

Islamic Banking in Pakistan – Problems and Prospects

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Abstract: This research paper suggests that Islamic Banking is spreading its wings in Pakistan and is positioning for growth. Islamic banking in Pakistan is also facing some challenges owing to the fact that conventional banking in the country is more penetrative and holding larger share in the economy.

A qualitative study was made through sending questionnaire to 15 banking and non banking professional of our network holding middle to top management positions in their work place. Also, six in-depth interviews were also carried out during the months of July - August, 2010. Three interviews were made from Islamic bankers, holding middle management positions in three different Islamic banks and three detailed interviewed were made from customers of those three different banks. Questions asked during interview were based on basics of Islamic banking, challenges faced, distinguishing feature, comparison with conventional banking, product and market development, challenges faced and future growth.

Through both ways of qualitative research (i.e. questionnaire and detailed interview) it is extracted that Islamic banking in Pakistan is positioned for growth, since Muslim community in our society is eager to know more about it and want to spend their lives in the light of Islamic preaching and fundamentals of religion. Need is however, felt to arrange a platform to increase and share the knowledge base in our country, increase awareness, introduced new products as per the need and requirement of the society, introduce courses and programs in all colleges, Universities, and Business Schools to familiar students about Islamic banking so that their learning curve built before they enter in job market and finally improve quality of the human resources particularly those working in Islamic Banks.

Keywords: Islamic Banking, Sharia, Islamic Finance, Islamic banking in Pakistan, Islamic banking challenges, and Islamic banking growth.

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Introduction

The most important element of Islamic economic society is the prohibition of interest. Synonymous terms are used such as Usury and Riba for Interest. All covers the meaning to load additional money on funds lent to borrower. As such it is fundamental to understand the Islamic economics to have fair idea about Islamic banking.

If we try to focus countries like Pakistan, Iran, and UAE we will come to know that these countries are practicing Islamic banking based on Islamic Financial laws, whereas, other countries like Malaysia, Indonesia, Bangladesh, Egypt, and Jordan are working on Islamic banking side by side with conventional banking. Foreign countries are also experiencing the taste of Islamic banking. Some countries like USA, UK, and Australia are taking lead and exploring new avenues in Islamic banking.

If we see to the crux of Islamic banking it is based on Islamic Sharia Laws that are helpful in identifying solutions to various financial and non-financial problems. Islam has clearly stipulated that Interest (Riba) is unlawful (Haram) since it causes lot of bad impact on the society such as poverty, concentration and unequal distribution of wealth, unethical practices and disparity in purchasing power of consumer. In conventional banking, utilization of money advanced is not important; they are concerned with return on money advanced. On the contrary, Islamic banks take risk while venturing with their business customers. Islamic banks neither take interest nor give it to their clients. All activities are sharia based and in line with ethical standards of life.

Islamic banking is although a new area to explore in our country and particularly for Muslims, but non Muslims are also contributing to it and taking full advantage of Islamic banking. Challenges although, are in the way of Islamic banking but emerging opportunities in this filed cannot be ruled out.

Research Objectives

Pakistan being Muslim country is a favorable ground for growth of Islamic banking. As per Islamic teachings 'Interest' (Riba) is haram, as such it was a solid ground after independence to practice and preach Islamic banking. But, there was no setup available. After independence our country was arrested with lot of teething problems, as such much attention were given to those issues, leaving the basic banking requirement as per Islamic norms and ethics.

Lately, it was realized that Islamic banking is neglected altogether in Islamic state. Therefore, all attentions were diverted to form system in our country to formalize Islamic banking. Upto 2002 frame work and other critical issues were dealt with by the stakeholders. From 2002 to 2010 substantial growth was witnessed. Although, the share of growth is 5% but it is expected that it will reach around 15% in next 2 to 3 years time.

During this transition Islamic banking is facing lot of challenges, at the same time it invites lot of opportunities for scholars and stakeholders to explore the new dimension of banking and utilize it as per the need of our country.

The objective of Research study is to identify the opportunities for Islamic banking in Pakistan. The main areas of Research Paper are hereunder:

- Is Islamic banking having the potential to grow and contribute in the economy of Pakistan?

- Are there investment opportunities in Islamic Banking?
- Is Islamic banking ready to cope up with the changing circumstances around the globe?
- Is Islamic banking catering the needs of banking and non banking customers?
- Is Islamic banking getting support from regulators?
- Is HR (Human Resource) of Islamic banks capable enough to accept the challenges of Islamic banking and explore ways to meet the challenges?
- Is product being offered by Islamic banks are sufficient enough to attract customers?
- Is Islamic banking has all the capabilities for product development?
- Identify ways to utilize funds in Riba free Islamic State
- Propose how to set right direction to focus growth of Islamic Banking coming years.

Literature Review

In literature review I will try to focus the concept, scope, ideology, principles of Islamic banking, difference between Islamic and Conventional banking and how Islamic banking emerged in Pakistan. Challenges face by Islamic banking during embryonic stage and its future expectations will also be discussed.

Introduction of Islamic Banking: Evolution of Islamic Banking started initially from Egypt. It was due to the efforts of Ahmad El Najjar who started saving bank based on profit sharing in one of the town in Egypt named Mit Ghamr in 1963. Within 4 years i.e. until 1967 nine more banks were developed in Egypt. All these banks were functioning on same pattern i.e. none of them were charging or paying interest. These banks were making partnership with others institutions / persons/ entities to invest in trade and industry. The return so derived is shared with investors / depositors. Apparently these were not exclusively Islamic Bank or Conventional Bank but categorized as Saving Investment Institutions. In 1971 The Nasir Social Bank was established in Egypt was named as ‘Interest Free Commercial Bank’ without disclosing any reference to Islamic Banking, Non Interest Banking, or Shariah principles in its charter.

