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# Chapter 1

## Introduction:

### Islam is a code of life

By observing the meaning of religion “Islam” we came to know that it is wide and if we confine it to private life of man, we find different results specifically such as if we say Islam is a complete code of life or Islam is a complete way of life then it means that it deals with all directions and field of human existence. Islam as a religion impacts on all walks of human life e.g. economic, political, social, legal, moral, national and international.

“Islam” word derived from Arabic means act of surrendering or submission. Technically it means submission to the will of Allah, The Creator. The “Muslim” word derived from “Islam”. The person who accepts and follows Islam is Muslim. The Muslim who accepts the will of Lord has confidence that Allah is only entity free from mistakes. The word (Aslama) is the verbal form of Islam. It means he/she has submitted himself/herself for the will of Allah. The word (Salam) means security or peace. Both words Salam and Islam derived from (silm) which means peace, security, tranquillity etc. Everybody wants peace in life but actually how many persons will get it? Why most of the people don't have peace in their life because these all want to spend their life according to their own will instead of Allah's will. Only the Allah knows the way of peace in life. It comes when we totally and completely submit our will to the will of creator (Allah). The whole creation obeys the creator.

Allah has prescribed the code for every animate and for every inanimate. Every creation is imposed with his codes except mankind. If we see in nature such as electron, neutron and proton have atomic functions according to the prescribed and divine code. Big tree and small plants also follow the codes. Its enrichment, growth and death every step follows its code. The animals from small ant to elephant are

born, lived their life and die according to prescribed code. No one else but Allah has the power to make such codes and everyone has to follow these codes. All the creation has to surrender to the will of creator.

The individually and collectively society explain the way in which Islam is preached and followed. Either we see the political, social, economic or religious aspect in which Islam is best in all ways. By comparing Islam with other religions, Islam teaches us excellent social behaviour. Every Muslim accepts Prophet Muhammad(Peace Be upon Him) as the role model in all aspects of human life. The Islamic government is entitled to encourage the people to work under the legal and moral system and strictly prohibit the people to do illegal and immoral tasks. And the success or wealthy growth in economic field depends on their sincere efforts of government. Other department such as banks and financial institutions have a key role in the development of economic. These financial institutions have far reaching impact on economic development.

The Islamic government is entitled to encourage the people to work under the legal and moral system and strictly prohibit the people to work illegal and immoral tasks. And the success and wealthy growth in economics field depends upon the sincere efforts of government.

### **Banks play vital role in the economy**

Banks and other financial institutions have a crucial role in the growth of economics. The surroundingsocieties consider that country developed in which such economic institutions are strong and they have far reaching impact as well. These financial institutions depend, in accumulating their financial resources, basically on the inflow of deposits endeavour, in view of their increase in volume, either by enhancing the material incentive, by emphasizing safety and security, and/or improving customer service. The survival of the banks depends on the number of

clients which they need to maintain by attracting them with different schemes according to their established terms and conditions.

The commercial banks mostly depend upon transactions based on interest rate, the interest rate act as a stimulating factor for its dealings. Islam prohibits dealing in riba(usury). Islamic banking is wide and have wide level of rules and principles and they are based on Islamic Shariah. One of the rules stipulates the return on work so that people concentrate on work and return should be in form of wages or in form of profit. The return and capital based on the type of wealth, it varies such as that wealth in which man have no contribution that is earth, water, animal and mines. Another form of wealth is inter-twinning labour and other productions which are necessary for human purposes such as money, building and machinery. Labour should be included in the productive services in order to create return, such as capital alone does not create e return. According to Islamic Shariah principles, labour factor exists and money alone can't make any return. There are different term forms of return such as profit in case of cash capital and rent in case of when capital is in the form of land or building. These are clarification which illustrate the Islam and consider the interest as a return on capital.

The fundamental concept of Islam illustrates the effect of interest on capital and factors which influence the production. For the development of assets, there are conditions as partnership(Musharakah) rather than loans and it is more better way to develop assets with the mutual partnership in which both partners have shares in equal, while in interest bearing loans, capital grow itself and it is strictly prohibited in Islam. This is called Riba.

### **History of Islamic banking**

Interest based finance is prohibited in Islam. In early times, banking took place in Malaysia in mid 1940, in late in 1950's in Egypt's MitGhamr saving bank(1963) and

Naseer Social Bank(1971). The concept of Islamic banking and finance grow since 1960. In Egypt, the first modern equipment took place but due to political regime anathema the Islamic image was not projected, that political regime was basically the fear of being seen as Islamic fundamentalism. The first saving Islamic institute in Egypt was established on the basis of sharing profit at MitGhamar 1963 by Ahmad El Najjar.

There were nine banks in the country in 1967. The banks which don't charge any amount of interest within capital or not even pay interest. Their investments were mostly based on trade and that was either in form of partnership or in form of share profit with depositors. These banks/institutions are named as saving investment institutions other than commercial banks. MitGhammar operations for the investment bank was closed and then taken by the national bank of Egypt and then operation of this bank were converted to interest based operations. The political dislikeness for Islamic financial institutions in Iraq, Oman, Syria, and Saudi Arabia leads to downfall of these institutions and only two institutions were survived that were Naseer Social bank and Tabung hajj that was established in 1963 in Malaysia.

Muslim Pilgrims Saving Corporation that was first Islamic financial institution set up in 1963 in Malaysia established for people to save money for haji's to perform their hajj. In 1969 this grows into the management of pilgrims and fund board are also named as Tabung hajj is the Malaysian pilgrim fund board. Its headquarter situated at Kuala Lumpur. The Tabung Haji acts as finance company that deals with the savings of hajjis to invest according to rules of Shariah, but it has limited role. The Tabung haji is non-financial bank with the success of Tabung Hajji Bank, the source of initiate provided for launching new bank named Malaysia Berhad (BIMB) act as a complete Islamic commercial bank in Malaysia. The BIMB initial capital was \$80 Million and in which contribution of Tabung Hajji was 12.5%. BIMB has 14

branches in different location of country. New 6 branches are planned to open so that in 1990, the total network of branches was Thirty-three.

The Naseer Social bank was established in 1971 in Egypt and act as interest free commercial bank while The Sharia and Islamic fundamental concept was not mentioned in their charter. After the launch of international Islamic Conference in 1970, in Makkah. The Islamic Economics was organized in United Arab Emirates. Dubai Islamic Bank was established right after the establishment of Islamic Development Bank Jeddah. In Egypt, many private and semi-private commercial Banks were established. Some other private commercial banks established in Sudan, Kuwait, Bahrain etc. All those Islamic Banks were established as a feasible and alternative of financial intermediation.

For the purpose of increasing the activities of economic development and progress of Muslim communities and countries with the accordance to the principal of Shariah .The first Islamic bank was established in Jeddah in 1975 on interest free banking. The first selected paper was presented in international conference in Makkah in February, 1976. In that paper, interest free banking system was explained as alternative for prevalent system of banking. It was also presented in conference that all Muslim countries should make their laws according to Islamic principals including their social and economic laws. That Islamic development bank won in its price ceremony in which Dr. Ziaud Din Ahmad raised speech on 5 issues in which major discussion was on concentrating the step inwhich Islamic bank play dynamic role in achievement of socio economic objectives.

Then Organization of Islamic Conference (OIC)was established the IDB in 1974 acts as an inter-govt bank who was probably provide fund for the development projects in countries. Those IDB's based on the rules of Islamic banking as profit sharing and fee based financial services. Their operations were free of interest and its principals were according to Shariah. In recent times, many changes accord in



political environment of Muslim countries. After that no need remained to cover the financial Islamic institution.

In Middle East, large number of Islamic institute came into being in Middle East as Dubai Islamic bank(1975), faisalIslamic institute of Soudan(1977) and bank of Egypt (1977) and Bahrain Islamic institute (1979). With changes of time, many of banks are influenced south Asia pacific region were not affected with that influences. The PhillipneAmanh Bank established in 1973 was a developed institutions having no reference of Islamic character in their charter. This bank PAB was basically planned to serve the need of Muslims and responded by Philippines government to the muslim rebellion of south. The main objectives and duty of PAB was to help in recoveryand dealing with issues regarding the reconstruction in Mindanao, Palawan, Sulu.This bank has 8 branches situated in major cities of southern province. Its head office situated at Zamboangacity. It was not officially written as a commercial Islamic bank in the charter and due to this many interest based operations were continued in that Islamic Financing for a long time. The system of PAB was distinguished as it operates with two windows for the transactions of deposits; thesesare conventional and Islamic windows respectively.Many types of efforts are done tochange that PAB into complete Islamic banking.The struggle was fulfilled at some extent in Malaysia in1983, but not without the antecedents.

