Box 3.2: SBP’s Strategy to transform the banking sector to Islamic mode – key challenges and opportunities

Introduction

The honorable Federal Shariat Court (FSC) in its judgement on Riba[89] dated April 28, 2022 has declared that Riba is prohibited in all its forms and manifestations, and directed to convert Pakistan into an interest-free economy by end of CY27. The verdict has directed to delete the word “interest” from all relevant clauses under different laws and to amend all laws with respect to the judgement.[90]

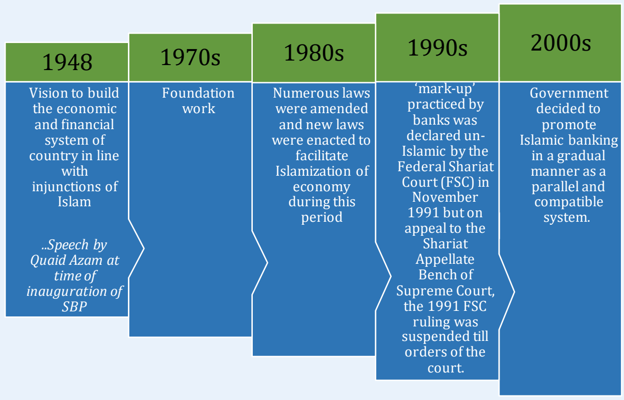
A. Islamic Banking in Pakistan – Historical Perspective and Current Status

Efforts for economy wide elimination of Riba started in late 1970s and several noteworthy and practical steps were taken in 1980s, in which, SBP played a key role.

However, the financing procedure based on ‘mark-up’ practiced by banks was ruled as un-Islamic by the FSC in November 1991; and the Supreme Court’s Shariat Appellate Bench delivered its judgment in December 1999 with the directions that laws involving interest would cease to have effect by June 30, 2001 and later the date was extended to June 30, 2002. However, on a review petition filed by a bank, Shariat Bench of the Supreme Court set aside the previous verdicts on Riba in June 2002 and remanded back the case to Federal Shariat Court for hearing afresh.

The extant paradigm of Islamic banking in the country can be traced in the government’s efforts of early 2000s to promote Islamic banking through a market driven approach. It aims at developing Islamic banking as a parallel and compatible system so as to ensure a smooth transition (**Chart 3.2.1**).[91]

Chart 3.2.1: A retrospective view of Islamic Banking in Pakistan



Source: SBP

Under this approach, Islamic banking has witnessed robust growth over the years to attain one-fifth market share, which reflects both growing confidence of the public and buildup of capacity among banking professionals and market infrastructure to support the sustainable growth of this faith-based discipline of banking. SBP has been playing a leading role in creating a conducive environment for the development and promotion of Islamic banking industry including the institution of enabling regulatory and supervisory framework and capacity development of the industry.

Pakistan is the world's fifth most populated country with world’s second-largest Muslim population. The country is estimated to have a population of around 232 million of which 96.5 percent is Muslim, indicating the needs of Shariah-compliant banking services.

Current Status of Islamic Banking

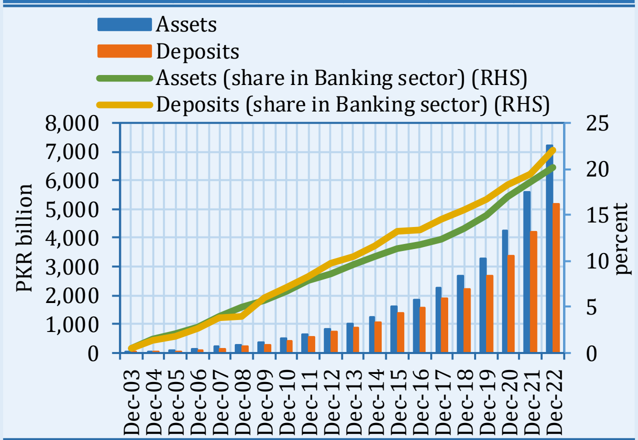
By end Dec-22, the network of Islamic banking reached 22 Islamic Banking Institutions (IBIs), including 5 full-fledged Islamic Banks (IBs) and 17 conventional banks having dedicated Islamic

[89] Shariat Petition No.30-L of 1991 & All other 81 connected matters relating to Riba/Interest.
[90] The verdict comprises 166 clauses; first 151 clauses provide the background of the case and the conceptual underpinning for the principle of Riba or interest and its implications for Pakistan’s economy, and the following clauses direct the government to implement a Riba free economy within 5 years.
[91] SBP - History of Islamic Banking in Pakistan.

