions.

Under the standard Ijara contract, the client does not normally have the option to purchase the leased asset in installments; he may however purchase the asset at the end of the lease period. This may be achieved by means of *Ijarah wa Iqtina* that is equivalent to a leasing and installment loan in conventional banks, whereby each lease rental payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life. The optional purchase price declines over the period of the lease agreement.

Sukuk:

A Sukuk is an Islamic financial certificate, similar to a bond in western finance, that complies with Islamic religious law. Since the traditional bond structure is not permissible, the issuer of a Sukuk sells an investor group a certificate and then uses the proceeds to purchase an asset, of which the investor group has partial ownership. The issuer must also make a contractual promise to buy back the bond at future date at a par value. Thus, Sukuk represent aggregate and undivided shares of ownership in a tangible asset as it relates to a specific project or a specific investment activity. An investor in a Sukuk therefore, does not own a debt obligation but instead owns a piece of the asset that is linked to the investment. This means that Sukuk holders, unlike bond holders, receive a portion of the earnings generated by the associated asset.

1.2) Meaning of Riba:

Riba is a concept in Islamic banking that refers to charged interest. Depending on the interpretation, Riba may only refer to excessive interest; however, to others, the whole concept of interest is Riba and thus is unlawful. Despite the fact that interest occupies a central position in modern economic system and that it became the life blood of the existing financial institutions, Islam considers that the principle of charging interest is quite opposite to the spirit of sharing and cooperation in business and that lending on interest is not as a business in the real sense.

Islam considers even interest-based loans taken for investment in a productive activity as not equitable because the profits are not always required to be known beforehand and if there is a loss, the entrepreneur has to bear the entire loss in spite of all the risk and engagement he took, whereas the money lender, who did less sacrifice than the entrepreneur, gets an effortless profit determined by a positive rate. In Islam both risks and rewards should be shared by the different parties.

Moreover, the high degree of interest rate volatility in the modern economies injects great uncertainty into the investment markets and makes it difficult for entrepreneurs to have a long-term investment vision and to make their decisions with confidence. Khan explained that Islam does not allow fixed or predetermined return on financial transactions. An uncertain rate of return represented by profits is allowed under Islamic law. For this reason the concept of modern Islamic banking has developed on the basis of profit sharing.

1.3) How are the Principles of Islamic banking determined?

The Principles of Islamic Banking follow Shariah Law, which is based on the Quran and the Hadith (the recorded sayings and actions of the Prophet Muhammad (PBUH)). When more

information or guidance is necessary, Islamic bankers turn to learned Scholars or use independent reasoning based on scholarship and customs, while also ensuring their ideas do not deviate from the fundamental principles of the Quran. Islamic finance is based on the Profit-sharing principle. Thus, instead of traditional accounts with given interest rates, Islamic banks provide accounts which offer Profit/Loss.

According to Islamic scholars and economists, the financing techniques based on the principle of profit-and-loss-sharing such as Mudarabah and Musharakah are the most suitable alternative and an ideal substitute for interest-based financing as they would guarantee an equitable distribution of income and wealth. The banks would be able to use their resources to support businesses and projects to increase overall production and employment which are helpful in reducing poverty and stimulating growth.

Another Islamic principle is that there should be no reward without risk-bearing. This principle is applicable to both labor and capital. As no payment is allowed to labor unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks.

Consider two persons, one of whom has capital but no special skills in business, while the other has managerial skills but he has no capital. They can co-operate in either of two ways:

Debt-financing (the western loan system). The businessman borrows the capital from the capital-owner and invests it in his trade. The capital-owner is to get back his principal and an additional amount on the basis of a fixed rate, called the interest rate, as his compensation for parting with liquidity for a fixed period. The claim of the lender for repayment of the principal plus the payment of the interest becomes viable only after the expiry of this period. This payment is due irrespective of whether the businessman has made a profit using the borrowed money. In

the event of a loss, the borrower has to repay the principal amount of the loan, as well as the accrued interest, from his own resources, while the capital-owner loses nothing. Islam views this as an unjust transaction.