Later in 1974 Islamic Development Bank (IDB) was established by the efforts of Organization of Islamic Countries (OIC). It was not established with the aim to promote Islamic Banking only but it came into being largely to finance for development projects in member countries. However, the principle for its formation was interest free operations based on shariah principles.

Thereafter, winds of change were institutionalized in Muslim countries. Some of the following banks were established during late seventies namely:-

- Philippine Amanah Bank in 1973
- Dubai Islamic Bank in Middle East in 1975
- Faisal Islamic Bank of Sudan in 1977
- Faisal Islamic Bank of Egypt in 1977
- Behrain Islamic Bank in 1979

The swing in Islamic Banking was taken place from Malaysia in 1983. Initially, in 1963 a saving corporation was set up in Malaysia for the welfare of Muslim pilgrims to facilitate them to perform Hajj. These saving corporations

later acted as finance companies to invest the savings of pilgrim in line with Shariah. Later on these ventures were proved to be main catalyst in promoting full-fledged Islamic Banking in Malaysia.

In Pakistan history of Islamic banking started in 1980 following changes in Banking Companies Ordinance, 1962.

Some of the key developments in the field of Islamic Banking during this period are mentioned hereunder:

- ICP (Investment Corporation of Pakistan) and NIT (National Investment Trust), being the Government owned mutual funds, started their investment in Profit and Loss sharing basis in 1979-1980.
- HBFC (House Building Finance Corporation) eliminated interest during their course of operation effective July 1st, 1979.
- PTC (Participation Term Certificate) being instrumental in corporate financing started issuing interest free instruments for their clients in June, 1980.
- Shariah compliant business structures for Modarabas were introduced through promulgation of the Modaraba Companies and Modarabas Ordinance, 1980 along with Modaraba Companies and Modaraba Rules, 1981.
- For recovery of loan made on interest free method of financing, changes were made in 1984 in Banking and Financial Services Ordinance, 1984 and Banking Tribunal Ordinance, 1984.
- Nationalized commercial banks started interest free counters for their customers effective January 1st, 1981.
- BCD Circular No. 13 of 1984 issued by State Bank of Pakistan advising that all financing to Federal and Provincial Governments, Public Sector Corporations and public or private joint stock companies would be made through interest free mode. This action was implemented through issuance of circular from January 1, 1985.
- Similarly, from July 1, 1985 banking in Pak Rupees was made interest free as such banks introduced Profit and Loss sharing schemes for their large net of depositors.

All these measures although were fair enough to promote Islamic Banking in Pakistan, but it was later realized that preparation and home work from financial institution was not done adequately. Federal Sharia Court challenged some of the Islamic products and processes and termed them un-Islamic. The Shariat Appellate Bench of Supreme Court upheld the decision of the Federal Sharia Court and order to address the issues in a defined timeline for further implementation. Review petition filed by the United Bank Limited thereafter, and this decision was later set aside.

Proper strategy was made to re-launch of Islamic Banking in Pakistan in 1990 and onwards, owing to the fact that lot of experience was gained during the first phase of launch of Islamic Banking in Pakistan. Some of the key lessons learned are enumerated below:

- It is not appropriate to force the industry to accept revolutionary method. Instead, evolutionary approach is far better, where acceptability to new method is felt from all stakeholders within.
- Transformation should be flexible rather forcible for a dynamic market.
- Sharia compliant mechanism should preliminary win the vote of confidence from financial institutions and customers at large.
- Stakeholders should be equipped with latest knowledge of Islamic banking before entering into a formal launch of interest free banking.

The Principles of Islamic Banking: To know the principles of Islamic banking we need to understand some basic terms of economics such as interest, time value of money, cost of capital, economic growth, theory of interest, risk

premium and its main categories. While explaining these concepts we will link it to Islamic ideology to have a better idea about Islamic banking and finance.

The concept of Riba: Riba means excess / gain in monetary form derived from loan on a given principle amount. As per Quran¹:

‘The interest that you give in order to increase the wealth of people does not increase in the sight of Allah, and the zakat you pay in order to win Allah’s approval, its prayers do indeed increase their wealth.’

Referring back to pre-Islamic era and compare it with present age we see that still financial institutions are charging interest which is strictly prohibited in Islam. As per Quran²

‘Allah deprives interest of all blessing and develops charity; and Allah does not like an ungrateful, sinful person.’

Muslim scholars focus on moral development of society. They emphasized that material development is also necessary part of human evolution but its true essence can only be achieved with moral development. Two factors can be considered important for moral development, i.e.:-

- Efficiency and
- Equity

Islam is also preaching the same philosophy that if individual preferences is subordinated to social preferences than moral development is possible which finally leads to material development.

Core issue: Application of Time value of Money: The outcome of time value of money is interest. It means that usage of money for a defined time frame will fetch some charge on it i.e. Interest. Islam on the contrary deny applications of time value of money and pronounce it as Riba, being unlawful.

Islam is however, ensures that investment needs to pass through a process of business and economic activity including risk taking and other ventures associated with carrying out business. Hence, return will depend on outcome of business activity. Therefore, arbitrary increase over cost of using money without taking risk is not applicable in Islamic and thus is the main selling point of Islamic Banking also.

Scarcity of Capital: Due to ‘interest’ component capital becomes scarce. As a result oligopoly enters in capital goods industries and monopolistic completion enters in consumer goods industries. Both ends up in economy slow down and decrease Aggregate Demand (AD). Decrease in AD push down Monetary Policy to increase AD. Despite ease in Monetary Policy, the impact not transferred and AD remains low because capital remains scarce. If it is followed by cost push inflation then it ends up in stagflation with decrease output due to shortage of capital and increase in interest rates. As such this aggravated situation can be ease by focusing on supply chain management and allowing progressive taxation system that may remove market imperfections.

