A. Introduction

Islamic finance has gripped the world with a strong fervor and passion. Interest in this discipline has proliferated to almost 60 countries, going beyond the Islamic world to the leading global financial centers. For quite sometime, United Kingdom has adopted an open door policy and provided a level playing field to Islamic finance and now Singapore is following its lead. Every day, Islamic finance is breaking new boundaries and new frontiers. Leading Islamic banks have fast spread their network from home base to develop a regional and global reach. Some of the Middle East banks are now entering into African and Central Asian markets and are sizing up Australian financial market.

Motivation and renewed interest in Islamic finance industry stems from its strong economic, financial and social considerations, backed by its unique features. Most significant is its appeal to add to financial diversity and innovation being skewed towards (i) asset backed and equity based transactions, which promote entrepreneur friendliness and consideration of project viability; (ii) equitable distribution of risks and rewards among the stakeholders; and (iii) inculcating market discipline and higher ethical standards given its emphasis on non-exploitation and social welfare. In the wake of high Asian domestic savings rates and build up of the region’s foreign exchange reserves as well as oil surpluses of Middle East in the last few years, Islamic finance is now also emerging as a way to wealth management, both of richer nations and high net worth individuals.

While the world is now recognizing the significance of Islamic finance industry, in Pakistan, as early as in 1948, Mr. Muhammad Ali Jinnah emphasized the virtues of Islamic principles and in his address at the inauguration of the State Bank of Pakistan (SBP), 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.”

B. Historical Context of Pakistan’s Islamic Finance

Pakistan has a protracted history of Islamic banking with the initial attempt to Islamize banking system in 1980s, leading to sweeping changes in the Banking Companies Ordinance,
1962 (BCO’62) and associated laws and regulations to accommodate non-interest based banking transactions. Some specific developments around this period are noteworthy:

i. In 1979, two Government-owned mutual funds in Pakistan, the NIT and ICP, started to eliminate interest from their operations by eschewing investment of their funds in interest bearing securities. Investor scheme of ICP was substituted as from October 1, 1980 by a new scheme based on profit and loss sharing.

ii. The state-run House Building Finance Corporation (HBFC) also eliminated interest from its operations from July 1, 1979.

iii. In June 1980, legal framework was amended to permit issuance of a new, interest-free instrument of corporate financing called Participation Term Certificate (PTC).

iv. A new law, namely, the Modaraba Companies and Modarabas Ordinance, 1980 along with the Modaraba Companies and Modaraba Rules, 1981 was promulgated to introduce modarabas, as a two-tier fund structure, for undertaking Shariah compliant businesses.

v. In 1984, the Banking and Financial Services Ordinance, 1984 amended seven laws and Banking Tribunals Ordinance, 1984 provided a new system of recovery of non-interest based modes of financing.

vi. From January 1, 1981, separate interest-free counters started operations in all the nationalized commercial banks to mobilize deposits on profit and loss sharing basis. Concurrently, banks were prohibited from specified interest based transactions, which resulted in development of Islamic modes of financing.

vii. Finally, SBP issued BCD Circular No. 13 of 1984 that called for elimination of Riba from the banking system and in January 1, 1985 all financing to Federal and Provincial Governments, public sector corporations and public or private joint stock companies was directed to be only through interest-free modes.

viii. From July 1, 1985 all commercial banking in Pak Rupees was made interest free. Resultantly, profit and loss sharing (PLS) deposits, as a percentage of total deposits, rose from 9.2% at the end of 1981 to 61.6% by end of 1985.

These measures resulted in a country-wide roll out of Islamic banking. However, the premature and sudden conversion of banking system to Islamic system coupled with the lack of preparedness and understanding among financial institutions and public posed difficulty in implementation. The Federal Shariat Court challenged some emerging products and processes and declared them un-Islamic. The Shariat Appellate Bench of the Supreme Court upheld the decision of the Federal Shariat Court and offered guidelines to address the issues involved, setting a timeline for implementation. This decision was later set aside in a review petition filed by the United Bank.