Banking Branches (IBBs).[92] The branch network of Islamic banking industry crossed the 4,000 mark to reach 4,396 (spread across 129 districts of the country) by end Dec-22 up from 3,956 in Dec-21.

Islamic banking industry's asset base and deposits grew at a phenomenal rate since its inception. For instance, average annual growth in Islamic banking industry's asset base since 2010 has been 25.9 percent compared to 14.1 percent growth in overall banking sector. Accordingly, Islamic banking has become an important component of country's banking sector, acquiring a market share of 20.2 percent in assets and 22.0 percent in deposits of the overall banking industry by end Dec-22 (**Chart 3.2.2**).

Chart 3.2.2: Trend in Assets and Deposits of IBIs



Source: SBP

SBP's efforts to promote Islamic banking...

To facilitate conventional banks desirous of converting their operations as per Islamic principles, SBP has provided detailed guidance and regulatory standards from time to time.

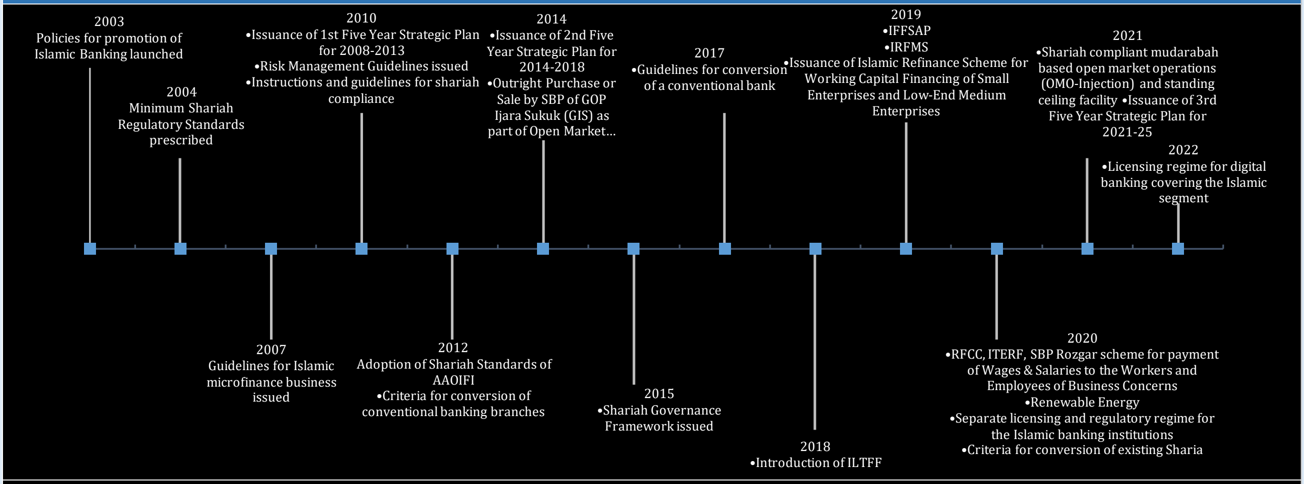
Besides, SBP also provides hand-holding and necessary facilitation for orderly conversion on an institutional or transactional level. One of the leading examples is Faysal Bank Limited's complete transformation from conventional to Islamic mode.[93] The transformation of Faysal Bank is not only the first-of-its-kind transaction in Pakistan's banking history where conventional business was transformed to Shariah-compliant mode, but also is one of the largest conversions of a conventional bank into Islamic mode on a global level. Such examples can provide both guidance and motivation to other market players in transforming their businesses to Shariah mode. It is encouraging to note that conversion of conventional banking branches into Islamic banking branches is also picking up pace; banks have already converted around 600 conventional banking branches into Islamic during the last five years (2018-22).

Some of the major steps taken by SBP for promotion and development of Islamic banking are presented in Chart 3.2.3 below.

[92] With the transition of Faysal Bank Limited, the number of full-fledged Islamic banks have increased to six with effect from January 01, 2023.

[93] Faysal Bank Ltd. has been granted license to operate as a full-fledged Islamic bank starting from January, 2023.