Mr. Atif Salahuddin³ has mentioned ways to solve the current economical crisis in the country by referring Islamic way. For taxation system he mentioned in his article that Islamic principle of taxation is based on amount of wealth a person have and zakat is applicable on the wealth a person have as per Nisab. He mentioned that in Islam if any landowner does not use his land for more than 3 years then it is handed over to poor farmer who has the ability to

¹ Surah Al-Rome Ayat No. 39

² Surah Al-Baqarah Ayat No. 276

³ Article published in Dawn dated September 13, 2010 on ‘Islamic way to solve the crises’

cultivate the land. Mere keeping the resources and not utilizing it for economic activity is not allowed as per Islamic ideology.

Economic Growth: Through economic growth capital formation and investment opportunities are developed. Capital formation is however, created in a business activity through following forms:

- Paid-up Capital
- Retained Earnings
- Borrowed Funds / Long-Term Debt

First two forms are making equity to generate profit / loss, whereas, borrowed funds / long term debt earns interest. Islam favors improvement of overall society through spiritual and worldly preaching for economic betterment. Some of those preaching are here under:

- Put off wasteful expenditure and focus on moderate consumption.
- Idle accumulation of wealth is not allowed; and
- Redistribution of income and wealth to enhance the level of Aggregate Demand (AD) in the society at large.

Islamic Banking encourages growth in its own way without instituting 'interest' in its financial setup.

Theory of Interest and Risk Premium: There are three components of Interest namely:

- Basic interest
- Administrative Expenses
- Risk Premium

As far as Basic interest is concerned we can say it is Riskless Interest, i.e. interest on financing where no element of risk is present and term of maturity is short (even in some cases long term maturities also considered as 'Riskless'). Take the example of Treasury Bills, inter-bank call money and such other government papers in which there is not much risk of price fluctuation or any risk of non- repayment is involved. There are two reasons of Riskless element i.e.

- Short Term Maturity, and
- Guaranteed soundness of the issuing or borrowing authorities or institutions.

Administrative Cost is the cost incurred by the loan providing body for computing exposure of borrower, developing mechanics for granting loan, staff salaries, documentation cost, and other ancillary cost associated with granting loan to borrowers. Loading risk taking cost with the cost of interest is called 'Risk Premium'. So, we can say that risk taking is an entrepreneur function rather a built in factor of capital itself. In other words capital itself is not involved in risk taking exercise. In USA after adding admin cost with basic interest it is called 'Prime Lending Rate'. Benchmark rate or Index Rate is also introduced for this purpose. In Pakistan benchmark rate for lending operations is KIBOR (Karachi Inter-Bank Offer Rate). Voices are rising in present times to introduce Islamic index to use as benchmark against Islamic financings. Even some development has already taken in western world where 'Dow Jones Islamic Market Indexes'⁴ is introduced where industry eligibility are screened and ensured that companies are not involved in any of the following activities (being unlawful / Haram in Islamic economic system):

⁴ Reference website

- Alcohol
- Pork-related products
- Conventional financial services
- Entertainment
- Tobacco
- Weapons and Defense.

Risk and Riskless Return in Islamic System: Of the three components of interest (as mentioned in previous heading also), Islam accepts ‘Administrative Cost’ only. There is no acceptance of taking / adding ‘Risk Premium’, because risk taking is the main function of finance providing agency, i.e. the Financial Institutions. Risk taking exercise is the fundamental basis of financial participation in an interest free system of financing wherein lending on the basis of a pre-determined rate of interest is prohibited.

Categories of Risk in Islam: There are three broad categories of Risk in Islam namely:

- Essential Risk
- Prohibited Risk, and
- Manageable Risk

Characteristics of each of above risk are defined below briefly.

Essential Risk: Based on two principles, i.e.:-

- Profit bears risks
- Return assume liability
- The level of risk depends upon the nature of contract

Prohibited Risk: When involves excessive risk and element of gambling:-

- Risk in Existence (For e.g. sale of an inexistent thing like crop or fruits on future basis).
- Risk in taking possession (For e.g. sale of a run-away camel or forcibly possessed commodity / property).
- Risk in Quantity (For e.g. sale price or rent being unknown in a sale or lease contract).
- Risk in Quality (For e.g. type, quantity or specifications of the subject matter of contract being unknown).
- Risk in Time of Payment (For e.g. a deferred sale without fixing the period).

Manageable Risk: The tools being adopted to manage the risks should not breach the principle of profit bear risk and should aim at minimizing or lowering the risk.

- The tools should not involve excessive risk, and
- The tools themselves should be Sharia compliant so as to mitigate those risks which Sharia allows to mitigate or avoid.

Rationalization between Interest and Riba: Interest free element is the distinguishing feature of Islamic banking, apart from two elements being vital in Islamic Banking i.e. equal distribution of income and wealth, and increase in equity participation of economy.

Preaching of Islam is focused on avoidance of Interest (Riba), disregarding the fact of the purpose and rate of interest charged. Certain thoughts were developed to differentiate between usury and interest. Similarly, attempts were made to distinguish between loans for consumption and loans for production. Arguments were made on the

point the Riba refer to usury when money lenders gave loans to borrowers, whereas, interest is different from it which is taken by modern banks and if such loans are on productive purposes interest (Riba) is not involved in it. But, due to low intensity of this argument it is not won the acceptance of majority of scholars. Muslim scholars however, are not shaky over the understanding that there is any difference between Riba and interest. Hence, these terms are used interchangeably.

At four different places in Quran prohibition of Riba is mentioned i.e.:

- Interest deprives wealth of God's blessings.
- Incorrect appropriation of property belongs to others.
- Stay away from interest for one's own benefit.
- Distinction between trade and interest emphasizing Muslims to take back principle amount from borrower without concentrating on return. Those who take interest are at war with God.

There is also debate on the why interest is considered lawful (halal) in case of rent of property and considered unlawful (haram) in case of borrowing/loan. But, it is clearly spelt out that it is subject to physical existence, calls for wear and tear, whereas, money lent out is not. The concern over attrition in the value of money is ruled out by Islamic scholars in the light of Hadith, which says that goods must be returned by its like i.e. 'gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt'. In short Muslims need no reasoning, logic, or proof for rejecting causes of classifying interest as haram (unlawful) due to divine wordings. It is just a matter of faith (Iman).