Some references are made for the places where Muslims were in minority. There was establishment of interest free savings in India in 70's (siddiqi 1988). ThatIslamic banking system was named as Islamic financial house which was established in 1978in Luxembourg that was firstly done in the western world and first attempt at Islamic banking. There are also types of Islamic banks as Islamic bank international established in Denmark and then another type was Islamic investment companies/institute was established in Australia. In 1991, Bank Mumalatwas established as first Islamic bank and in 1978 the Islamic commercial bank was

established in Bahrain. 35 years ago, Islamic banking was an unknown concept but after the development in Islamic world 5 developing countries made connection with Islamic banking. As noted by different scholars as Mufti Usmani, there are 200 Islamic institutes and 43 countries in the world have financial pools and their annual rate is increasing with 10-15%.

### **History of Islamic banking in Pakistan**

The concept of Islamic banking is as old as the history of Pakistan when Quaid e Azam inaugurated SBP. He showed his concern for the interest free banking but at that period it was not named as Islamic banking. At start, the purpose was to remove interest (Riba) which was showed in many of laws and principals at that time. Its effort was started from 1970 but the practical implementation of this interest free laws occurred in 1980s.

In 1977 the Islamic financial system was started to implement. At national level, there were two other countries and third one is Pakistan which tried to enforce interest free system. In Pakistan early initiatives were taken since 1980 to introduce interest free system. Pakistan was third country which derived the interest free banking system at that time. An Islamic council with the name of council of Islamic ideology(CII) was selected in 1979 in order to alter the banking setup into Islamic or interest free setup.

Another moderation was development of three credit institutions named as Mutual fund investment corporation of Pakistan, national investment trust and house building corporation. These institutions were also developed to make all banking operations based on interest free system. It was a big step and was not easy to convert such a big commercial banking system into completely Islamic banking. It took longer time period. Many of banks are included in this process whose purpose was to remove interest from their systems such as national investment trust and

Investment Corporation of Pakistan. These financial institutions are government owned which was a motivated step by government at that time to implement non interest base financial system. Their purpose was also to demotivate such investors which invest in securities based on interest.

Islamic ideology council showed changes on system by practical implementation in their procedures. The plans which state bank has made for bringing changes were that many of commercial banks would work with already defined rules and procedures but their monetary operations such as investment, funds, securities would be under defined rate of returns, instead of same fixed interest rate or fixed number of returns which those interest based system provide. The main reason of report was an execution of Islamic financial in different stages that is observed by same person who make strategies and bankers to complete Islamic (Khan & Mirakor, 1990) some other implications and new moderation in system was developed later on. Such as Mudarbah techniques which was introduced in 1980. At that time it was made important for those companies, banks and financial institute which follow the Mudarbah system, need to register under Mudarbah certificate.

In Jan 1980 in conventional banks, a counter with name of interest free counter was opened. Its purpose was to accept profit and loss sharing based deposits. This system was present at all domestic branches of one foreign bank and national commercial banks (bank of Oman). Those banks started the operation based on Islamic financial system "Mudarbah". Another system was "Musharkah" which was developed to fulfil the need of working capital for trades & industries. Musharkah was introduced in July 1982. Interest free system with different names and different ways were started implementing. One of them was participation term certificate. It was for corporate financing and it was replaced with term finance certificate.

In 1984, the finance minister officially announced that from the next coming financial year. The banking system should shift into completely Islamic mode of financing. The banks which are allowed to follow that system were strictly prohibited to close dual windows operation and they were instructed to dismisstheir operation in a financial year. In the month of July 1985, banking companies were strictly prohibited to accept the interest based deposits except those of foreign currency deposit which were continue to earn interest. The Mudarbah or profit and loss sharing system was first introduced in conventional bank on April 1, 1985.

In 1991, the federal shariat court officially announced that all transactions which are based on the interest based system would be cleared or banned. In spite of many actions and recommendation, no desired results were achieved until the development of Shariah compliance mechanism. There was lack of proper work at high level banking and also in financial banking/institutions which can easily manage that sudden shift from conventional to Islamic banking. Islamic banking in 2001 was re-launched when the decision of promoting Islamic banking was taken by government. It was considered as parallel and compatible system in line with best international practice. So its implementation was focused. At state bank of Pakistan on 15 Sep, 2003, the Islamic banking development was established its aim was to strengthenthe Shariah compliances and to promote the Islamic banking system as a best system to implement.

### **Development of Islamic banking in Pakistan**

In worldwide system of banking, the Islamic banking mode of financing is growing. In near future, the size of Islamic banking reaches to USD 1300 billion. These Islamic financial institutions are further on attached with the Islamic academies and supervisory institutions and are offering their services worldwide. In Pakistan, where there was no complete financial system, there are separate

windows and counters are made to perform such banking operations based on Islamic mode of financing.

In late 70's the Islamic banking was started but its growth was occurred in 2001. It was difficult in start for Islamic banks to compete with those of other conventional banks which are already running in financial market. The system of Islamic banking is totally changed from those of other conventional banks in regards to its product and services. The system of Islamic banking is different because they offer returns which are based on profit and loss sharing.

In 2001 at state bank different policy measures were taken in order to view the model of Islamic institute, which was working in Bahrain, Malaysia and Saudi Arabia. The Meezan bank was the first bank to which a full fledged Islamic banking license was given in 2002. Before this issuance the Islamic banking system was present but it was not properly working and there was lack in its growth. This lack of growth was due to incomplete information about the product and services of Islamic banking. In SBP, the separate department with name of Islamic banking was established. Its purpose was to regulate and promote the Islamic banking sector. Under this policy of SBP, five other Islamic banks were established which were given permission to start an Islamic banking business named as emirates global Islamic bank limited, , Dawod Islamic bank limited and Dubai Islamic bank limited. At the end of year 2007, six Islamic banks were working. After than government of Pakistan issued license to other banks as Islamic banks, six of them were full-fledged Islamic banks, thirteen were conventional banks with the separate window named as Islamic window.

In June 2010, the assets of Islamic banks reached to 411 billion and this growth was counted as increase with 31%, and in year 2010, the deposit growth was 39% on yearly basis. The branches of Islamic banking were 667 at the end of June 2010 and 751 at the end of 2010 and currently there are 990 branches of Islamic

banking which are separately working in the different cities of Pakistan and according to given surveyed SBP figures, The shares of Islamic banking values stands at 8.9% which is equal to 603 billion. This figure was from June 2011 and at the end of 2012 the figure was 7.6% as deposited of Islamic banking were 640 billion rupees.

Islamic banking is 1304 with deposits of 868 billion in 2013. And their assets are of Rupees 1014 billion. The new thing which Islamic banking has brought in its system was the offering of competitive saving and deposited products which don't target specific people but of all kind like senior citizens, Pensioners and also for households. There is large number of competition in market in spite of all that the Islamic banking showed healthy growth in its figure and customer bases. At first quarter of 2014 the assets of Islamic banking were recorded as Rs 1016 billion. These deposits increase to 872 billion with the passage of time. The number of market shares of Islamic banking industry deposits has increased and reached to 10.7% in March 2014. In the end march, 2014 Islamic banking profitability registered at rupees 3.2 billion and it was greater profit as compared to the end of March 2013 by 2.2 billion rupees.

Pakistan has linked with a number of international Islamic financial institutions as active members of different committees and boards

- Islamic financial services board (IFSB)
- Accounting and auditing organization for Islamic financial institutions (AAOIFIs)
- International Islamic financial market (IIFM)

The concerned authorities of Pakistan connected with these institutions have proved to be helpful for the improvement and expansion of Shariah ruling and standards for Islamic banking growth.

The development in Islamic Banking and Finance in Pakistan was not in a position to grow without the efforts of government and SBP. To keep an eye on the functions that are performed by Islamic banks and for reframing the Shariah and legal framework, the department of Islamic banking was also established in SBP to take care of Islamic matters. In 2008 guidelines that were issued to conventional banks are also revised and reviewed in month of April 2014. The basic purpose to examine the instruction is to make the Shariah compliance environment helpful to the Islamic banking industry of the country. To cope with rising competition in global market SBP has made many reforms and it is observed that without the help of SBP (central bank) the Islamic banking industry cannot grow. It proposed 5 year strategic plan for the Islamic banking industry and currently working on this plan. These latest developments and new offerings are good but little changes occur in its system such as initial promises of equitable distribution of resources by offering distinct financial products can't be fulfilled sometimes.

### **Reason for slow development of Islamic banking in Pakistan**

There are different reasons behind this slow development in Islamic banking. First of those is lack of experience:

#### **Lack of experience:**

There is not proper understanding of Islamic banking system and there treatment with the conventional products. This is important for researchers in Islamic finance industry to understand this system for the product innovation and differentiation. It is also important that there should be people with right abilities and communication to run the Islamic financial institutions. Within high growth amount in market, the emphasis of SBP, IBI is on the special adequate qualified human resource which is hired by Islamic banking. Before getting license from SBP, the banks are asked to provide appropriate training.