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3 Mohsin S. Khan and Abbas Mirakhor: *Islamic Banking, Experiences in Islamic Republic of Iran and Pakistan.*
C. Current State of Industry

Some key lessons emerge from Pakistan’s experience of 1980s. Firstly, it is prudent to allow industry to adopt an evolutionary process, rather than adopting a revolutionary approach, in order to nurture acceptability and development of Islamic finance industry. Secondly, flexibility rather than rigidity allows for effective accommodation of changing needs of a dynamic market. Thirdly, the markets and customers must have confidence in Shariah compliance by the Islamic finance industry to ensure sanctity of the system. Lastly, all stakeholders involved, including the regulators and the industry, have to be properly equipped and prepared for the eventual launch of a new system.

Valuable experience and lessons learned by the policy makers and the industry helped in the re-launch of Islamic banking in Pakistan in 1990s. In recent years, a notable element of SBP’s financial sector strategy was the introduction of Islamic Banking Policy in December 2001. Under this policy, Islamic banking is being promoted in parallel to the development of conventional finance industry in an integrated, gradual and steady manner. SBP has been issuing licenses for Islamic banking to stand alone Islamic banks and Al-Meezan Investment Bank, which had been functioning as an Islamic Investment Bank, became the first Islamic bank of the country upon award of Islamic banking license by SBP. In addition, SBP allows conventional banks to set up Islamic banking subsidiaries or dedicated Islamic banking branches to offer range of financial services.

SBP has put into place a comprehensive and robust multi-tiered Shariah compliance mechanism to lend customers and investors confidence in the Islamic banking industry. Shariah compliance mechanism has three main pillars: (i) a Shariah Board at SBP which approves policies and guidelines as well as the fit and proper criteria for Advisors; (ii) Shariah Advisors in all banks to provide guidance to banks and comfort to customers on Islamic financial services; and (iii) a Shariah audit system.

SBP has introduced nine model agreements and contracts for major Islamic modes of financing and Shariah audit guidelines for banks, after vetting and approval of the SBP Shariah Board. Work is underway on three more model contracts, namely, Diminishing Musharaka, Istijrar and Wakalah. Shariah compliance inspection of Islamic banks will start this year and will cover a review of the Islamic banks’ arrangements and operations, their services and products, financial statements and accounting records to ensure that all transactions are being carried out in accordance with the injunctions of Shariah.

Backed by this elaborate structure, today 6 full fledged Islamic banks (IBs) and 13 conventional banks offer a network of around 170 branches. Total assets of Islamic banks are close to Rs135 billion as on End March 2007 while Islamic deposits and financings stand at 2.9% and 2.4 % of market share respectively.

Further, it has also been specified that a Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. Needless to mention that, Shariah Advisors of IBIs are also prevented from having any substantial interest in or becoming employees of same types of organizations like Exchange Companies, Corporate Brokerage Houses or Stock Exchange. These provisions in the Fit and Proper Criteria for Shariah Advisors have ensured objectivity in evaluation criteria, minimization of conflict of interest and induction of new lot of Shariah advisors in the market.

As on End March 2007
D. Future Strategy and Outlook

While the number and operations of Islamic banks are fast expanding, this segment of the market is still small relative to the appetite for Islamic finance. Pakistan, in light of its past experience, is launching a gradual and steady approach to Islamic banking. Despite rapid expansion in industry, the share of Islamic banking in the total banking system is a modest 3.2%. Moreover, it only caters for around 23,000 borrowers through around 170 branches relative to the country-wide 5 million borrowers (or 4.8 million excluding microfinance borrowers) tapped through 7,700 branches by conventional banks. Financing and investment levels of Islamic banks barely range around Rs77 billion, which is below 3% of the total banking system’s advances. On the product side, Islamic banks so far offer about 75% of products currently available in conventional banking while clean lending for consumer financing products, like personal loans and credit cards, still pose a challenge. Islamic banks operate exclusively in large cities with some now venturing into secondary cities but they are absent from rural areas where there is great potential for business growth.