Islamic does not support the concept Interest do not qualify that Islam is not supporting Capital as one of the factor of production. Islam however, does not allow the factor to make prior arrangements of surplus in the form of interest. To this profit sharing is a most suitable and viable alternate. More specifically in Islam, owner of capital can share the profit made by entrepreneur. Profit sharing ratio is said to have been adequate in allocating resources nicely, which is influenced by market forces. One of the eccentric view is that replacing profit sharing for interest is not perfect although there is no distinctive form for the alternate to the interest rate.

Composition: Islam emphasis that owner of capital has no right to fix a predetermined rate of return as interest. Instead, Islam concentrate that no one is qualified to charge any addition to the principle sum until and unless risk in undertaking business is involved. The owner of capital is called Rabbul-Mal has right to use his expertise to use the capital for best purpose, particularly for productive purpose and share the profit, if any with the borrower (called Mudarib). This is one of the important modes of financing in Islamic banking and according to jurists, was approved by Prophet even in the pre-Quranic days. Another way of Islamic mode of financing is Musharaka i.e. equity participation, whereby partners use their capital in a joint venture to earn profit/surplus. This profit and loss is pre-determined as per their equity contribution.

Musharaka and Mudarba holds lion's share in Islamic Banking and therefore, construed as two basis pillars of Islamic Banking. If we look at Musharka we can link it with concept of partnership and Joint Stock Companies as applicable in modern times. Likewise, as trustee of the fund placed by depositors in financial institutions, Islamic bank act as Mudarib for deposits placed by Rabbul-Mal with them to venture lead to profit generation to share with their depositors, in addition to place those funds in other modes of Islamic financings. It is important to mention

that Mudarba and Musharaka both are used as Asset and Liability. More specifically Islamic bank works as Mudarib in case of deposit taking institute and at the same time as Rabbul-Mal while venturing such capital in Islamic modes of finance. Similarly, in Musharaka Islamic bank act as partner with depositor as far as liability management of the bank is concerned whereas, Islamic Bank works as partner while financing their clients.

The fundamentals and principles of Islamic Banking and Finance: Followings are the fundamentals of Islamic Finance:

- Lending to attract Interest is Riba and is haram (Unlawful).
- Sale of debt is not allowed.
- Finance and venturing in speculative activities is not allowed.
- Not suppose to involve in transactions that calls for uncertainty.
- Money does not beget money.
- Promote real and productive economy.

As far as modes of financing in Islamic banking are concerned, following are the common modes of finances in Islamic banking:

- a) Murahaba (Cost Plus Financing)
- b) Musharka (Partnership Financing)
- c) Mudarba (Trust Financing)
- d) Ijarah (Leasing)
- e) Bai Muajjal (Deferred Payment Sales)
- f) Quard Hassan (Welfare loan)
- g) Istisna
- h) Salam
- i) Hawla
- j) Kafala
- k) Diminishing Musharaka
- l) Sukuk

As far as principles of Islamic finance⁵ are concerned it is based on following six basic principles:-

- Avoidance of Interest
- Risk Sharing
- Treating of money as potential capital
- Prohibition of speculation
- Sanctity of contracts, and
- Avoidance of prohibited activities (such as those connected with alcohol and gambling).

Islamic Banking – Portfolio Management: Investment account has two areas where banks pour in depositors' money. In first case depositor has choice to give his advice regarding venture account, and other where there is no

⁵ Dr. Zamir Iqbal mentioned it in his book 'Islamic Financial Systems' published in June, 1997

such choice is available and bank decide its own mechanism to invest funds inline with sharia guidelines. Return on these investments ranging from 8 to 16 percent which is almost equal to the yield of other conventional banks. As far as return given to depositors (Raab-ul Maal) is concerned it is also almost near to rates offered (in advance) by conventional banks i.e. within the range of 13 to 17 percent. The basic problem with Islamic banks are on its asset side where due to limited avenue funds are not adequately utilized in all modes of finances available. Around 60 to 80 percent financing (mostly in short term i.e. commercial and trade transactions) is made in Murabaha and Musharaka, as mentioned earlier. There no issue on the liability side where Islamic bank gets deposit from masses. What I understand that slow pace in conversion of liability side to asset side is due to lack of adequate personnel in Islamic banks. This is also observed during the primary survey.

In Pakistan history of Islamic banking commenced in 1980. Domestic banks were operating at that time under interest free and interest based mechanism. In the second phase, all transactions were done on the basis of no interest with the exception of transactions in other than local currencies.

In Pakistan, Meezan Bank started its operations in 2002 being first Islamic Bank in the country. However, during this second phase efforts were made to make the basic principles of banking unchanged. We can say it was old wine in new bottle. However, this transition was primarily become the motivating factor to promote Islamic banking in Pakistan. Initially it was Profit and Loss Sharing Accounts in all Commercial Banks without impairing monetary policy in the country. But, it was also proved that profit sharing ratio and modes of payment vary from country to country. For example payment of profit is different in Malaysia, Egypt, Bangladesh and in Pakistan, i.e. at some places it is monthly, in other countries it is quarterly, half yearly, and yearly. Yes, the common feature in all these countries is nature of deposits which is short term. This also shows the preferences of people. Likewise, on asset side Musharaka is more important than Murabaha in some countries, whereas, in other countries it is in inverse. But, the common factor in all these countries is that Murabaha and Musharaka are the most commonly used modes of financing.