Chart 3.2.3. SBP initiatives for promotion of Islamic Banking



Note: ILTFF=Islamic Long Term Financing Facility, IFFSAP=Islamic Financing Facility for Storage of Agricultural Produce (IFFSAP), IRFMS=Islamic Refinance Facility for Modernization of SMEs, IRFCC=Islamic Refinance Facility for Combating COVID-19, ITERF=Islamic Temporary Economic Refinance Facility
Source: SBP

In recognition of its efforts, SBP has been voted as the best central bank in promoting Islamic finance six times (2015, 2017,2018, 2020, 2021 and 2022) by a poll conducted by Islamic Finance News (IFN), REDmoney Group Malaysia. Moreover, Global Islamic Finance Awards (GIFA) has also awarded SBP as "Best Central Bank of the Year 2020".

B. Challenges in implementation of FSC's judgement

Eliminating Riba is a comprehensive task that requires concerted efforts from various stakeholders and involves a number of challenges and milestones. While new challenges may prop up from time to time as the country moves ahead with complete conversion of banking and economic system, some of the leading policy issues that will particularly need attention and concerted efforts are as follows:

- **Implementation of monetary policy and public policy objective of price stability**

  Price stability is a key public policy consideration of every state to ensure sustainable economic growth. For this purpose, SBP has been specifically entrusted with the statutory objective to maintain price stability. To this end, SBP uses policy rate and several other monetary policy management tools, like other central banks. For fuller conversion of economic and financial system to Shariah-compliant mode, there will be a need to develop and implement Shariah-compliant tools for the operation of monetary policy. Like other central banks, SBP uses short-term policy rate to affect aggregate demand in the economy to achieve the goal of price stability; the rate is managed through various monetary policy management tools e.g., OMOs and the interest rate corridor.

  While the SBP has already instituted Shariah-compliant OMOs injection and Shariah compliant standing facility, there is a need to build a Shariah-consistent mechanism to mop up surplus liquidity as well as a suitable alternate to policy rate for anchoring the price expectations. However, development and implementation of suitable mechanism will, inter alia, require adequate capacity on the part of market participants as well as sufficiently large size of the Islamic banking sector and Shariah compliant securities and assets.

- **Conversion of existing government debt to Shariah-compliant instruments**

  The government has been heavily relying on bank credit to finance its budgetary needs, and investments in government securities constitute around 48 percent of banking sector's assets base at end Dec-22. Major part of this investment comprises conventional MTBs and PIBs, which form 87.3 percent of banks' total holding of government securities of PKR 16.8 trillion, while Sukuk constitute only 12.7 percent.

  Investments in government securities have recorded an average growth of 28.9 percent during last 3 years (CY20 to CY22). Much of this growth has emanated from new issuance of conventional government securities. In this backdrop, there will be a need to have sufficient pool of government assets, with clear titles of ownership and potential to generate revenues, to help in issuances of Shariah-compliant government securities (to replace the stock of PIBs/ TBs). However, the dearth of eligible assets can create a challenge in transforming the existing conventional stock of domestic public debt into Shariah-compliant instruments.

- Concerning external debt, IMF, World Bank, ADB and other international agencies recognize the importance of Islamic finance and have taken initiatives to promote Islamic Finance. However, it is important to note that while Shariah-compliant financing is more practical in case of project financing, availing financing for balance of payment support may require special efforts to develop Shariah-compliant products and arrangements.

- For conversion of existing foreign currency debt and raising fresh financing from international market, FSC judgement aptly highlights different type of Sukuk that can be issued in international capital markets by the government to raise funding. However, due to prevailing macroeconomic stresses, the credit rating of the country is low and the global financial conditions are also unfavorable.[94] These circumstances can have implications for the efforts to convert existing external debt or raise fresh financing.

- **Liquidity Management**
  Significant efforts have been made across the globe to develop liquidity management instruments and money markets for Islamic banking and financial institutions. However, the limited range of liquidity management tools and dearth of high quality liquid assets including sovereign Sukuk remains an issue especially in developing Islamic banking markets.

  In Pakistan, the money market has gradually come a long way in terms of its outreach and availability of Shariah-compliant instruments. SBP has developed various tools to manage liquidity with both conventional and Islamic banks. As a lender of last resort to the banking sector, SBP has instituted Shariah compliant standing facility for Islamic banks to help them manage their liquidity needs by seeking financing from the central bank, though the facility to deposit excess liquidity with SBP is still under development.

  Moreover, emergency liquidity assistance (i.e. LOLR facility) has also been developed to assist Islamic banks in exceptional

[94] Pakistan's ratings are Caa3 (Moody's), CCC+ (Fitch) and CCC+ (S&P) date accessed: April 10, 2023.

circumstances when they are faced with extreme liquidity shortages. However, money market and its Shariah-compliant instruments may still need significant development and maturity over time. These policy considerations will particularly become important when the entire banking sector is transformed to Shariah-compliant mode.