Mudarabah (the Islamic way, or PLS). The two persons co-operate with each other on the basis of partnership, where the capital-owner provides the capital and the other party puts his management skills into the business. The capital-owner is not involved in the actual day-to-day operation of the business, but is free to stipulate certain conditions that he may consider necessary to ensure the best use of his funds. After the expiry of the period, which may be the termination of the contract or such time that returns are obtained from the business, the capital-owner gets back his principal amount together with a pre-agreed share of the profit.

The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined at the time of entering the contract with the consent of both parties, before the beginning of the project. In the event of loss, the capital-owner bears all the loss and the principal is reduced by the amount of the loss. It is the risk of loss that entitles the capital-owner to a share in the profits. The manager bears no financial loss, because he has lost his time and his work has been wasted. This is, in essence, the principle of mudarabah.

1.4) What is the History of Islamic banking?

LITERATURE REVIEW AND HISTORY:

The Origin of the Islamic Banking dates back to the very beginning of Islamic in the seventh century. The Prophet Muhammad's first wife, Khadija, was a merchant and he acted as an agent for her business, using many of the same principles used in contemporary Islamic Banking Principles, and these ideas spread throughout Spain, the Mediterranean and the Baltic States,

providing some of the basis for western banking principles. In the 1960s to the 1970s, Islamic Banking resurfaced in the modern world.

Ariff (1988) wrote about evolution of Islamic banking in his paper. He said that the first modern experiment with Islamic banking was undertaken in Egypt under cover because he did not want to project an Islamic image as he was afraid of being considered as an Islamic fundamentalist which was offensive to the political regime. In this regard, the first attempt was made by Ahmad Al Najjar and he started a form of a saving bank based on profit sharing system. Until 1967 there were nine such banks in the country and these banks neither charged interest nor paid interest. The banks were investing in trade and industry on partnership basis usually and shared the profits with their depositors. Then the Nasir social bank was created in Egypt in 1971 and it was declared an interest-free commercial bank but its charter was not according to Islamic principles or Shariah. Another study was made by Rika Nakagawa in 2009 on Malaysia. Nakagawa said in his paper that Malaysia has succeeded in promoting a comprehensive Islamic financial system but profit and loss sharing system does not seem to be popular in the country. Nakagawa also pointed out some problems that are yet to be solved by the Malaysian government. He said that Islamic financial sector needs more professionals who have balanced knowledge regarding both Islamic concepts and financial technologies.

Dr. Rukhsar Ahmed, Dr. Kamran Siddique, Mufti Dr. Immamuddin wrote a very good article “Islamic Banking in Pakistan-problems and Prospects”. A qualitative study was made by distributing questionnaire to 15 banking and non banking professionals. Also there were six detailed interviews conducted during July – August 2010. The results suggested that Islamic Banking is gaining potential for growth but there is also a need to increase and share knowledge about Islamic Banking and its advantages.

The authors also wrote about the scope of Islamic banking in Pakistan and also described various challenges faced by Islamic industry all over the world (Penalty on defaulters , Islamic banking literature, Pricing formula, Accounting Practice, Regulations and Control etc.).

In January 2009, Beng soon Chong and Ming- Hua Liu published an article with the title of “ Islamic Banking : Interest free or interest- based?”

In this paper, the authors concluded that although the unique feature of Islamic banking is that it is interest-free but in practice , however, they found it very similar to conventional banking.

They mainly focused on Malaysia. They found that Islamic banking structure in Malaysia is not very different from conventional banking.

The key point is that there is no fixed interest involved in Islamic banking practices but some critiques of the topic just don not accept this feature (Chong and Liu, 2009). The main conclusion of this article was that the Islamic banking contracts are in accordance with Islamic principles but actually Islamic Bankings are copying conventional banking practices. (Liu and Chong 2009).

Another comprehensive study was made by Dr. Mashkooor Siddiqui , Dr. Abdul Malik, Dr. Abdul Ghafar and these three wrote an article “ An Islamic Model of Interest Free Banking”.

In this article the authors first presented a model of interest free financial system developed by Uzair , Siddiqui and Ahmed and then described and commented on the features of this model.

The authors cocluded that there should be clearly defined frameworks of Islamic banking so that people may understand the true concept of Islamic banking.