**Distribution network:**

There were 582 branches of Islamic banking at the end of June 2000 only when compared to conventional side which numbers was 7800. The finance available through Islamic banking is limited. Apart from complete Islamic banking system provided by SBP, there is alternate delivery channel is provided to make better the accessibility of Islamic banking service within the country. This type of banking is called branchless banking.

**Lack of awareness:**

Large number of people needs some time to fully comprehend the system of Islamic banking and finance, whenever new system is introduced in market like applications and changes in Islamic banking; it needs to be fully understood and applicable. In the beginning few of people understand it and the advantages behind it, with the passage of time the number of people increased and its practicability is felt to be implemented by everyone.

Many researchers and commentator expressed their doubt about this new system failure in Pakistan. The factors vary behind this doubtful attitude about this Islamic banking system in 1980. The large number of factors which affects the large awareness of Islamic banking system makes the overwhelming knowledge sharing.

**Common Fiqah:**

There are two main reasons for this:

- It is unthinkable to follow the banking system based on one particular school of thought.
- According to Shariah verdict, the Islamic banking transactions work to distribute or disburse the finance.



The findings of Shariah scholars are based on the principles of Shariah. But those are not completely explained because this is just Shariahruling and they give the interpretation and reasoning for the Islamic banking practices. The procedures and the system understandings varies in different school of thoughts as we observe the system of “fatwa” this concept is differently understood by one school of thought from that of other school of thought. This is an Islamic verdict and no one institute’s issuing fatwa can be used by all of other nations.

#### **Penalty on defaulters:**

TheIslamic mode of finance reviews and gives concept of penalty to understand it’s all concepts properly. Islamic banking denies the concept of taking interest and like other conventional banks the penalty on late payment is not made in Islamic banking. This concept attracts large number of customer but sometime they take advantage from it and make default. So it is a challenge for the Islamic Shariah and Islamic banking to make a system which introduces the penalty for defaulters.

#### **Islamic Banking literature:**

If we study the Islamic banking manuals, its reading material, books and procedures, the knowledge of bankers increases. Different Shariah advisors, their working experience and knowledge with the banks are mentioned in these manuals and books. The Shariahadvisor of DawoodIslamic bank, Mufti Muneeb issued four thousand fatwas are published in four volumes. His literature with the name of “TefheemulMasaael” is issued in market. These types of literatures and study used as substantial and helpful material in the field of Islamic banking system.

### **Accounting Practices:**

To record the claims, rights and all obligations come under the definition of accounting. In term of Shariah there is no separate set of accounting which is according to Islamic principles. So it is felt as necessary to review those already existing accounting practice.

### **Legal Framework:**

To promote the Islamic banking system in Pakistan, some laws and regulations are issued in general. There is a need to focus attention for the introduction of changes according to Islamic banking system in these laws and practices of banking. There is a regulatory issue in Islamic Banking. Lack of jurists competent in both Shariah that are usulfiqah and usulmuamalat is also a problem. There is a lack of jurists and lot of shortage of jurists and professionals which results in hiring the same jurists or person to different institutions. There is a lack of details that are disclosed of reasoning, procedure and justification of Shariah supervisory board meetings in product approval and also in the issuance of fatwa and that is why it can be the hurdles in good discussions.

A legal framework is a demand for a practical Islamic banking system and there is a lack of such legal frame work. To make such framework is another challenge for them. Like as in UK there is no legal framework which deals with IB.

### **The role of SBP in development of Islamic banking**

The state bank of Pakistan played an important role for the development of Islamic banking. So its role is not neglect able. It is known that banking and financial system is important to be managed for the development of a country. The SBP did this; it made a separate department with the name of Islamic banking department. The major role of this Islamic banking was department is to provide an opportunity

and right choice as a priority to suppliers and investors in the banking sector. It is important that there should be transparent Shariah compliances with the international practices of SBP.

Since 1979 the major attention and work was done to change interest based system into complete Islamic banking structure which would be interest free. To interchange this interest base banking system, several ways of Islamic banking has introduced predominantly by creditor of SBP. The Council of Islamic Ideology in 1980 advised the SBP to make changes in the discount rate in money market by presenting the system of loss and profit sharing (Memon, 2007). Islamic banking implementations initiated by SBP in 1980 that bring major changes in guidelines of Islamic banking. Every commercial bank became interest free on 1<sup>st</sup> July 1985 after accepting loss and profit sharing system (Khattak&Rehman, 2010). The Meezan bank of Pakistan registered as complete Islamic bank in 2000.

The competition has been developed by the entrance of Islamic banking system with presently working conventional banks, (Ahmed et al., 2010).

On the 15th Sep 2003, the compatible banking system according to sharia is developed by Islamic banking department which objectives and motives are to develop and promote Shariah and its complaints. At fast pace this Islamic mode of financing and banking system is globally growing.

From several years this Islamic banking system is growing rapidly in Pakistan. The six licensed Islamic banks are fully fledged and two conventional banks having window work with Islamic banking department are working in Pakistan but this is not enough for the promotion of this industry. The promotion of system of Islamic banking and its increase shares in market, many of other banks requested which is under consideration.

The first priority and preference in this Islamic banking system is the promotion of fully fledged interest free system by SBP. Cash reserve requirement (CRR) 5% and statutory liquidity requirement is 8% for both Islamic banks and conventional banks by SBP (Memon, 2007).

It is also mentioned in the mission statement of SBP to develop such an Islamic system which is aligned and totally compatible within the world's financial sector that provides the products and services according to unique Shariah compliances in order get equitable economic growth in country increase.

SBP has developed programs in Islamic banking for the better understanding of this system as a uniform curriculum for certification and master level programs in Islamic banking. In Pakistan educational institutes these curriculum are adopted after the review of HEC revision committee. In this way the quality of offering by education, training and institute of research is ensured at certain extent.

SBP conducted seminars in order to create awareness and to spread knowledge about Islamic finance. Pakistan is also a member of Islamic Financial Services Board (IFSB) but these efforts are not fulfilling the requirements.

### **Critical analysis on the role of SBP in the development of Islamic banking in Pakistan**

SBP plays vital role in the progress of Islamic banking but this role may be positive or some time negative. One is that it faces the problem of acceptability. This is because people don't have complete awareness about this system and Islamic mode of financing. So its role regarding the awareness is negative. The SBP also don't play any role regards creating awareness of Islamic mode of financing between people. There are less number of training institutes and lack of professionals in Islamic financial institutions. It is needed that the proper training and marketing with the high skilled professional would be there for progress of Islamic banking system.

SBP takes issues of manpower development with seriousness and it is strictly enforced on the Islamic banking industry. There is shortage of professionals and practitioners of Islamic Banking. This is another big challenge faced by Islamic Financial institutions regarding this. There is a need of proper understanding of conventional and Islamic products as well for practitioners that would help them in product innovation and differentiation. So there is a need of person having high trained skills to run Islamic Financial Institutions in a better way. The staffs of Islamic banking play the meaningful role in the development of economy by receiving training and relevant information understanding about the Islamic banking. Another thing that there is not any kind of rules and regulations are made on defaulters of Islamic Banking. There is a need to review the concept of penalty on defaulters by State Bank and there is a proper law should be made for defaulters.

The main thing is that there is a regulatory issue in Islamic Banking. Jurists competent in both sharia that are *usululfiqah* and *usululmuamalat* are lacking. There is a lack of jurists and lot of shortage of jurists and professionals which results in hiring the same jurists or person to different institutions. The number of jurists and shariah advisors should be increased in order to avoid this kind of problem.

In the Islamic banking, for the settlement of problems on Islamic banking the SBP have to collaborate with the Judiciary to have Shariah courts.

There is a lack of details that are disclosed of reasoning, procedure and justification of Shariah supervisory board meetings in product approval and also in the issuance of fatwa and that is why it can be the hurdles in good discussions. Shariah supervisory board should have the role in Islamic Financial Institutions and also for the development of nation.

There is very limited literature about Islamic banking so SBP didn't take any steps for easy availability of literature. And the other problem is the lack of expertise

and the less number of Islamic banking branches and SBP don't want to take steps to overcome this issue.

The main focus of central bank is to strengthen the legal framework for the operations of Islamic banking and its growth and survival. Observing the operations of conventional banks which are fully on interest, the Government is taking action to avoid from interest for the development of Islamic banking system. Further research is needed in order to increase development in this sector by state bank of Pakistan.

### **Limitations:**

This research is about documented progress and plans about the SBP. Islamic Finance is newly introduced term and literature available on this topic is very limited. The area of the research is limited to the use of secondary information acquired from several sources. Required data limited. In my research i have to focus on recent studies or analysis of previous researchers in current scenario and also focus the government specially role of SBP.