Global interest in Islamic finance industry and Pakistan’s success in laying basic foundation and core infrastructure of Islamic financial system lends confidence that the country has good potential and prospects to further exploit this industry. Going forward, however, it is important that Pakistan adopts a more calibrated and coordinated approach and strategy for the development of Islamic finance industry. In designing this strategy, Pakistan will conform to the standards being promoted by the Islamic Financial Services Board (IFSB) – the sixteen member Council of Governors of Central banks with several associate and affiliate members – whose chairpersonship Pakistan assumes effective January 2008.

The goal and objectives of the forward looking strategy should be to offer an alternative avenue of financial intermediation, which is competitive and promotes efficient allocation of resources in an equitable manner. Strategy should aim to supplement conventional banking industry’s efforts to broaden and deepen the process of financial intermediation and financial penetration. Islamic banking can serve as a key vehicle to improve and strength the access to development finance by bringing in financial innovation that can cater adequately to diverse demands of the population as well as corporate sector’s and country’s infrastructure financing requirements, while ensuring that it nurtures faith based system of financing consistent with the Shariah principles.

Major elements of this strategy would require both industry and SBP to closely work together on multiple fronts. Some of the key areas of focus include:

*Aggressive deposit mobilization to augment domestic financial savings of the country.* Although late starter, Islamic banks have phenomenal potential to exploit resource mobilization. Substantial savings have still not been channeled into the financial system because of reservations relating to interest based system or return deficiencies of the conventional system. Islamic banks, besides catering to the needs of small depositors through profit and loss sharing basic accounts with no charges, need to tap high net worth investors and companies which are increasingly being driven to the attractive options and returns being offered by more innovative players worldwide. Fast adaptation of these practices by the Islamic finance industry will be helpful in competing more effectively with conventional banks in raising

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deposits. Resource mobilization is critical for Islamic finance industry to grow effectively and meet the alternative requirements of economy and society.

**Diversification and innovation of financial structures.** This would involve either applying innovative Islamic products on a stand alone basis or applying a combination of Islamic instruments to suit project finance needs. In attempting the latter, it needs to be ensured that vanilla Islamic products such as Murabaha, Ijara and diminishing Musharaka etc. are implemented with their necessary preconditions, consistent with Shariah principles, to promote modes that can be used to finance commercial and project finance activity. This would require greater reliance on equity based financing, given that it is akin to participation and risk sharing consistent with infrastructure financing requirements and Islamic principles. At the same time, it requires financial engineering, flexibility in the evolving Sahriah system and alliance both among domestic and with the bigger global players (such as Standard Chartered, HSBC, UBS, Citibank etc.) to diversify Islamic financial structured products to support project finance in addition to associated real estate, shipping, trade, and aircraft financing.

Islamic financing products/structures are now quite common in Middle East and Saudi Arabia and have gained ground in non-Muslim countries too. In most cases it has to be recognized that Islamic financing is incorporated within a multi-sourced project financing offering, along side the conventional project financing structures backed with or without supportive credit enhancement or export credit agencies financing. The Islamic financing element of the project is provided *pari passu* with the other senior debt. Istisna's and variant structure of Ijara are frequent products used. If required, there should be standard legal structure for establishing and operating with ease Islamic SPV as the financing vehicle. Islamic finance tranches are known to offer additional benefit of competitive pricing and tenor.

There should be harmonization of these alternate and multi-financing legal and regulatory structures and appreciation that conventional project financing documentation could be acceptable to different Shariah Boards/Committees. Pakistan has been exposed to these structures, given its earlier experience with the Hub River project, which in early 1990s incorporated Islamic Tranche of Istisna, and more of such recent deals. In designing such structures there has to be more tolerance among participants to:

- integrate Islamic and conventional funds to allow co-financed projects with different players;
- accept ownership risks (since in all Islamic transactions, lender is at some stage the owner of financed goods) but with comfort of clarity of legal issues surrounding ownership;
- ensure proper tax treatment of the proposed Islamic financing structures, avoiding adverse treatment relative to conventional borrowing, e.g. often profit participating payments are subject to tax while interest payments on loans are tax deductible;
- ensure flexibility in selection of assets for Islamic tranche;
- understand issues surrounding asset risks; and
- provide for payment of insurance and maintenance expenses for Islamic financed assets etc.