Anjum Siddiqui (2008), wrote about financial contracts, risk and performance of Islamic banking. The author said that because the risk profile of Islamic banks is different from that of conventional banks, there should be examination of various regulatory issues about capital adequacy and requirements of liquidity.

(Lo and Leow, 2014) wrote a very comprehensive paper on Islamic banking in Malaysia. They said that Islamic banking concept was introduced in Malaysia in the early 80s with the noble cause to assist the Muslims as a better banking system as compared to the saving scheme established in 1963. They said that for the past three decades, the Malaysian Islamic banking sector has been growing rapidly with an average of 18% growth per annum in terms of assets since 2000.

However, if compared to conventional banking sector in terms of assets and customers size, the Malaysian Islamic banking sector is considered at its early stage. Lo and Leow (2014), said that this is due to late establishment of Islamic concept into banking system. Since the customer is the main source for the business and profit generation, understanding consumer behavior is crucial.

(Siddiqui, 2006) wrote a very good book on development of Islamic banking and finance. He said that contemporary practice of Islamic banking and finance is now 30 years old, however, Islamic banking theory is still not very well developed. There is a felt need for evolution of what has gone by during the last 30 decades in the field of Islamic banking and finance. More important than focusing on its growth, commercial performance and market share is the need for evaluating it in terms of its contribution to introducing and promoting the understanding of the economic and financial aspects of the overall Islamic way of life.

Siddique (2006) also wrote about the beginnings of Islamic banking. He said that the earliest practice can be seen during early sixties. The nineteen-sixties saw the establishment of an interest-free bank in Karachi, that of Tabung Haji in Malaysia and saving-investment banks in Mit Ghamr in Egypt, that were based on sharing profits and avoided interest. Only Tabung Haji survived due to its roots in the community and clear structure as a business. Early in the nineteen-seventies came the Dubai Islamic bank, taking deposits in current as well as investment accounts and engaging in profit-making activities directly as well as through working partners.

The Islamic Development bank, which started operations in 1975, was designed to serve Muslim countries and communities by arranging finance for trade and development on non-interest basis. By late nineteen-seventies there were half a dozen more banks in the private sector in Egypt, Jordan Kuwait and the Gulf. The following decade saw a rapid expansion bringing the number of banks to dozens by the end of the decade.

The most significant development during the late nineteen-seventies and early eighties was the arrival of murabaha or cost-plus financing. What the business man got from the Islamic bank under this arrangement is the commodity he needed purchased by the bank at his request, with the promise to purchase it from the bank at a price higher than its purchase price, to be paid after a period of time. The seventies also saw Pakistan officially committing to interest-free Islamic banking followed by Iran and Sudan in the eighties. Meanwhile Malaysia developed a new approach of introducing Islamic banking and finance officially while the main system continued along conventional lines.

World Bank group also issued a report in 2015 and described that Islamic banking and Finance is growing rapidly and it is an effective tool for financing development worldwide.

According to World Bank's figures in 2015, the Islamic finance industry has expanded rapidly over the past decade, growing at 10 – 12 % annually. The financial assets under Islamic system are almost US\$2 trillion covering bank and non-bank financial institutions, capital markets, money markets and insurance. In many Muslim countries the Islamic financial assets are growing faster than the conventional banking assets.

“Islamic finance is equity based, asset – backed, ethical, sustainable environmentally and socially- responsible finance”.

<http://www.worldbank.org/en/topic/financialsector/brief/islamic-finance>

(World Bank 2015), World Bank described detailed report on Islamic finance and its advantages.

Some advantages of Islamic banking and finance are as follows:

1. Islamic banking and finance system is very beneficial for economic growth and helps in reducing poverty.
2. It helps to stabilize financial sector. As the 2008 global crisis destroyed the financial system but the Islamic financial institutions were least affected by the crisis because they were protected by their fundamental operating principles of risk-sharing and avoidance of leverage and speculative financial products. IMF issued its working paper in September 2010 and analyzed the impact of global crisis on performance and profitability of Islamic banks and conventional banks. This comparative study suggested that on average Islamic Banks performed better than Conventional Banks during crisis because of their lower leverage and higher solvency. One reason can be the Profit and Loss Sharing system and avoidance of interest.