### **Objective of the Study:**

Since the emergence of Islamic banking in Pakistan in (1977-1978), the subject matter has been under great consideration of the researchers (Ashraf, 2013, KhawajaAmjadSaeed), for the reason that the Islamic banking has a prudent role in the livings of muslims. Various studies have been conducted in order to check the performance and development of Islamic banking sector (Ashraf, 2013). But the literature is deficient in answering the question for the role of SBP in Islamic banking development. SBP has formulated several policies in order to protect and promote Islamic banking. Islamic Banking Department is working in SBP for the purpose. But, implementation of the formulated policies is questionable. Though, the present

dissertation aims to analyse, whether the SBP playing any role in promoting the Islamic banking or not.

## Chapter 2

### Literature review:

In the United Kingdom, population are non muslims so the banking system and its financial rules are in the favour of conventional banking rather than IB system. From year 2003 to 2008, development took place in Islamic banking. The UK government is concerned in progress of Islamic banking. The muslim communities contributes in the economy in result of the growth of IB. In this country Islamic banking is facing the problem of legal system. Findings of the study shows that Islamic banking practices are according to the Islamic Shariah law and it is satisfying all the obligations of Islam and all the products of IB that are approved by the Islamic Shariah committee.

The study shows that all the products are permitted by the financial services authority and there is not any kind of restrictions on Islamic banking setup if these institutions are working according to rules and guidelines of the government law. Islamic banking in the UK has advantage of acceptance and approval. UK government is playing asignificant role in promotion of IB and their role to encourage awareness about Islamic banking among population is positive. The UK government are keen for the growth of Islamic financial institutions and their products. The UK government enhances opportunity for the muslim community to invest in the economy by awareness of Islamic products and Islamic banking. UK is non muslim country and all rules are not in the favour of Islamic banking but for conventional banking.

The main problems that are facing by the Islamic financial institutions are legal and institutional framework, competition and supervisory framework. In the UK there is not strong supervisory framework and legal institution for Islamic banking like conventional banking. Islamic banking wants to grow accounting standards and proper policies. There is anabsence of alertness about IB products among muslim



community. There is a requirement of professional and to focus on research and development (bank officer of HSBC). And there is lack of Islamic products and need to conduct seminars and training programs (bank officer from IBB). (Waseem Ahmad, 2008)

The study analyzed the role of Indonesian central bank in Islamic banking. Indonesian central bank is more concerned about the development of Islamic banking. The central bank of Indonesia permitted local conventional banks to offer Islamic banking products and services in the Indonesian financial market. The central bank of Indonesia encouraged the development of Islamic banking and finance in Indonesia because central banks see benefits for banking institutions. and institutional objective, which is "to achieve and maintain the stability of the Rupiah value", which is linked to payment system, monetary policies and banking system. (Shofwan Al Banna CHOIRUZZAD, 2012).

Indonesia is the most popular muslim country and in 1973 the Islamic banking system has grown with the progress of Islamic development bank in Indonesia. The first Islamic bank in Indonesia was developed in 1991 and started operating in 1992. (A.M Safeddin 1976) played an important part in the development of Islamic economy movement in Indonesia. His work openly called for Islamisation of economy. The bank Islam (BI) establishes a team led by Fajriyah, Ramzi A. Zuhdi, and Muchtar Syafi'i.<sup>37</sup> and many of them had no idea of Islamic banking before it and they started learning from very first. But they continued journey, this was a supportive act by central bank of Indonesia even when many member of central bank called this attempt as "Bank Mustahil Indonesia" ("Indonesia's Impossible Bank"). This movement made a large development and acceptance of Islamic banking system which drew it to the state policy making process and also a part of banking and financial system. The central bank of Indonesia organized a small but dedicated group of people for the development of Islamic economy project within

state bank. This close participation made them connected with the Islamic activities so far.

The Central Bank of Bahrain was established in 1973 as Bahrain Monetary Agency. Central Bank of Bahrain has developed internationally recognized standards, regulations and infrastructure for Islamic financial institutions. Islamic banks in Bahrain provide a variety of products like Murabaha, Ijarah, Mudarabah, Musharakah, Alsalam and Istisna. Central Bank of Bahrain emphasized to strengthen the Shariah governance and they are introducing the new measures to strengthen this more. It includes new Shariah governance which will expand on the roles of internal Shariah review and internal Shariah audit functions and also introduce a compulsory requirement for external independent Shariah audit. A central Shariah board is also being established to encourage and motivate the Islamic banking industry to achieve consistency in Shariah opinions. University of Bahrain started a programme three years earlier 4-year bachelor degree program combining Shariah studies with finance, business, banking and statistics to produce qualified graduates in Islamic finance. It means they are keen to develop Islamic banking professionals. The role of Central Bank of Bahrain is encouraging and its attitude towards Islamic banking is positive. (Website of Central Bank of Bahrain, 2014).

Australia is a non muslim country and they show a keen interest in establishing Islamic finance and Islamic banking. It is watched keenly by Islamic Financial Scholars and developments regarding this are encouraged. Australia is efficient and active market and there is a good platform for Islamic Finance to grow. Australian government is working to remove regulatory barriers to the development of Islamic finance products. In a renewed attempt to make Australia's financial infrastructure more attractive government made recommendations including steps to ensure Islamic finance is enabled in Australia (Muehlenberg, 2010). The future of Islamic Finance in Australia is bright and government concern in promoting Islamic

Finance will further encourage Islamic Financial Institutions to spread in the country. (Maas Riyaz Malik, 2010).

Central Bank of the Islamic Republic of Iran and country itself shows a keen interest in establishing Islamic finance and Islamic banking. Central Bank of Iran conducts different types of training and courses, main purpose of these courses is to give training to bank officers and experts in IB and to share experience with other countries, mainly those that have applied Islamic Banking parallel with the conventional banking system or have chosen to convert their whole banking system according to the principles of IB. Major concern of the authorities is to give Islamic teaching of banking system and establishing banking system which is usury free. Islamic Republic of Iran is the country where Islamic banking operations are fully obeys with the Shariah rules of Islam. (Website of Central Bank of Iran, 2014)

In Malaysia central bank there is array of Islamic finance products; but, there is no concept of buy back known as “bailnaah” and sale of debt as “bai-aldayn” in the Malaysian central banks as compared to other country’s central banks. The monetary instruments and liquidity management framework of Islamic banking in central banks of Malaysia has many salient features such as: Mudarabah Interbank Investment (MII), Islamic Accepted Bills (IAB), Islamic Negotiable Instruments (INI), Islamic Private Debt Securities, ArRahnu Agreement-I (RA-i), Sukuk BNM Ijarah (SBNMI) etc it shows that Islamic banking system is followed and accepted by the central bank of Malaysia.

According to the central bank website of Malaysia the scope of Islamic banking has increased to USD65.6 billion from the past and this was a great change with which growth increased to 18 to 20% annually. The Malaysia is acting as the role of leadership in Islamic banking system due to its wide and acceptable system. In regards to the saving and current account, the Malaysian Islamic banks have developed the system of Wadiha(safe custody) with a contract named

Dhaman(suretyship contract). According to these concepts the custodian of deposits can utilize their money until they would be liable or charge for any loss on their deposits. The bank of Malaysia also provides them insurance for the safety of their deposits. But there is some limitation as these Islamic banks don't provide any fixed return but a discretionary reward as Hibah. This system act parallel to the commercial banks and it is important as Islamic banking system in Malaysia. The Malaysian government decided to implement Islamic banking system by opening Islamic windows in their conventional banking institutions to increase the implacability of Islamic banking system at the less cost and within shorter period of time (Bank Negara Malaysia, 1994, 1999). By doing so, the development and worldwide acceptance of Islamic banking system increased thus the Malaysian banking industry became competent and improved its performance and efficiency of Islamic banking industry (Alias et al., 1994; Kaleem, 2000).

With the most extended system of Islamic banking by the central bank of Malaysia and by offering of large number of incentives and acceptable system of Islamic windows they had performed efficiently during 1980 to 1990s. With the advancement in banking system, the answers to issues regarding the financial liberation in Islamic banks have become clearer. The central bank of Malaysia played its part by offering complete Islamic bank license to the foreign banks which are the part of financial liberation of Islamic banks in Malaysia (Bank Negara Malaysia, 2004). The intention behind offering of these licenses to the foreign bank was to strengthen and spur the growth of local Islamic banks and also to encourage them (Sidhu, 2004). The issues and criticism was made on this move, one was the chances to increase the cost due to duplication of resources. Another problem discussed by researchers was that issuance of license leads the more bank in the competition with small unchanging banking sector (Fernandez and Shamsudin, 2004).