Difference between Islamic and Conventional Banking: Keeping mark-up factor in mind people usually mix Islamic mode of financing with conventional banking and try to fix Islamic Banking as copied approach practiced by Conventional Banks. Let me clarify. In case of Murabaha financing, Islamic bank appoint his customer as client to purchase the goods on bank's behalf. Since, bank does not possess skills in purchasing Islamic / sharia compliant goods therefore, Islamic bank appoints client as agent. Once, goods purchased, Islamic bank sell it to his client, adding a mark up on cost-plus basis, owing to the fact of risk taking in purchasing goods. This act of purchasing, safe keeping, taking risk, and handing over goods to client is a completely different feature, which is not existed in Conventional banking. Conventional Banks usually lends money to the client disregarding the fact that for what purpose client is using the loan amount, since, its concentration is on interest, the predetermined fixed amount.

Bai' Muajjal i.e. sales made on deferred payment basis is another form of Islamic finance. Here Islamic Bank engages in sale and purchase of properties on deferred payment basis. It is lawful to charge higher price for a good if payment is made at later date. People may consider it interest, however, it is not. Since, in such transaction Islamic banks are not carrying out lending transactions instead trading transaction are made.

Likewise, Ijarah is one of the Islamic mode of finance. Ijarah may be for services as well as for goods. Ijarah is derived from Ujrat, means compensation. Here again Islamic bank buy goods (equipment or machinery) for its clients and obtain rentals for using it.

Salam and Istisna are other commonly used modes of finance in Islamic Banking. In salam transactions Islamic bank finance production activities. In Salam price is paid at the time of entering into contract but delivery of goods is made on predetermined fixed date. Whereas, the same process is used in manufacturing processes also and is termed as Istisna.

Keeping in view of details given in some of the Islamic modes of finance it is clear that Islamic banks go beyond the process of financing and involve themselves in trading, equity and economic activities in line with sharia principles. Farhan Ahmad⁶ explained the difference between Islamic and Conventional banking through three terms which are not practices in Islamic bank but used widely in conventional banking i.e.:

- Riba (Interest)
- Gharar (Uncertainty)
- Maisir (Speculation)

Emerging interest on Islamic Banking and Finance: As a viable alternative to the global financial system, Islamic Banking is emerging interest in following non-Muslim and Muslim countries:

Non Muslim Countries: UK, Germany, France, Malta, South Korea, Japan, Hong Kong, Thailand, Singapore.

Muslim Countries: Iran, Saudi Arabia, Qatar, Bahrain, UAE, Kuwait, Sudan, Malaysia, Indonesia, Jordan Brunei, Pakistan.

Policy formation to promote Islamic Banking in Pakistan: State Bank of Pakistan started reviewing and formalizing their financial sector strategy to promote Islamic banking in Pakistan in December, 2001. This was a balanced move from regulators to promulgate Islamic Banking in a steady manner. Licenses were issued to Islamic banks, and Al-Meezan Investment Bank, became first Islamic investment bank in the country. Conventional banks were also asked to open their Islamic banking window branches to assist regulators in promoting Islamic banking in Pakistan.

After learning from the experience in first phase of Islamic banking in 1980, State Bank of Pakistan put in place a comprehensive program to boost Islamic Banking. In this regard Sharia Compliance mechanism was introduced for Islamic Banking with following broad objectives:

- Setting up Sharia Board at SBP for approving proper guidelines for Islamic banking product and policies.
- Formulating 'Fit and Proper Criteria' for Sharia Advisor.
- Provide guidelines to all banks related to Islamic Banking and for the convenience of customers also.
- Implement Sharia Audit.
- Preparation of model agreement and contracts used in Islamic mode of financing.

Scope and Development of Islamic Banking in Pakistan: Quaid-e-Azam made his speech at the foundation laying stone of the State Bank of Pakistan on July 1st, 1948 and mentioned that:

⁶ Article published on the topic 'Cutting edge Islamic Finance' in Dawn dated July 10, 2006.

'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.'

Islamic banking in Pakistan although taken off late in 2001 but its present progress and future expectations are very high. If we see the statistics of December, 2003 and compare it with statistics of December, 2009 we can see that in 2003 number of Islamic bank and branches were only at 17 which reached to 649 in 2009 and total asset composition reached from 0.5% of total banking asset size to 5.6%⁷. Comparative statement prepared below considering Islamic banks and Islamic branches of commercial bank positions as of March, 2007 (total 217, i.e. 160 Islamic banks and 57 conventional bank's Islamic windows) and September, 2010 (total 714, i.e. 429 Islamic banks and 285 conventional bank's Islamic windows).

Financial Crisis and Islamic Banking: International financial crisis which occurred last year is still showing its impact on world economy including on Pakistan. It worth over trillions of dollars impact and it may take worse shape especially after debacle of Lehman Brothers. However, it is interesting to note that Islamic Banking remains unaffected with subprime mortgage crisis. Even many foreign bankers and scholars are turning up to Islamic banking due to the fact that it is safe from the evils of interest (Riba).

Mr. Atif Salahuddin⁸ suggested that government should put ban on interest and introduce Gold and Silver as monetary standard to control the money supply rather to print money as per internal requirements and increase unending inflation. It is important to mention here that Malaysian state launched Islamic Dinar and Dirham as an alternate currency⁹, allowing the golden and silver coins to be used as legal tender alongside conventional banknotes. Saad Sarwar Muhammad¹⁰ mentioned that Islamic banking remained away from current financial crisis due to the fact of underlying transaction where interest (Riba) is unlawful.

Challenges of Islamic Banking: Islamic banking remained under various challenges, whether it is third world countries or developed nations and this has been witnessed during last 3 decades and more. One of such challenge is the procedure of sentencing fatwa, which usually if acceptable by one school of thought than declined by other school of thought. There is no one institute which shall be used to issuing Fatwa (Islamic verdict) to be used by all nations in letter and spirit.

In Malaysia Sharia Board is supported by their Government. Voluntary body in Bahrain on Accounting and Auditing Organization for Islamic Financial Institutions has been established religious scholars who are authorized to issue Fatwa on Islamic financial products. Again its binding on other countries is not restricted as such few countries refer their verdict and other do not. As such lack of authentication is a big challenge for Islamic banking industry.