3. Describing the recent operations, World Bank said that it helped Egypt and Turkey to make financing system that is compatible with Islamic laws for small and medium sized enterprises.

Recently World Bank issued another report (2016), “Islamic finance, a catalyst for shared prosperity “. This is very long report comprising on 9 chapters. In this report the authors explained all aspects of Islamic finance with detail and said that Islamic finance is very helpful to overcome the problems of rising inequality and injustice in the economy.

World Bank group revised its objectives and introduced its new mission in 2013. The new mission is to reduce poverty and inequality in the economy and to increase shared prosperity and according to World Bank group Islamic banking and finance is capable of achieving these objectives, because the main principles of Islamic finance, asset-based system and risk-sharing system, can help to become an economy prosper and stable. Islamic banking is dominant component of Islamic finance industry. Recently, the Islamic financial services board (2015) estimated the size of banking industry in terms of assets at \$1.87 trillion and the size of banking sector at \$1.4762 trillion as of mid-2014.

Chapter 2

History of Islamic Banking in Pakistan:

Pakistan appeared on the map of the world on 14th August, 1947 as an independent state. It was founded in the name of Islam and it was decided that it will make its identity as a Muslim State purely based on the principles of Islam. Mr. Muhammad Ali Jinnah emphasized the virtues of Islamic principles and in his address at the inauguration of the State Bank of Pakistan, said:

“ I shall watch with keenness the work of your organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice.”(http://www.sbp.org.pk/about/history/h_moments.htm)

Now, if we look at the history of Islamic banking in Pakistan, it starts during 1970s. Pakistan was the third country that adopted the Islamic banking system after this system was introduced in the world.

In Pakistan, ICP (Investment Corporation of Pakistan) and NIT (National Investment Trust) began the process of eliminating interest from their overall financial operations. ICP (Investment Corporation of Pakistan) launched a new investor scheme in October 1980 based on profit and Loss sharing.

The HBFC (House Building Finance Company Limited) also eliminated interest from their operations completely in July 1, 1979.

Seven major amendments were made in the Law in the name of banking and financial services ordinance, 1984. From July 1, 1985 all commercial banking in Pak rupees was made interest-free.

In 2001, the state Bank of Pakistan issued its first Islamic Banking Policy. This policy stated that the Islamic banking should be promoted side-by-side with conventional banking. 2002 is marked as a year when the first Islamic bank in Pakistan was given the license to offer complete range of Islamic products.

Khan and Mirakhor in 1989 wrote a very informative research paper about the development of Islamic banking in Iran and Pakistan. According to them, Pakistan and Iran are the only two

countries that have initiated the most effective and far-reaching experiments with Islamic banking system.

Iran and Pakistan adopted two different approaches to develop Islamic banking. Pakistan adopted a careful and well planned approach while Iran`s approach, on the other hand, was quick and rapid because it was a result of the Islamic Revolution in Iran.

Now, if we compare Pakistan`s process of development of Islamisation with Iran, we can see that there can be some similarities and some differences. According to Khan and Mirakhor, Iran`s process of Islamisation with divided into three phases.

In the first phase (1979-1982) the banking system was nationalized, restructured and recognized but in this phase Policy makers could not develop a very comprehensive planning for Islamisation. Then the second phase was from 1982 until 1986. In this phase, the attempts were made on legislative and administrative basis to implement the model of Islamic banking. In Iran, the law for interest-free banking was passed in 1983 and the banks were supposed to adopt Islamic policies within a short period of one year. The third phase started in 1986 and is still ongoing. In this phase, it is now expected that the Islamic banking is an integral part of the Islamic Government.

Khan and Mirakhor`s study revealed that in Iran, short-term and long-term profit sharing modes were not used as major financing modes. The reason for this slow growth of Islamic profit sharing financing is the structure of banking system in Iran.

On the other hand, the process of implementation of Islamic banking in Pakistan was very gradual and it began in 1979. The government appointed a council of Islamic Ideology and the process of Islamisation started in Pakistan after several year`s study by this council. The

president of Pakistan then announced that the interest is supposed to be removed from the economy within the period of three years. In the first stage, three of the specialized credit institutions were to remove interest from their financing operations immediately. These three institutions are as follows;

1-The House Building Corporation.