The concept of Islamic banking system in Nigeria came in 1990. With the central bank and other commercial and financial institutions the banking Act 1969 was replaced with the Islamic banking system (BOFID) 24 and 25 of 1991. This idea was to establish the non interest banking system in country. In 1992 two license were approved but the operation was started after the establishment of former Habib Nigeria bank limited where the non interest banking window was opened in 1999 (Umar, 2011; &Usma 2003). This was a massive move by CBN, but still the problems aroused due to lack of political will and determination. In spite of this poor development the central bank of Nigeria (CBN) brought new provision for the suitable system and development of Islamic banking system conceptualized as “Non interest Financial Institution (NIFI). This non interest financial institution has played important role in adding inspiration to Islamic banking projects in country. This was a daring effort by the CBN (central bank of Nigeria) for the bright future of Islamic banking in the country.

The problems aroused on role of Central Bank of Nigeria in Islamic banking due to perceptions such as lack of Shariah governance institutions, capital inadequacy, shortage of manpower and also a little fear on the presence of non-Muslims. Different researchers also gave an empirical view to inspect the role of Nigerian Muslim youth on the apparent role of CBN with regards to establishing of Islamic banking system. Hence, Obiyo (2008) pointed out that Nigeria need to restructure its banking laws before the Islamic banking system so that it can be successfully implemented in the country. Under the concept of Islamic system the operations and system of central bank of Nigeria will be multidimensional than the so far traditional banking system (INCEIF,2006b). This is a welcome development by the CBN for the establishment of operations of Islamic banking system.

In August 2010 the CBN established the new banking model which is categorized as non interest banks as specialized banks. The CBN further developed

the two models in addition to Islamic banking first was non-interest bank of capital base of N10 billion and its operations acted in every state of FCT (federal capital territory) and the other model was Local non-interest bank with capital base of N5 billion and its work was to operate in 6 states and maximum of 12 attached state of alliance (Umar,2011).

A non interest financial institution (NIFI) explained by CBN is usually the system of transacting banking business, it is engage in trading, investment in all provision of financial products according to the rules of Shariah of Islamic commercial jurisprudence (CBN, 2011a, p. 1). As noted by CBN (2011a), the development of IBs in CBN shows the increased figure of requests from other financial institutions like JBI, which was developed in April 2003 and its objective was also the establishment of Islamic investment holding company for the generation of non-interest institutions such as Islamic bank, Takaful (Islamic insurance) and pension fund administration. The introductory aspect of IBs in CBN clearly states the avoidance of non permissible transaction, contracts and instruments’

The perception based study critically analysed the role of central bank in Nigeria towards Islamic banking. The attitude of CBN for the Islamic banking is very crucial. This is because the outcome is strongly positive on the need for the CBN to be more anxious about the solidification of the legal framework for Islamic banking operation in the country for the persistence of development and existence of the industry. The methodology used is based on the survey method as relevant primary data is collected for research purpose. In Islamic banking field, it is found that many respondents have strong positive perception to promote suitable research for CBN( Daud et al., 2011). Islamic banking is growing tremendously and efficiently in Pakistan cultural differences have affected the Islamic banking to some extent .This rivalry will create a hugechallenge for Islamic banking. Along with Islamic banks, conventional banks are also in competition to target the mass with Islamic banking

requirements. The research is based on limited descriptive parameters to evaluate the performance of Islamic sector banking comparing it with conventional banking system (Akram et al., 2011).

In Kuwait the considerable growth in Islamic banking drove the central bank to establish banking business compliant with the Islamic Shariah provision. This shows that Islamic banking has far distinguished position in the banking sector. A systematic approach is used in Kuwait in which central banks has established a monetary policy and its operations based on Tawarruq to manage the system's liquidity in Islamic banking system. In latest years, the Islamic banking setup in Kuwait has got strength. The system followed by central bank of Kuwait has made window for Islamic banking due to demand of product and services that are compliant with the Shariah law and further growth is also expected in the future. The Kuwait finance house KFH is a leading Islamic bank in Kuwait that is taking full advantage of restructuring Islamic mode of financing within the central bank of Kuwait. The system ensured the better flow of services and quality of clients and also making work according to Shariah rules and principles more efficiently. Thus the Islamic banks have strengthened its root in Kuwait. It seems that Kuwait central banks and Islamic banking system would continue to ride the wave of global growth in the country and bring the new innovation in the country. (Website of Central Bank of Kuwait, 2014)

The role of central bank of Turkey in the development of Islamic banking is wide. It is related to the system of Sukuk followed in Malaysia. Their framework for sukuk shows their concern in enabling the means for more Islamic finance. Thus in Turkey central bank, the system of Sukuk has become a popular form for Islamic banking. The Turkish bank offer sukuk which is resembled to conventional bond but differ in structure. In February 2011, the Turkish parliament for the promotion of Islamic finance, passed legislation for an international deal and improve

access to funding based on religious rules. The Islamic development bank IDB of turkey is funded by central banks which further finance the institutes and companies operating under procedure of Islamic production. According to the agreement of 1999 between ICD and IDB member countries Islamic Development Bank, or IDB, would provide financing to companies in Turkey operating under procedures of Islamic production. (Website of Central Bank of Turkey, 2014)

First Islamic bank established in Bangladesh in 1983 in the name of “Islamic Bank Bangladesh Limited”. The study shows that in past two decade, it shows great success in achieving the goals of Shariah. The initiative taken by central Bank of Bangladesh in 1990 by establishing Islamic economics cell at the research department. The purpose of this department is to conduct analysis on Islamic economics and Banking. Domestic and International seminars and workshops are organized with collaboration if Islamic Development bank to know the current dynamics of banking.

Bangladesh Bank has not set up yet the Islamic banking department like State Bank of Pakistan to supervise guide and control Islamic banking operations. Inspection and supervision taken by Bangladesh Bank are from general guidelines that are framed for conventional banks. The guiding, supervising and controlling of Islamic Banking operations by Bangladesh Bank according to the Islamic Shariah is at beginning. The supervisors of Bangladesh bank have been going through training programmes to understand methodologies and different technicalities of the Islamic Banking system. Bangladesh Bank Training Academy and BIBM have also been arranging training courses on Islamic banking. Bangladesh Bank identifies different problems and advised different Islamic banks to take steps for the through mutual discussions in 1997.

- Development of an Inter-Bank Islamic Money Market
- Constitution of Central Shariah Supervisory Board



- Preparation of draft Islamic Banking Act
- Establishment of Islamic Insurance Company

In response Islamic Banks Consultative Forums was established, later on central Shariah board has also been formed. For facilitating Islamic banking and finance in 2005 focus group was constituted on Islamic banking has been established in Bangladesh to setup necessary guidelines. Bangladesh bank is also a member of Islamic Financial Services Board. In accordance with the best international standards the prevailing supervisory procedures of Bangladesh bank might be restructured.

The study shows legal and supervisory standards, which can address the exclusive features of Islamic banking operations, are necessary to encourage effectiveness of the Islamic banking sector. For the growth of stronger and booming framework of supervision in Bangladesh, the IFSB act as a motivist. To carryout their regulatory function, competency group competency on Islamic banking has established at the department of banking inspection to develop 'Shariah compliance checklists' as instrument for bank supervisors. Islamic banks face different challenges they are not able to divide their interest free mechanism to put their funds on short term basis. The basic modes like Musharakah and Mudarabah are not in practices due to improper supervision. Evident from the Shariah council's annual report of banks shows Shariah councils were dissatisfied for extreme delay in Shariah application in transactions or unwilling to follow rules by the management and from owners of the banks.

Study shows some problems faced by Islamic banking institute are lacking in legal framework for Islamic banking and lack of Shariah compatible regulatory, supervisory standards, lack of corporate governance and weak follow up of Shariah implementation so there is a need to supervise and proper guidelines by the central Bank of Bangladesh in this regard (Abdul Awwal Sarker, Deputy General Manager,

Internal and Islamic Economics Division and External Economics Division, Research Department, Bangladesh Bank, Dhaka.).

Islamic bank of Asia in Singapore was established as first Islamic bank in 1997. The Monetary Authority of Singapore (MAS), the SBP of Singapore wishes to improve Islamic finance in Singapore by leveraging on its prevailing strengths in banking, insurance, wealth management, trade finance, and capital markets. MAS works diligently with the industry to review its legal system to confirm that essential financial infrastructure and business situations are in accordance to support the further development of Islamic banking and finance in Singapore. In 1998 financial Islamic services were provided through Islamic banking windows in banks. To enhance the development of Islamic finance, MAS revised its rules and regulations in 2005. In contribution to the Islamic finance, MAS linked the Islamic Financial Services Board and keenly taking part in working groups and task force in areas e:g supervisory review and Islamic money markets.