Other challenge is shortage of qualified professional both at banking and sharia side. Legal frame work is another challenge for this industry. In few countries like in UK there is no legal frame work to deal with Islamic Banking.

⁷ Dawn dated August 9, 2010 written by Mohiuddin Aazim on 'Islamic Banking'.

⁸ Article on 'Islamic way to solve crises' published in Dawn dated September 13, 2010

⁹ The Nation, dated August 13, 2010

¹⁰ Article on 'Islamic Banking and Finance: Historical Perspective and Future Prospects' published in Daily News, dated February 20, 2009

Limited size growth is also a challenge. Another challenge is the one window operation of conventional banks to offer Islamic banking. Since, these conventional banks are not prepared and encouraged to spread Islamic banking therefore, they are just meeting the regulatory requirement to open Islamic windows. Following are some of the important challenges / issues in Islamic Banking:-

Common Fiqh: There are two main reasons for this:

- Banking based on particular school of thoughts is unthinkable.
- Every Islamic banking transaction, particularly related to disbursement of finance needs to route through Sharia verdict.

Sharia scholars conclude their findings on basic principles of sharia, but those principles are very rarely explained. These are sharia rulings only without brief interpretation and reasoning to a common banking practice.

Penalty on defaulters: There is a dire need to review the concept of penalty in Islamic modes of finances. Since, Islam prohibits taking interest as such penalty for late payment is not allowed in Islamic finance. However, a large chunk of customers take it as advantage for them and use to make defaults. So, it is a big challenge to introduce sharia compliant mechanism to review introduction of penalty on defaulters.

Islamic Banking literature: Proper Islamic Banking Manuals, reading material, text books, systems and procedure books should be introduced to increase the knowledge base of bankers. Sharia Advisor of Dawood Islamic Bank, Mufti Muneeb¹¹ mentioned that during his working experience with the bank he has issued around four thousand Fatwas and are published in four volumes. This literature is issued in the market with the name of ‘Tafheem ul Masa’el’. Such sort of literature proves to be a substantial material for further research and development in the field of Islamic banking.

Pricing Formula: At present, KIBOR is used as bench mark to determine price for finance. However, it would be appropriate to introduce Islamic bench mark to fix rates for all finances made from Islamic modes.

Accounting Practices: Accounting means documenting mechanism to record claims, rights and obligations. However, there is no separate set of accounting in terms of sharia based Islamic principles. As such it is felt to conduct a comprehensive review of existing accounting practices.

Regulations and Control: Banking related regulations and control are applicable through BASEL accord. Basel I and Basel II are released in this regard to provide control and regulatory requirement related to other practices including meeting requirement to core capital to address the issues related to Risk Management. Basel III is also about to implement in banking industry to further tighten capital and other regulatory requirements. However, it is noted that Basel regulations are practically speaking, are applicable for interest based banking. Need is therefore, felt to correlate Basel requirements with Islamic banking.

Legal Framework: Some general laws and guidelines are issued at the moment by regulators in terms of promotion of Islamic Banking in Pakistan. However, there is need to pay attention for introduction of necessary changes in the banking laws and other related laws that affect Islamic Banking.

Conclusions & Recommendations

¹¹ Interview given to ‘True Banking’ journal in their July-August, 2010 issue.

Although, lot of theory and practical work is required to address issues related to promulgation of Islamic Banking in Pakistan. But, if these issues are addressed properly by policy makers, then I'm confident that Islamic Banking will grow in Pakistan with more velocity. Some of the possible solutions are hereunder:-

- Setting up unresolved Fiqh Issues
- Development of high potential resources well versed in Islamic Banking and Finance.
- Increase the knowledge base of customers, staff, and general public about the importance of Islamic banking and finance.
- Availability of Sharia Compliant products.
- Institutionalizing legal, regulatory and other policy framework complying with Sharia Principle.
- Penalty clause should be incorporated for delayed repayment of finance.
- Pricing of product should be through Islamic benchmark.
- Advancement in technology to support Islamic Financial solutions and design.

During review of all this literature I understand that Islamic banking is at growing stage in Pakistan. Lot of development has been taken places in some Muslim and Non Muslim countries. Still new avenues are expected to achieve in long run. In Pakistan, Islamic banking is meeting the requirement of general public, although, level of awareness is not up to the mark. Pace of growth is slightly slow, but it assumed that after passage of time it will gain momentum. Islamic banks are presently offering wide range of products that meet consumer and business requirements, but still need is felt to develop more products to reduce banks concentrations on Murabaha and Musharaka. Some of the challenges are faced by Islamic banks i.e. lack of qualified man power, lack of customer awareness, one window operations of conventional banks, lack of standardization of products, and structure of Sharia Board and its implementation. In addition to that we should understand that Islamic Banking is equity oriented and not credit oriented. However, it is still in its infancy stages as far as its application to the present day problems is concerned. In an effort to apply Islamic principles to modern situation there are different approaches based on interpretation of Islamic philosophy and early historical precedents. Pure capital cannot exist as factor of production, based on Islamic understanding; however, there is a combination of Capital and Enterprise. All funds will have to be in the form of equity, and there can be no capital funds in the form of debt. Not all the Islamic Scholars and Economics are agreed on it but, it is said that Capital and Enterprise combined together would constitute a factor of production and profit would be its reward.

Methodology

Owing to the fact the Pakistan is a Muslim country and Islamic banking is touching upon the concept of religion, therefore, it is assumed that Islamic banking in Pakistan will take lead in coming years and offset the concentration of conventional banking in Pakistan. Since it is passing through transition phase therefore, Islamic banking is facing several challenges at one end, but also providing opportunities for growth and investment in this area. The purpose of this study is to examine and analyze the growth and opportunities of Islamic Banking in Pakistan.