2-National Investment Trust.

3-Mutual Funds of Investment Corporation of Pakistan.

The House building finance corporation ordinance of 1979 provided the rules to make the operations of this corporation on non-interest basis. National investment trust (NIT) was previously investing in bond and stock portfolios. It stopped investment in fixed rate of return securities in July 1979.

The Investment corporation of Pakistan converted its assets and liabilities into profit and loss sharing modes in October 1980. By the 1981 all the main specialized credits institutions in Pakistan converted their operations into profit and loss sharing type financing modes (Khan).

In Pakistan, however the elimination of interest from the commercial banks has proved difficult and complicated. Islamic Ideology council did not provide any recommendation for changes in the structure of the banking system. It means that only the operations of credits institutions, commercial banks and central bank were to be based on an unknown rate of interest without changing the institutional structure. In 1981, separate counters were made in the commercial banks for accepting deposits on a PLS basis under the scheme of Islamisation process and the commercial banks were not to utilize PLS deposits in their interest based operations and their accounts were to be maintained separately.

Although Iran and Pakistan have the same purpose or goal i.e; to make the whole banking system Islamic, the strategies adopted for this purpose were quite different in both countries. In Pakistan, the Islamic banking system was implemented in way that the main structure or inter-mediation role of banking system remained unchanged.

In Iran, on the other hand, the banking system is thought to be an instrument for achieving the goals of Islamic revolution .As described in previous chapter, the banking system in Malaysia has also same dissimilarities with the banking system of Pakistan. One main difference between the banking system of both countries is that, in Malaysia, the customers are still reluctant to use profit and loss sharing system which is the basic feature of Islamic banking while in Pakistan profit and loss sharing system is accepted and appreciated by the public to make the economy interest-free.

Although Pakistan is facing many difficulties in implementing Islamic banking system properly or thoroughly but still Islamic banking is improving continuously in Pakistan. People are getting more aware of the system and they feel this system should be more developed. When the Islamic banking system was introduced in Pakistan, the people at first did not accept it because they thought that it is the same as the conventional banking but due to the serious dedication and effective efforts done by the State Bank of Pakistan and the governments of Pakistan, the system started to develop after 1990. The State Bank of Pakistan tried to find out the reasons for the non acceptance of the Islamic Banking system. Based on its findings, the State Bank then re-launched and re-assembled the entire system and it was decided that the Islamic banking system should work side by side with the conventional banking system in Pakistan. The State Bank has also made efforts to spread awareness among the public about the advantages of the Islamic banking products and services. As a result of tremendous efforts done by the State Bank , the Islamic

banking started developing after its re-launch in 2002. Islamic banking has made fast growth during the last decade and it is still growing every year. According to Financial Stability report 2016 IFSB, Pakistan's contribution in total Islamic Banking Industry is almost 10%. In June 2017, IMF Multi country report was issued and according to that Pakistan's share in total Islamic Banking and Financing sector is 11.4% by end of 2015.

State Bank of Pakistan is now working on promoting the Islamic banking system and creating more awareness among the people of the country about the products and services offered by the Islamic banking system.

Mr. Yaseen Anwar , a former governor of State Bank of Pakistan , addressed to a conference on the topic of Islamic banking potential of Pakistan on 15th January, 2014. He said that the industry has been growing at an impressive annual growth rate of over 30% over the last five years. Islamic banking was spread across 80 districts of the country with a network of 1200 branches. These branches offered full-fledged Islamic products and services. Islamic banking assets at the end of 2013 were recorded to percent of the overall banking system in the country. The share of deposits was above 10 percent.

Chapter 3

Data:

In the previous section , the theoretical explanation is provided about the development of the Islamic banking system in Pakistan. To support the theoretical findings about the development and growth of the Islamic banking system in Pakistan so far, we have collected some data and facts and figures from reliable sources (State Bank of Pakistan).In this section, we analyzed the news bulletins issued by the State Bank of Pakistan every month and also analyzed the annual

statistical reports from the state Bank covering the period of the last five years. All the data is taken from the website of the State Bank of Pakistan (www.sbp.org.pk) for the period of 2011-2017.