In 2009, MAS sukuk facility was launched to meet regularity and liquidity requirement for Singapore based financial institutions which offer Shariah compliant financial services. In 2010, the Singapore Business Federation and MAS arranged the first Islamic Banking and Finance seminar to support awareness among Singapore companies. In June, Singapore was host of inaugural annual world Islamic banking conference: Asia summit. Singapore works in rising awareness about Islamic Finance and giving platforms for professionals to share their knowledge. There is not proper regularity framework for Islamic banking in Singapore. MAS are committed to keep regulatory framework proper and efficient and according to present scenario and relevant to ever changing and fast growing industry. But its method is to look through the form of the Islamic products to assess the economic matters and risks involved, and use that valuation as the source for regulation. This is not the proper

and well-mannered approach so there is a need of proper regulatory framework. (Website of Central Bank of Singapore, 2014)

Central Bank of Saudi Arabia is the Saudi Arabian Monetary Agency(SAMA) established in 1952. Governor of SAMA in “Symposium on Islamic Banking Prudential Standards” said in his speech is Islamic financial services are totally arranged in global markets. Islamic financial industry subjects to same supervisory control like others financial institutions. Encouraging Islamic financial institutions into global market will push them forward to compete with other financial institutions to meet the need of corporate and individual customers. Important point is here is to understand and to aware of the risks and to minimize that risks and ability to compete in market and fulfil the customers need. It is more important here for Islamic banks to publish their financial statements with the full transparency. A number of central banks including SAMA established the Islamic Financial Services Board to promote the establishment and Shariah compliant financial services industry by adopting the existing and new international standards compatible with the Islamic banking industry. SAMA is playing their role in creating awareness about Islamic finance. (Website of Saudia Arabian Monetary Agency, 2014).

Islamic banking has been started in 1977-1978 in eager to Islamize the economy by government of Pakistan. SBP is a monetary authority, they have to observe keenly regarding monetary transactions and operations of conventional finance and Islamic finance as well but here is a lack of practical implementation regarding operations of Islamic banking and finance. There is a regulatory issue in Islamic Banking and Finance. There is a lack of jurists competent in both sharia that are usulfiqah and usulmuamalat. There is a lack of jurists and lot of shortage of jurists and professionals which results in hiring the same jurists or person to different institutions. The number of jurists and shriah advisors should be increased in order to avoid this kind of problem. There is a lack of details that are disclosed of

reasoning, procedure and justification of Shariah supervisory board meetings in product approval and also in the issuance of fatwa and that is why it can be the hurdles in good discussions. Shariah supervisory board should have the role in Islamic Financial Institutions and also for the development of nation. As leaders for Muslim Ummah, jurists and Scholars have to observe keenly regarding all operations of Islamic Banking and Finance and must have to achieve goals of Shariah (Maqasid Al Shariah) in the practical implementation of Islamic Banking and Finance. That would be help in economic growth, reducing unemployment and self sufficiency. State Bank of Pakistan has to keep check and balance regarding supervisory framework. (Dr. Muhammad Alwosabi)

There is not any kind of rules and regulations are made on defaulters of Islamic Banking. There is a need to review the concept of penalty on defaulters by State Bank. Islam prohibits the interest on the late receiving's from the borrowers because penalty on late payments are not allowed in Islam. By this situation, large number of customers and borrowers take advantage of this and make themselves as defaulters. State Bank should possess the rules on defaulters and have to introduce the Shariah compliant mechanism and to review the introduction of penalty on defaulters. And there is a lack of literature about the Islamic Banking and Finance is available. There should be a need of proper manuals, text books, and journals about Islamic banking and Finance. So SBP have to observe keenly this matter of fact. (Dr. Rukhsar Ahmed, Dr Kamran Siddiqui, Mufti DrImmamuddin)

There is shortage of professionals and practitioners of Islamic Banking. This is another big challenge faced by Islamic Financial institutions regarding this. There is a need of proper understanding of conventional and Islamic products as well for practitioners that would help them in product innovation and differentiation. So there is a need of person having high trained skills to run Islamic Financial Intuitions

in a better way. Banks are asked to provide training by practitioners and professionals to their staff before getting license from SBP (Agha Zohaib Khan, 2009).

Another problem is shortage of Islamic banking branches. There are just 799 branches of Islamic banking in 2011 whereas on the other side there are 8000 branches of conventional banking in 2008. Islamic banking branches are in the 73 districts of Pakistan out of 100 districts. Pakistan is an Islamic country and banking system should be according to Islamic banking but there is a shortage in number of Islamic banking branches in this regard. SBP have to increase the number of Islamic banking branches for the easy access of Islamic products. ( Agha Zohaib Khan, 2009)

SBP have to play an important role in the Islamic Financial industry and the government as well. But Government of Pakistan shows a less interest in it and bureaucrats of Pakistan as well. The bureaucrats have got a position in Financial Affairs but they showed a less interest in Financial Affairs regarding Islamic banking Operations. This can cause a serious damage to healthy environment and Islamic finance.( The SBP's constitution is to regulate monetary and credit system of Pakistan and foster its growth in the national interest. Political and administrators of the country restricts SBP to play its autonomous role (Saleem, 1993; Ahmad, 1993, 1994a, b)). The Legal System for Islamic banking is weak and tardy in Pakistan. The banks need to wait for court decision against defaulters. So SBP have to strengthen their framework (Akram, 1997; The 1999 SC Judgement on Riba, p. 65).

Central bank as a lender resort for commercial banks provides loans but there should be a system for Islamic banks on providing loans without interest because Islam prohibits interest. (MunawarIqbal, Ausaf Ahmed, Tariqullah Khan)

## Hypothesis:

- **H1: SBP plays negative role in promotion of Islamic Banking**

Islamic banking was started in 1977-1978. Pakistan is an Islamic state so there is a need of Islamic banking. But SBP lacks in different matters regarding their operations and SBP have to to make rules and regulations and to keep an eye on Islamic banking regulations. But there is a lack of supervisory framework, lack of practitioners and professionals. There is a drawback regarding the penalty on defaulters and there is not any kind of policy for the defaulters. SBP asked the bank to trained staff before getting license from SBP. Central bank has to keep increasing Islamic banking branches for easy access of Islamic products to people. Bureaucrats have got position in Financial Affairs but they show a less interest in it this can cause a damaging effect on economic growth and on Islamic banking as well.

## Chapter 3

### Methodology:

A descriptive methodological approach is used for this theoretical research. This research attempts to analyse the role of the SBP in Islamic Banking. This research is based on the available literature about the performance of SBP in the promotion of Islamic banking. In research, role played by SBP for the use is considered as secondary source. The previous analyses on related topics made by the scholars are used as secondary source for the research. There is a limited literature are present that motivates for this research. The hypothesis will be tested by the document analysis technique and by the use of available literature. This research will help the government authorities, bankers and law practitioners. It would help the SBP to understand and remove obstacles in promotion of Islamic Banking. This research will help others to analyse the effort of SBP in promotion of Islamic Banking.

Secondary data collected from the past papers, articles and books will be analysed in the prospect of SBP's performances and roles. To analyse feasibility of selected data and implementation, the further improvements in the Islamic banking need to be made.

## Chapter 4

### **Analysis of growth rate of Islamic banking in SBP as compared to other countries and reasons of accepting hypothesis:**

Why did Islamic banks remain stable during the early phase of the crisis in Pakistan?