For our Research study We have chosen qualitative method. In conducting qualitative research different methods are used namely, questionnaire, interview, case study, direct observation, role play and focus group. We have used primary and secondary method to obtain data on the subject. In primary research we have taken obtained input

from professionals, Islamic bankers and Islamic banking clients. We have asked closed ended and open ended questions but in a structured way. Data for our primary researches are collected through two methods namely questionnaire and detailed interview. Research methodology is based on analysis. This research paper is based on primary data collected through questionnaire¹² sent to 15 banking and non-banking professionals within our network¹³ including 06 professional from UBL (where I'm currently working). Among others, professionals were selected from State Bank of Pakistan (SBP), Askari Bank, JS Bank, Bankislami, Dubai Islamic Bank Pakistan Limited, Citibank, Institute of Business Administration (IBA), and Mohammad Ali Jinnah University (MAJU). Questionnaires were sent in the first week of September, 2010 and information is gathered in three weeks time. The core questions addressed during research include the followings:-

- Do you believe that Islamic Banking can contribute to economic growth?
- Are you satisfied with the present progress of Islamic Banking?
- What is the main issue for slow growth of Islamic Banking?
- Do you feel that Islamic Banking will grow exponentially in coming future?
- Do you favor the concept of 'Interest' or Riba in economic system?
- Do you feel that our educational institutes are playing leading role in spreading Islamic Banking knowledge to students at large?
- Do you feel that Islamic Banking in Pakistan is according to Islamic Ideology?
- What is the unique selling point for Islamic Banking in Pakistan?

During research We have also made structured interviews with three Islamic bankers¹⁴ of different banks, asking 15 questions related to topic¹⁵. The interviews were scheduled after taking prior appointment from Islamic banking professionals and they provide responses. Likewise, three interviews¹⁶ were also obtained from same bank's customers through structured interview.

The existing literature is the secondary data for Research study and is obtained through various resources such as Periodicals, Journals, Newspapers, and Internet to review challenges and growth in Islamic Banking.

While getting input through six interviews (three from Islamic bankers and three from same Islamic banking customers) there is possibility of disruption which cannot be ruled out. Similarly, it is not possible to use tape recording or other recording device while taking interview with professional, since everyone has their own reservations and there is a possibility that interviewee feel hesitate to transfer the information. Similarly, questionnaires were sent to professionals on their official emails and follow up made on phone calls. In 30% cases responses were given by professionals on follow up phone calls due to their acute busy schedule in, and outside

¹² Please refer closed ended 15 questions in Annexure II sent to professionals of our network to provide their response on 'Islamic Banking'.

¹³ Please refer Annexure I indicating details of 15 banking and non banking professionals

¹⁴ Working in Dubai Islamic Bank Pakistan Limited, Meezan Bank Limited, and Emirates Global Islamic Bank

¹⁵ Refer Annexure – III, IV, and V for detailed interview questions and answers from each Islamic Banker.

¹⁶ Refer Annexure – VI, VII, and VIII for detailed interview questions and answers from each customer of Islamic Bank.

office. We have also tried to contact non Muslim Islamic bankers and customers for feedback on Islamic banking but I could not find any person.

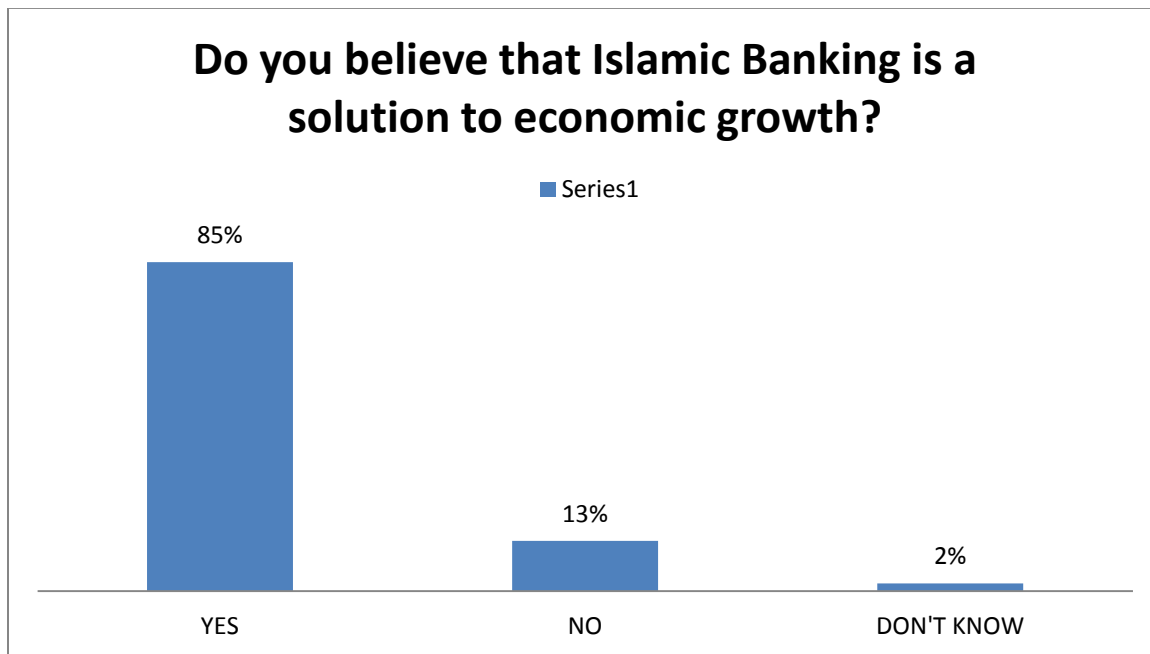
Results and Discussions

The purpose for this study is to explore challenges and opportunities of growth and development for Islamic banking in Pakistan. Responses received through questionnaire and interviews are matched with the aim and objectives of the Research Paper. More specifically, primary and secondary research results are matched and compared to find out the actual position of Islamic Banking system, its present position, challenges faced and underlying opportunities.