Table 1 below, shows the data about the deposits of Islamic banking for the last few years (2011 - 2016). As we can see from the data that the deposits showed a continuous growth overall and according to the recent news from the State Bank of Pakistan the deposits are still increasing during 2017. In 2011, the amount of the deposits was Rs. 502,128.94 billion and the percentage to total deposits of the banking sector was 8.8 percent. This percentage increased to 13 percent at the end of the June,2017. The increase in the deposits indicates that the Islamic banking system in Pakistan is developing continuously.

According to IMF, at the end of 1984 total PLS deposits were 29,684 million Rupees (Table 6, page 20 of IMF working papers of 1989)

https://www.jstor.org/stable/1154031?seq=1#page_scan_tab_contents) and if we compare our recent deposits to that time then it is also clear that the Islamic Banking Industry is growing in Pakistan since 1980s.

Profit and loss sharing deposits-1981- 1985

Billions of Rs.

	1981	1982	1983	1984	1985
Total deposits	70.00	82.8	106.9	111.70	130.6
PLS deposits	6.5	12.90	19.90	29.70	80.50
PLS deposits/total deposits (in percentage)	9.20	15.40	18.60	26.30	61.60

Data taken from IMF working papers of 1989

The detailed annual reports of the State Bank can be seen on the website of the Bank and the some details are also attached to the appendix.

Table 1

Islamic banking statistics about the deposits :

(Accounts in numbers)
(Amounts in million Rupees)

No. of years	Deposits		
	No. Of accounts	Amount	Percentage to total deposits
2011	1,437,483	502,128.94	8.8
2012	1,857,612	682,606.40	10.3
2013	2,168,997	824,193.60	10.9
2014	2,572,405	988,141.44	11.8
2015	3,379,209	1,238,650.77	13.2
2016	3,741,280	1,316,240.93	13

Note: The data about 2016 is half yearly that means until June, 2016. All other data is of the complete year.

<http://www.sbp.org.pk/reports/annual/>

Source: Annual reports of the State Bank of Pakistan.

In table 2, the data about the financing of the Islamic banking sector is given (Islamic Financing modes are described in chapter 1). If we look at the data, it is obvious that the financing under the Islamic modes of financing is also increasing. As we can see from the table that the amount of financing was Rs. 207,135.84 million in 2011 making 5.9 percent of the total financing. The total financing includes advances and bills. In the June 2016, the financing was 12.9 percent in

the total financing. One should keep in mind that the complete statistical report about the 2016 is still not available on the website but the news bulletin showed that the growth percentage is still increasing during 2017.

Table 2

Islamic banking statistics about Financing:

(Accounts in numbers)

(Amounts in million of Rupees)

No. of years	Financing		
	No. Of accounts	Amount	Percentage in total financing
2011	54,455	207,135.84	5.9
2012	46,294	241,769.33	6.2
2013	51,188	307,940.44	7.4
2014	76,483	407,996.39	9.0
2015	96,482	642,714.54	13.1
2016	165,824	692,415.30	12.9

Source: Annual reports of the State Bank of Pakistan.

Note: The data about 2016 is half yearly that means until June, 2016. All other data is of the complete year.

<http://www.sbp.org.pk/reports/annual/>

Table 3 includes the data about the investments of the Islamic banks starting from the year 2011 to the June 2016. At the end of 2011, the amount of investments was Rs. 240,738.33 million with a percentage of 7.8 percent to total investment. It can be seen in the table that the amount of the investment started declining after 2013 and was recorded 5.9 percent of the total investment at the end of 2014. But it started increasing again during 2015 and then at the end of the June, 2016

it made a percentage of 8.2 which seems still low as compared to the years 2012 and 2013 but the positive sign is that after decreasing a bit the investments started to gain momentum recently.

Table 3

Islamic banking statistics of Investment:
(Amount in million of Rupees)

No. of years	Investments	
	Amount	Percent to total investment
2011	240,738.33	7.8
2012	353,538.39	8.9
2013	358,152.85	8.4
2014	305,130.41	5.9
2015	461,897.13	6.8
2016	621,977.32	8.2

Source: Annual reports of the State Bank of Pakistan.