**Extend the outreach of financial services in a holistic manner with focus on underserved regions and poor and vulnerable groups.** Islamic banks will be allowed to pursue their plans for branch expansion as long as Islamic banks, like conventional banks, open at least 20% of new bank branches in rural areas. Conventional banks will have the option to
seek partial or full conversion to Islamic banks. Microfinance banks are to be allowed to set up special windows or dedicated branches for Islamic Microfinance operations and licenses will be given to dedicated Islamic Microfinance banks. Guidelines have been already issued to promote Islamic Microfinance industry. Similar initiatives will be launched to issue guidelines for promoting SME, Agriculture and Infrastructure financing.

**Promote financial industry diversification** by requiring that, in tandem with Islamic banking, there is adequate development in Islamic capital markets, which so far has lagged behind the banking sector.

**Enhance understanding and capacities of Islamic Banking Risk Management.** Risk magnifies in Islamic banking, considering that banks and customers operate on profit and loss sharing mechanism. Because of this participatory risk relationship, the financial institution may not be exposed to traditional credit risk associated with conventional banking but more to risks associated with assets financed and off-balance sheet risk linked with the transfer of assets and its management as well as any volatility in the values of underlying assets. In structuring new products, there is need for institutions to factor in appropriate risks of real commodities, properties and equipment being financed with proper risk mitigation management and techniques. The strategy has to recognize the risk associated with Islamic banking and as such it has to include appropriate mechanisms and approaches to mitigate these.

**Promote development of liquidity management instruments to ensure investor confidence while effectively managing Islamic banking system’s systemic risk.** Apart from Government’s efforts to launch Shariah compliant SLR securities, SBP will need to launch Shariah compliant Treasury Bills along the lines of other central banks which have a range of short term securities based on sales and purchase contracts that are tradable in the secondary market and launch Sukuk cum Ijarah instrument proposed by the Central bank-Islamic Industry Task Force in 2006. Islamic repos would be also need to be structured. To facilitate the issuance of these types of instruments, amendments will be required in SBP Act as well as setting aside of specific assets of public sector by the Government. Once these instruments grow, SBP will align the SLR for Islamic banks at par with the conventional banks’ SLR as the risk associated with Islamic banks are in some senses far greater than in conventional banks given their reliance on equity based diversified products. Some countries have even considered higher SLR for Islamic banks as their inherent risks are often times varying in nature and far steeper.

**Promote international standards and best practices in Islamic Industry.** Aside from standard application of conventional banking regulations and guidelines, Islamic banks will be encouraged to adopt IFSB and AAOIFI (Accounting and Auditing of Islamic Financial Institutions) standards with appropriate tailoring to suit domestic requirements. SBP is an active member of these international bodies and has provided input into the technical design and formulation of these standards.

**Promote good corporate governance in Islamic banking.** Islamic banks must exhibit unique fiduciary responsibilities towards investment account holders, ensure Shariah conformity and select investments that are Shariah compliant (avoiding products/businesses that are haram) as well as implement sound internal risk management. As such, they will be required to follow a distinct corporate governance framework in line with the IFSB’s Guiding Principles on Corporate Governance.
Launch joint capacity building efforts for Islamic finance industry. SBP and the industry will promote capacity building for greater understanding of Shariah principles, asset and liability management, and features of product structure. In addition, specialized training will be needed to promote smooth and effective implementation of IFSB and AAOIFI standards.

E. Conclusion

With its promising prospects and potential, Islamic banks will need to grow at least by 40-50% annually to be able to raise its share from 3.5% to about 15% of the total banking system. Given that banking industry as a whole has been growing at a substantively fast pace, the level of effort required for Islamic banks would have to be steeper to claim this share. Given the success of some countries in achieving this share for Islamic banking, it is important that concerted efforts are put in to propel Islamic banking system further and deeper in Pakistan.