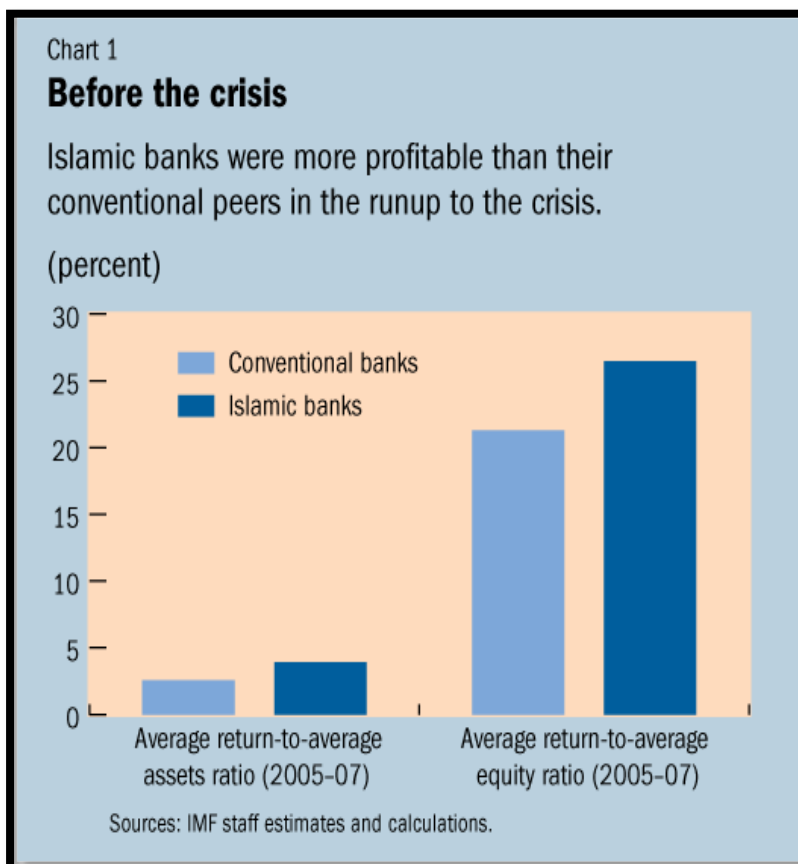
To the extent Islamic banks try to emulate the conventional banks in the design of their financing products they showed themselves to similar credit, liquidity and solvency risks that drive to the similar systemic instability as experienced by conventional banking. The urge towards similarity with conventional banks is low than a result of the current and regulatory environment which does not provide all the demanded support and infrastructure institutions that are needed for a well functioning Islamic banking industry. Greater reliance by Islamic banks on credit type financing (murabaha and ijara) at the expense of participatory financing is also a partial result of this. These factors translate into financial fragility similar to that of conventional banks. Focusing on the actual practice rather than the theory and examining the factors that provided stability to the Islamic banks and financial markets during the crisis we find that three factors stand out for their stability in the wake of crisis.

First, Islamic banks' financing activities are more attached to real economic activities than their conventional counterparts. Though profit and loss sharing modes of musharakah and mudharbah provide better risk sharing along with maintaining a strong connection with the real sector, they are used minimally for various reasons. Most of the financing activity is being done through murabaha and ijarah modes followed by that through Istisna financing.

Why did Islamic banks and financial institutions start getting affected at a later stage of the crisis?



The financial crisis has strengthened a chain reaction whereby the slowdown in the real economies of the developed countries has started to affect economic growth and investment activities in export driven economies of the developing countries through lower trade in goods and services as well as through the declining commodity prices including that of oil. The economic downturn is not only affecting the investment and financing activities of financial institutions including those of Islamic banks, it is also reducing the funding of these banks through lower personal savings and declining corporate profits. It should be noted that most of the Islamic banking industry comprises of commercial banks whose major funding source are retail deposits, investment banking constitutes only a small portion of the industry Islamic banks in some regions may face risk on their financing and investment side of the balance sheet due to the crisis induced volatility of equity markets where these banks have large positions.





From the analysis it is clearly seen that the growth rate of Islamic banking in Pakistan is lowest among all of other countries. The reason behind this is given above. That is why the hypothesis which states the negative role of SBP in promotion of Islamic banking is accepted. The further regulatory issues are mentioned below that further explain the reason behind this accepting of hypothesis.

## **Regulatory Issues in Islamic Banking and Finance:**

### **Legal framework**

At present, there is no specified authority present that controls the Islamic financial industry and not the widely accepted rules and regulations regarding the interpretation of Shariah have given. All the Islamic banks in Pakistan or in other countries have their Shariah boards which are different from each other and they do practices in resolving or verifying bank's problem regarding the Shariah laws. The number of Shariah scholars is included in these Shariah boards that have complete knowledge about Shariah and finance.

The Shariah board has become burdened due to less number of knowledgeable and experienced scholars and it became difficult and unpredictable to solve all the problems regarding the matters or issue. The wide range of products is offered by the Islamic banks that meets the consumer and the business requirements. But there is a need to enhance the development of few more products so that bank's concentration on the Mudarbah and Musharkah reduced.

There is a lack of regulatory and supervisory framework for Islamic Finance. There is a lack of jurists for Shariah opinions. Shariah supervisory boards have to play the role in development of industry and in the nation. The most important thing in this regard is to enable the legal framework. Present legal framework does not differentiate between Islamic and conventional banking. BCO 1962 is equally valid for Islamic and conventional banking institute. There should be a change in the proposed law related with the Islamic Banking with the government to enhance the productivity of this industry. Islamic banking is providing alternates on conventional banking products but not with differentiated solutions in order to resolve this problem Islamic banking have to engage themselves in real trade, real states, investment banking businesses and act as a Mudarabah management company will be judged. The required changes in regulatory and legal framework are intended to be carried out by SBP in next 5 years. But there is a need to show proper interest and practical implementation by SBP.

### **Shariah Supervisory Boards**

There are some issues related to Shariah supervisory boards developed by SBP are following:

- There is lack of jurists competent in both Shariah(usulul-fiqh, fiqhAlmuamalat) and modern day economics and finance. Training in economics and law is urgently needed to overcome that kind of problem. The

lack of knowledge about modern day economic and legal issues can be harmful. Shariah scholars have to know about modern day economics and finance for issuing well informed ruling on financial products and investment activities.

- There is a lack of jurists which results in hiring the same jurists for many institutions. This may cause a problem of conflict of interest. Number of Shariah advisors should be increased in order to avoid stretching the present advisors and also they have time to spend with economists and practitioners that would be helpful for new Islamic financial products.
- SSB should play an important role not only for Islamic financial institutions but in the nation development.

To overcome all problems, there is a need of unified Shariah board instead of having one supervisory Shariah board for every institution. The scholars and jurists represents different Islamic school of thoughts have knowledge in Shariah and modern day economics and finance as well. The unified Shariah board would help in settling divergent points of view and in achieving harmonization and convergence in the concepts and application and it would avoid inconsistency between the fatwas and applications by Islamic financial Institutions. The unified Shariah board will increase the performance and finance related rulings of Shariah.

### **Mechanism for Dispute Resolution**

Legal proceedings are time consuming and much costly to resolve the dispute issues. In comparison of this there is a dispute resolution mechanism are working

around a globe and encouraged. SBP have to adopt this mechanism in order to resolve that kind of dispute and it avoids time and cost as well.

### **Prudential Standards**

Adoption of International Practices is important with respect to supervisory issues. It will be completed through the adoption of prudential standards and guidelines issued by regulatory bodies like Inter Services Financial board (IFSB). SBP is an active member of IFSB and playing an important role in the progress of IFSB's standards. The standards issued by IFSB for IB Industry will be revised according to local and regulatory framework and should be accepted with required adjustments whenever mandatory with the opinions of Shariah advisors and professionals.

### **Awareness**

Absence of awareness about IB and their products are the main reason of confusion and misperception among people. Awareness is a big challenge for Islamic banking products. Conventional banking has not faced any difficulty to launch its new product than Islamic product. This is a new thought and people are ignorant of this concept so SBP have to observe keenly this matter of fact and do awareness programmes regarding this. Seminars should be held more n more for awareness of Islamic finance and products at different platforms. Lectures about Islamic Finance should be provided in different institutes by SBP. There must be press coverage of seminars and events held about Islamic banking and finance. There should be proper campaigns organized for promotion of Islamic banking and there must be marketing about Islamic products. There is a need of proper and well organized marketing for this industry. SBP have to take some serious steps about awareness of Islamic finance for the growth of this industry.

## **Taxation Issues**

The state bank of Pakistan has made groundwork to make it easy for all other conventional banks to solve the issues regarding the financial services. This ground work consists of a committee which determines the modes of Islamic transactions and their accounting treatment. The effective taxation treatment which is made for the conventional banking is also a need of Islamic banking for the Islamic transactions. The issues regarding the double taxation on Mudarbah transaction was the focused by SBP and proposed some beneficial addition in the law of taxation. Thus the focus was to deliver a playing field for the IBIs.

A budget was proposed in 2004-2005 in which some addition was made (Statutory Regulatory Order 445(1) / 2004) in the Sales Tax Act, according to which any of good which is delivered under the concept of Mudarbah need to be first approved by state bank of Pakistan, in other case if it is not approved than it can't be treated as a supply. Another amendment which includes the minimum turnover tax was made. In the bill 2007 it is confirmed that the Shariah complaints of Islamic banking are treated as the conventional banks. The need is to make effective transaction treatment within Islamic banks which is present in the other conventional banks. The system of double taxation which was developed by state bank of Pakistan for conventional banks and for IBIs need to be eliminated to increase its growth.

## **Financial Reporting and Accounting Standards**

The financial reporting framework for the Islamic banking consists of:

- The International Financial Reporting Standards (IFRS);
- The Banking Companies Ordinance (BCO), 1962;
- The Companies Ordinance (CO), 1984; and
- Different rules established by the SBP and the SECP

The issues regarding the Shariah compliances in the Islamic banking system and their guidelines by SBP are given in the financial reporting standards. These financial standards need to be followed by the Islamic banks. Some of modes or areas are not covered in mentioned standards. The IBIs suggested to follow the AAOIFI Accounting Standards. Also in the annual report of state bank the IBIs are asked to show their work of profit which they deposit to their distributors, financing breakups due to Islamic mode of financing and the Shariah advisor.