Note: The data about 2016 is half yearly that means until June, 2016. All other data is of the complete year.

<http://www.sbp.org.pk/reports/annual/>

According to the data presented in table 1,2 and 3 , it makes sense to say that the Islamic banking industry is growing overall day by day in Pakistan. This is due to the better policies of the State Bank and the government of Pakistan. This can be thought as an evidence for the theoretical framework described in chapter two of the paper.

It is also a fact that all the picture is not clear from the data of the annual reports presented above but it is also true that to describe each and everything in one paper is very difficult and the theme

of the paper is to describe the evolution and growth of the Islamic banking in Pakistan and the data extracted from the reports seems compatible with the theme of the paper.

Now, we will try to analyze the growth and development of Islamic banking on the basis of the data taken from the monthly and quarterly bulletins issued by the State Bank of Pakistan because these are issued on monthly basis and describe more detailed view about the Islamic banking industry in Pakistan .

Table 4 shows amount of total assets and deposits of Islamic banking industry for the last four years from December 2013 to December 2016.

According to IMF research department the total deposits of Islamic banking industry were 130.6 billion in 1985(page 18,Table 4 of IMF working papers of 1989 prepared by Mohsin S. Khan and Mirakhor)(https://www.jstor.org/stable/1154031?seq=1#page_scan_tab_contents), and then we tried to gather information from monthly bulletins issued by State bank and summed up in the following table.

Table 4
Rs. (In billion)

Item	Dec.,2013	Dec.,2014	Dec.,2015	Dec.,2016
Total assets	1,014	1,259	1,610	1,853
Deposits	868	1,070	1,375	1,573
Net financing & Investment	709	765	-	-

Total assets and deposits of Islamic Banking industry

The Islamic banking industry had an asset base of Rs. 1,014 billion and the growth rate was determined at 21.2 percent. Total deposits of Islamic banking industry were 868 billion Rupees at the end of 2013 and the net financing and investment was 709 billion Rupees.

As we can see from the table.1 that the asset base of Islamic banking industry reached Rs. 1,259 billion at the end of 2014 and showed an increase of 24.2 percent as compared with the previous year.

As it is clear from the above table that the asset base of Islamic banking industry is showing an continuous increase every year and the same is true for the deposits also.

According to the news bulletin issued by State bank in June 2017, Assets of Islamic banking industry grew by Rs. 150 billion during the quarter April to June , 2017, and were reached at Rs. 2,035 billion compared to Rs. 1,855 billion in the previous quarter . Deposits of Islamic banking industry increased by Rs. 156 billion during the quarter and reached from Rs. 1,564 billion to Rs. 1,780 billion during the quarter .

According to the facts and figures provided by the State bank of Pakistan, we can see very clearly that the Islamic banking in Pakistan is actually growing rapidly and it has a big growth potential .

The net investment of Islamic banking industry, however, showed a decrease from 2012 onward till 2016 but during 2017 , it increased by 9.9 percent and were recorded at Rs. 537 billion by end June , 2017.

This increase can be due to issuance of Government of Pakistan Ijara Sukuk of Rs. 71 billion in June, 2017. Market share of Islamic banking industry's assets in overall banking industry's assets was recorded at 11.6 percent by end June, 2017.

All these facts and figures provided above clearly reveal that there is a great potential of growth for the Islamic banking industry in Pakistan and the evolution is still ongoing.

Chapter 4

Conclusions:

In Pakistan, the Islamic banking is on its way to success. The number of customers are increasing day by day at almost all Islamic banks in Pakistan (see appendix). There are also so many commercial banks that are offering products and services of Islamic banking. Islamic banks in Pakistan are providing products and services truly under Islamic law or Shariah. In Pakistan, Islamic banking system is supported by the government and the State Bank of Pakistan especially after 2002.

It is evident from the data collected from all sources that Islamic banking in Pakistan is growing and the share of it in total banking sector is increasing with the passing years. The data and the facts and figures collected show that the findings of many researchers (like Siddiqi, Mohsin, Mirakhor, Zamir Iqbal) are true about Islamic banking development in Pakistan. This also confirms the previous literature on the topic. Another reason to this growth is the awareness of public about Islamic banking because the State Bank with the help of government and the social media is continuously trying to promote the system in the country.