- **Reformation of laws, judicial system and legacy contracts**
  Banking business involves close interaction with various business and commercial laws. Accordingly, clause 161 of the FSC judgment identifies the need for amendments in fifteen (15) different laws[95] to bring them into conformity with the injunctions of Islam by December 31, 2022. The Federal Shariat Court suggests some of these amendments in the Banking Companies Ordinance 1962. It is worth mentioning that under common law framework as practiced in Pakistan, the legal underpinning of business and financial transactions are covered in multiple sources including various case laws as well as statutory laws. Review and amendments in the relevant laws will require coordinated efforts of all the relevant stakeholders.

C. Opportunities in implementing FSC's judgement

The financial deepening and outreach of financial sector is limited in Pakistan. However, the strong growth in Islamic banking since early 2000s indicates that it can play a significant role in improving financial depth and inclusion in the country.

According to a recent study conducted by SBP in collaboration with Department for International Development (DFID), religious beliefs contribute 23 percent to demand for Islamic banking and the overall demand for Islamic banking is higher amongst household (retail) than the businesses.[96] Though Islamic banking has recorded a consistent increase, its assets to GDP ratio stood at around 8 percent, which is quite low when compared to some other jurisdictions (**Chart 3.2.4**). In the context of this low level of deepening, the exceptional growth posted by Islamic banking industry over the last two decades indicates that there is huge potential for growth. Further, there is also great potential for financing in agriculture, SMEs, housing, and microfinance sectors. These sectors hold promising prospects to generate lucrative returns, productivity and employment, provided necessary financing is available. These sectors largely remained under served due to multiple reasons, including the religious considerations of proprietors and entrepreneurs.

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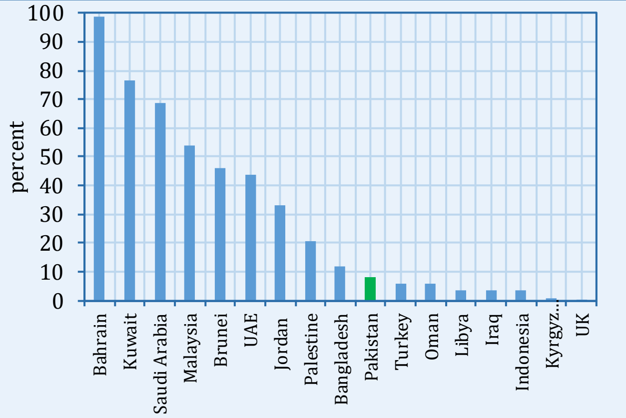
[95] The laws identified by the FSC judgement are:
1. Interest Act, 1839 held completely repugnant to the Injunctions of Islam.
2. Section 10 of The Government Saving Banks Act, 1873.
3. Section 78, 80, 114, 117 (c) of the Negotiable Instruments Act, 1881.
4. Sections 28, 32, 33, and 34, of the Land Acquisition Act, 1894.
5. Code of Civil Procedure, 1908. Section 2(12), 34, 34-A, 34 B, 35 (3) and 144 (1); and various statutory Orders and Rules;
6. Provision 59(2) (e) The Cooperative Society Act ,1925
7. Rule 141(h), 22,41 along with appendices 1 to 4 of the Cooperative Societies Rules, 1972.
8. The West Pakistan Money-Lenders Ordinance, 1960.
9. The West Pakistan Money-Lenders Rules, 1965.
10. The Sindh Money-Lenders Ordinance, 1960.
11. The N.W.F.P Money-Lenders Ordinance, 1960.
12. Rule 17 of The Agricultural Development Bank Rules, 1961.
13. Section 25 (2) (a) of The Banking Companies Ordinance, 1962.
14. Rule 9 of The Banking Companies Rules, 1963.
15. Rules 9 of The Banks (Nationalization) Payment of Compensation Rules, 1974.

[96] Knowledge, Attitude and Practices of Islamic Banking in Pakistan, SBP.

Chart 3.2.4: Islamic Banking Assets to GDP in selected countries (Q22022)



Data source: IFSB and Haver Analytics

With adequate business strategies and focus, Islamic banks can explore the potential of underserved segments and create value for both their investors as well as the society by meeting the banking needs of these high potential segments. Thus, the uphill task of converting to Islamic banking brings with it not only challenges but also enormous opportunities.

Capable managerial skills and trained human resource will be a key element in exploring the fuller potential of Islamic banking. Besides, innovation and efficient use of technology can play a crucial role in reaching out to the whole spectrum of the population and addressing their financial services' needs through convenient and cost effective products.