There is also a need to add the individual balance sheet and profit and loss statement of Islamic banking in the annual report of conventional banks with the Islamic banks branches. They are also encouraged to add the cash flow statement of Islamic banking in their financial statement disclosure. The institute of standard chartered made a commission on Accounting and Auditing Standards for Interest Free Modes of Financing and Investments. The committee members are from all the relevant fields as lawyers, bankers and Shariah scholars.

The purpose of this board is to review all the accounting standards that are made by accounting and auditing organization for the Islamic banking and Islamic financial institutions, Bahrain (AAOIFI) review them and if feel necessary; can make new accounting standards. The system of Murabaha has established by the SECP through SRO 865 (I) / 2005 in August 2005 under section 234 of the Companies Ordinance, 1984 and now it has become the part of law.

Current accounting and auditing standards are more for conventional banks than Islamic banks are applicable presently but Islamic banking are differ in their nature from conventional banks. So SBP have to collaborate with ICAP for issuing accounting and auditing for Islamic banking industry.

### **Competition and Globalization**

Competition is good for any industry. It keeps the industry up to date and according to present scenario and customers demand. Now a day's market is wild

increasing and accepts the variations very quickly. The businesses are spread in the world due to globalization effect. Islamic banking has the challenge of rivalry as well as globalization. Islamic banking has to survive in the globalization by working on a competitive basis. Globalization can play main role because huge amount of funds can run this industry smoothly. It is easy to grow Islamic banking system in Asia because of globalization. The utilization of funds from the west to Asia and to our country is helpful for the growth of Islamic banking. SBP have to show a keen interest in globalization. SBP should held different kind of seminars with other muslim countries and make this industry attractive.

### **Lack of Expertise**

Another important challenge worth discussing for is the capacity building which is faced by Islamic banking. For the differentiation and the bringing of more innovation in products, the proper understanding of Islamic banking service is necessary step for the researchers. It is also an important thing to have the people with skills and knowledge of Islamic banking in order to cope with the new emerging challenges.

With the establishment and growth in the Islamic banking system, SBP is gaining more attention on the qualified human resource which is hired by the Islamic banking industry. All the Islamic banks must give proper training to their employees as the other conventional banks do. The international and national exposure in the employees is the need, thus department of SBP which are dealing with the Islamic banking need to ensure the proper training of employees.

The international training programs, seminars, conferences on the Islamic banking are conducted which educate the state bank of Pakistan staff on the Islamic banking system to deals with the problems and the issues regarding finance concept.



SBP have to conduct seminars, campaigns and events about the awareness of Islamic banking and SBP should hire professionals, Islamic scholars, jurists and Shariah advisors to train their staff and also Islamic banking staff. SBP also take help from other countries that are showing progress in this industry like Malaysia.

### **Network Issues**

There are very less number of licensed number of branches in Islamic banking. It shows the limited financing of Islamic banking. To improve or widened the accessibility of Islamic financing, the Islamic banks are encouraged to choose the alternate ways or channels. The option of opening Islamic banking windows and the branchless banking within the conventional banks is adopted.

The ethnic and religious dimension of Islamic finance made its massive appeal for adoption in multiple countries. It has also showed its influence in the field of agriculture, small and medium enterprise, infrastructure finance etc. The appeal for increased and varied system of Islamic banking in the country has made too much attention towards the promotion of Islamic banking system and launching.

There is also a limited awareness about the Islamic bank micro finance so that the Islamic banking is still in the development phase. Due to high cost problems and other issue, it is challenge for Islamic banking to enter in to new sectors and rural areas. Now the break even stage is brought to deal with such avenues. On the other side, the consumer banking related challenges as personal loans and credit cards are still the point of focus. SBP have to focus to overcome this issue by issuing license to Islamic banks before proper scrutiny. SBP have to issue license before they ask Islamic banks to provide proper training to their bankers. For the easy access of Islamic products and services, more number of branches should open to overcome this issue.

## **Islamic Banking literature**

Islamic banking literature is very limited. Islamic banking literature is not readily available. SBP have t observe keenly this matter and do something to overcome this problem. There should be proper Islamic Banking Manuals, text books and reading material. The books should be introduced related to Islamic banking literature would increase the knowledge of bankers and also create awareness in public. Mufti muneeb that is Sharia Advisor of DawoodIslamic Bank mentioned that during his working experience with that bank he has issued around four thousand Fatwas. It was published in four volumes. This literature is in the market with the name of “TefheemulMasaeel”. That of literature is very helping material for further research and development in the field of IB industry. SBP should take a step towards the publication of that kind of literature. SBP should hire Islamic scholars, jurists and professionals to hire for the publication that would be helpful for both the bankers and for the public.

## **Innovation**

Islamic banking lacks in innovative products but on the other side conventional banking has the innovative products. Innovation is necessary in Islamic products to attract the customers. For the differentiation and the bringing more innovation in Islamic products, the proper understanding of Islamic banking service is necessary step for the researchers. It is an important thing to have the people with skills and knowledge of Islamic banking in order to meet with the new challenges. SBP have to focus on innovation by hiring professionals who should work according to current scenario and modern day economics and finance.

## **Suggestions for effective role of SBP in Islamic Banking**

This is a fact worth accepting for that Islamic banking has saved the financial world from a big storm. The non Muslims countries are also trying to make a channel

in which they can compete with the other countries in the hub of Islamic finance. But still the growth of Islamic banking is has been facing large number of challenges and problems.

In year 2000 SBP made a strategy to initiate Islamic banking equivalent to other banking. After that verdict SBP passed directions in which it is obligatory for other commercial banks functioning in Pakistan to start offering products of Islamic banking. There is a separate department for Islamic Banking is established in the SBP. SBP have to keep an eye and to monitor the operations of Islamic banking and finance because without their efforts Islamic Banking cannot grow tremendously but SBP is not doing proper work and not putting proper efforts to grow generously this industry. SBP is lacking in regulatory framework they are not doing awareness programmes and proper trainings.

SBP is not working for increasing network of this industry to easy access of people to Islamic products. They are lacking in professionals and Shariah advisors and they have to work on providing literature easily regarding Islamic Banking and Finance. Large numbers of challenges Islamic banks are facing. Few of them are lack of qualifies man power, lack of customer awareness, standardization of product is low, conventional banks one window operations for the Islamic banking, the unrealistic and problematic system of Shariah boards and their implementations. The system of Islamic financing is dependent on equity based system not on the credit based. So far as the problems of present day is concerned related to Islamic banking. Here are different other major operational and institutional issues or challenges are discussed which the Islamic banking is facing and the recommendation and some solutions are given which is the need of Islamic banking for the near future.

Here the focus of paper is to highlight those issues and challenges which the Islamic banks are facing and negative role of SBP in the growth of Islamic banking. So

there are some suggestions for effective role of SBP for this industry by analyzing above work.

## Conclusions

Islamic banking is emerging promptly in Islamic countries as in non Muslim countries. Many commercial banks run separate Islamic banking branches and Islamic banking windows. People are not aware of the mechanism and products of Islamic banking. Islamic banks are working under supervision of SBP. Islamic banking department was established in Sep, 2003 for promotion of Islamic banking. This section started its responsibilities and duties by the expansion of Shariah advisory board of Pakistan. Objectives of this department are to strengthen the regulatory framework and adopt standards issued by IFSB, conduct awareness programmes and to analyse data related to Islamic banking industry etc. Islamic banking system is not interest earning but it is equity based operations. For Islamic and conventional banks in Pakistan has same legal and taxation rules, for this in the BCO 1962 the amendments were introduces at the initial phase of Islamic banking. Operations among the both industries are diverse. SBP is working with related authorities for stability of Islamic banking.

SBP are not playing an effective role in promotion of Islamic banking as compared to other countries. There is lack of regulatory framework and accounting standards for Islamic banking industry. People are unaware of Islamic banking. There is a lack of expertise and network issues. SBP have to take steps for effective growth and promotion of Islamic banking. The focus of my study is to highlight the issues regarding the adaptation of Islamic banking system and role of state bank of Pakistan which lacks the expertise and major measures to tackle with these problems. My recommendations suggests that if the Islamic banking system want to get enhancement and business in country, there should be introduced a large number of accepted policies hub. The financial tools and financial policies of Islamic banking are

the major point of concern. The trust of people on Islamic banking system is not wide because of its early age arrival and a few number of adaptability. Still the large numbers of people trust on the conventional banking system and they are not satisfied with the Islamic banking system to achieve their entire requirement in the Pakistan.

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