At first, during 1980s, Islamic banking did not made much achievement in Pakistan due to lack of careful planning and research but then the government and the State Bank realized that there is something missing and we should revise our policies. In 2002, the Islamic banking was re-launched in the country and now its going on the right track. The current policy is that the Islamic Banking is working side by side with the conventional banking system in the country

because according to the policymakers it is the right way to convert the whole banking system into Islamic banking. The main goal is to replace the whole banking system according to Islamic principles gradually.

One thing should be kept in mind that in Pakistan, the importance of Islamic banking is not just due to its increasing growth and demand in the world but it is inevitable because Pakistan is an Islamic country and almost 95 percent of its population is Muslim and Islam is the base for the creation of Pakistan. It is clearly written in the constitution of Pakistan that no laws are acceptable in Pakistan that are against the Islamic principles and Shariah.

It is true that Pakistan is still struggling to convert the banking system into Islamic system even after passing 70 years of its Independence but hopefully the goals are going to be achieved in the future. Today, the world is also looking towards Islamic financing because of its risk and reward sharing nature. Islamic principles also help to increase efficiency in allocating resources to the real sectors of the economy that makes it a more stable financial system to make a stable economy.

Despite its growth in the country, the Islamic banking system also has some challenges to cope with. Some of the challenges are as follows:

1. There is a lack of proper supervision on the Islamic banking system. The State Bank is working on developing a supervisory framework for the Islamic banking industry.
2. There is a need to enhance product innovation , improvement in operational efficiency and service quality.
3. There is a need to improve market development and regulatory regimes for overall macroeconomic environment.

4. Pakistan is an agricultural country mainly and the banking sector supported this sector very little. There is a great potential for development of shariah based Agricultural products.

5. There is need for the improvement of public awareness and steps should be taken to add knowledge and information about Islamic banking system in the books and curricular at least at the university level.

Pakistan's contribution in total Islamic Banking system is almost 11.4% but if we talk about Pakistan only the Islamic banking system is growing even with slow speed.

Appendix

Overall position of Islamic banking in Pakistan at the end of June, 2017.

Particulars	Industry Progress			YoY Growth (%)	Share in Overall Banking Industry (%)		
	Jun-16	Mar-17	Jun-17	Jun-17	Jun-16	Mar-17	Jun-17
Total Assets (Rupees in billion)	1,745	1,885	2,035	16.6	11.4	11.7	11.6
Deposits (Rupees in billion)	1,461	1,564	1,720	17.8	13.2	13.2	13.7
Number of Islamic banking institutions	22	21	21	(4.5)	-	-	-
Number of Islamic banking branches*	2,146	2,317	2,320	8.1	-	-	-

Source: Data submitted by banks under quarterly Reporting Chart of Account (RCOA)

*Including sub-branches

Branch Network of Islamic Banking Industry

The network of Islamic banking industry consisted of 21 Islamic banking institutions; 5 full-fledged Islamic banks and 16 conventional banks having standalone Islamic banking branches by end June, 2017. Branch network of Islamic banking industry was recorded at 2,320 branches (spread across 110 districts) by end June, 2017. Province/Region wise breakup of branches reveals that Punjab and Sindh jointly account for 77.1 percent share in overall Islamic banking industry's branch network. In terms of cities, 55 percent branch network of Islamic banking industry is based in five cities (Karachi, Lahore, Rawalpindi, Islamabad and Faisalabad). The number of Islamic banking windows operated by conventional banks having standalone Islamic banking branches stood at 1,255 by end June, 2017 (see **Annexure I** for details).

Province/Region	Total Number	Share (%)
Punjab	1,091	47.0
Sindh	699	30.1
Khyber Pakhtunkhwa	258	11.1
Baluchistan	99	4.3
Gilgit Baltistan	10	0.4
FATA	8	0.3
Federal Capital	119	5.1
AJK	36	1.6
Total	2,320	100

<http://www.sbp.org.pk/ibd/Bulletin/2017/Jun.pdf>



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