Besides furthering financial inclusion, balanced economic growth, and growth potential for market players, Islamic banking can also contribute to the key policy objectives of price and financial stability. The very nature of Islamic banking business – that it is based on partnership in ethical business activities and real assets – makes it less prone to financial fragilities and price bubbles.[97]

The current landscape of Islamic banking seems to be in a mature stage from the perspective of knowledge and skills in Islamic banking, footprint and regulatory and supervisory guidelines and frameworks. The already enabling environment presents vast opportunities for conventional banks to explore the huge potential of Islamic banking.

D. Strategy to implement FSC's Judgment

Over last two decades, SBP has provided enabling legal and regulatory framework along with necessary market infrastructure that has facilitated in increasing the share of Islamic banking to around one –fifth of the banking sector. While these arrangements and experience gained in enhancing the Islamic banking foot print will continue to facilitate growth in Islamic banking, a time bound full-scale conversion requires coordinated and sustained efforts from multiple stakeholders. In this context, SBP has initiated a consultation process with the relevant stakeholders with a view to ensure fast track adoption of Islamic banking in line with the judgement of the FSC.

The government has demonstrated a firm commitment towards the promotion of Islamic banking and finance in the country and has constituted a high-level steering committee for providing strategic guidance in the implementation of FSC's judgment on Riba under the patronage of the Minister for Finance and Revenue. The committee is being chaired by Governor-SBP, and comprises of key stakeholders such as Ministry of Finance, SBP, SECP, Institute of Chartered Accountant of Pakistan (ICAP), Shariah scholars, bankers, legal experts and representatives of the business community.

[97] Empirical literature has documented that Islamic banks are usually financially stronger than the conventional banks. Source: Cihak, Martin and Cihak, Martin and Hesse, Heiko (2008). Islamic Banks and Financial Stability: An Empirical Analysis. *IMF Working Paper No. 08/16.* For details, please visit https://www.imf.org/external/pubs/ft/wp/2008/wp0816.pdf.

In order to steer the process of conversion of conventional banking into Islamic banking, SBP has constituted a high-level committee for transformation of conventional banking into Islamic. The committee comprises of senior officials of SBP and Presidents/ CEOs of some commercial banks. Additionally, SBP has formed different working groups, in diverse areas like legal reforms; regulatory & supervisory reforms; awareness creation & capacity building; review of conversion plans of banks; fast track adoption of international standards; and coordination with government and other stakeholders. The working groups would provide policy and operational recommendations in their respective areas to ensure transformation of conventional banking system into Shariah compliant banking. These working groups have representation from all relevant stakeholders like SBP, banking industry, Shariah scholars, etc.

Under the guidance of Steering Committee and in consultation with the relevant stakeholders, SBP is working on the development of a transformation plan for conversion of conventional banking system into Islamic one. In addition, a working group comprising of officials from the ministry of finance, SBP, SECP, representatives from the Islamic banking industry, and centers of excellence in Islamic finance education is working to explore and recommend the possibility of using a variety of underlying assets for issuance of assets-light Sukuk structures of different tenors by the government, so as to convert public debt to Shariah-compliant mode and ensure regular availability of Sukuk in the market.[98]

Keeping in view the extensiveness of the transformation task, SBP has also modified its institutional arrangement for better prioritization of objectives and enhanced focus. For this purpose, a dedicated Islamic Finance Group has been established in SBP which comprises of two departments: Islamic Finance Policy Department and Islamic Finance Development Department. Islamic Finance Policy Department will especially work on policy formulation for the transformation of conventional banking into Islamic banking and ensure its timely implementation while Islamic Finance Development Department will focus on the promotion of Islamic finance through awareness and capacity building initiatives, market research, and international collaboration. With further strengthening of SBP's institutional capacity and concerted efforts of various stakeholders, the drive for conversion to a Riba-free financial system and economy is expected to gain traction going forward and hopefully meet the timeline as advised by the FSC.

Chart 3.2.5: Challenges in implementing FSC judgement

Implementation of Monetary policy and public policy objective of price stability

Conversion of existing government debt to Shariah-compliant instruments

Liquidity Management

Reformation of laws, judicial system and legacy contracts

Source: SBP

[98] Sukuk market development positively affects the financial stability of Islamic banks. Source: Ledhem, Mohammed Ayoub, (2022). The financial stability of Islamic banks and Sukuk market development: Is the effect complementary or competitive? *Borsa Istanbul Review*, Volume 22, Supplement 1, 2022.