This is what the primary area in research to find out as if professionals are aware with the basic understanding of Islamic Banking. All the questionnaires were collected in time. Data is analyzed on the basis of percentages extracted from the number of responses to each question by the respondents.

In assessing the responses to the question that ‘do you believe that Islamic Banking can contribute to economic growth’, We have received 85% responses where respondent marked ‘Yes’ to this question. Whereas, 13% said ‘No’ and remaining 2% were have no idea to this question. Please refer the details in following bar chart.

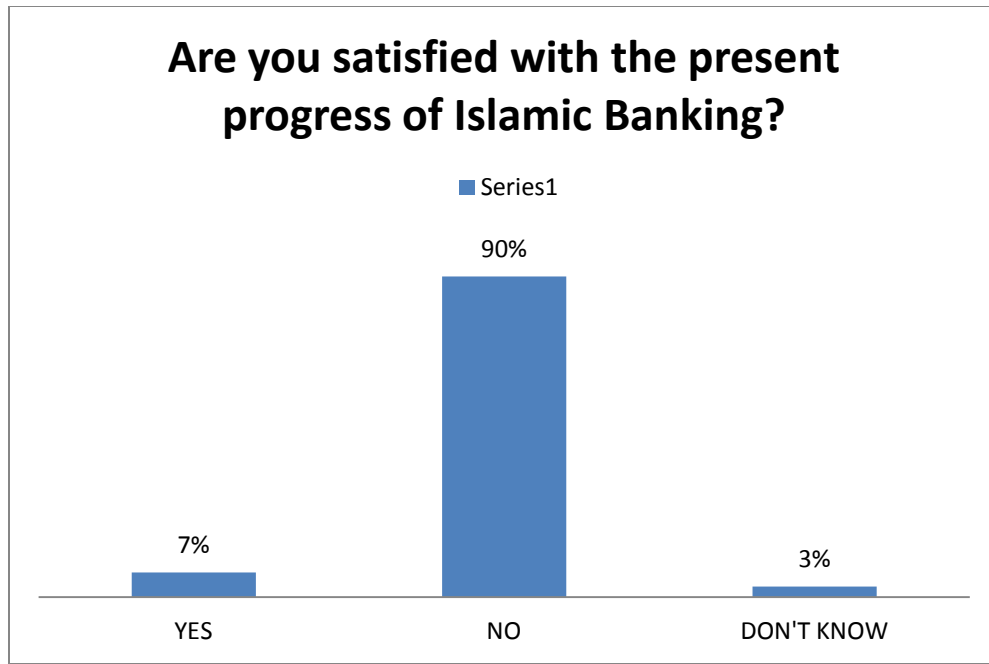
Chart 1 Islamic banking and economic growth



Islamic Banking – Present progress?

In assessing the responses to the question that ‘are you satisfied with the present progress of Islamic Banking’, We have received 90% responses where respondent marked ‘No’ to this question. Whereas, 7% said ‘Yes’ and remaining 3% were have no idea to this question. Please refer the details in following bar chart.

Chart 2 Present progress of Islamic banking

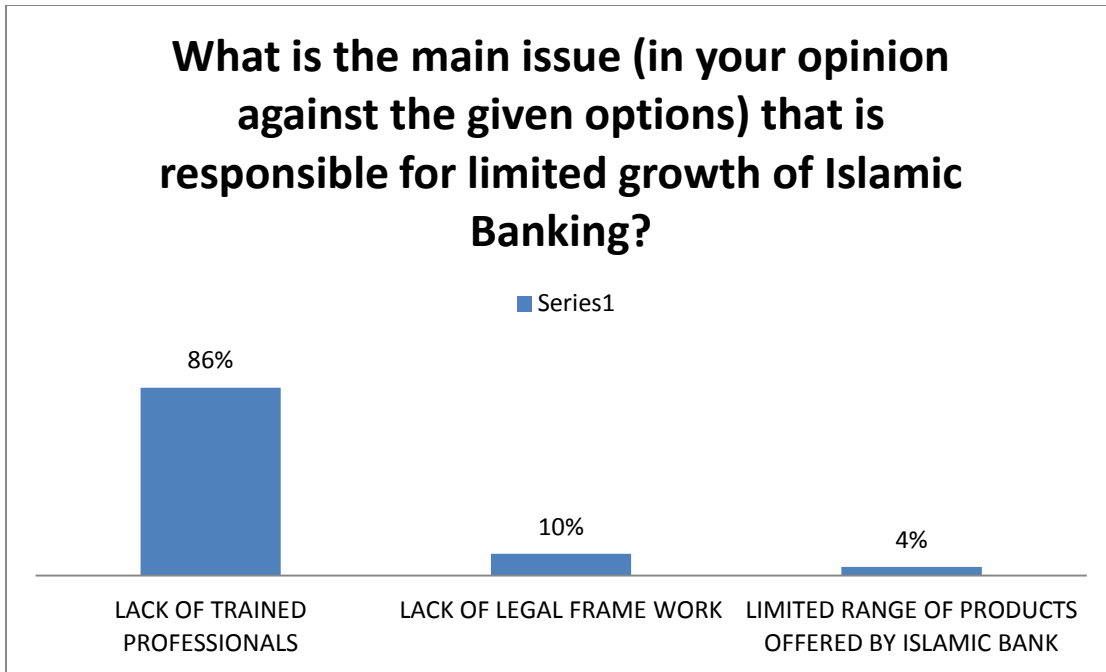


This result also shows the reality of Islamic Banking in Pakistan where it is reflecting 5% overall growth rate, although 12% growth is expected in coming two to five years.

Reason for slow growth in Islamic Banking?

In assessing the responses to the question that 'what is the main issue for slow growth of Islamic Banking', We have received 86% responses where respondent mentioned reason as 'Lack of trained professionals' for limited growth of Islamic Banking. 10% said that it is due to lack of legal frame work, whereas, 4% said it is due to limited products offered by Islamic banks. Please refer the details in following bar chart.

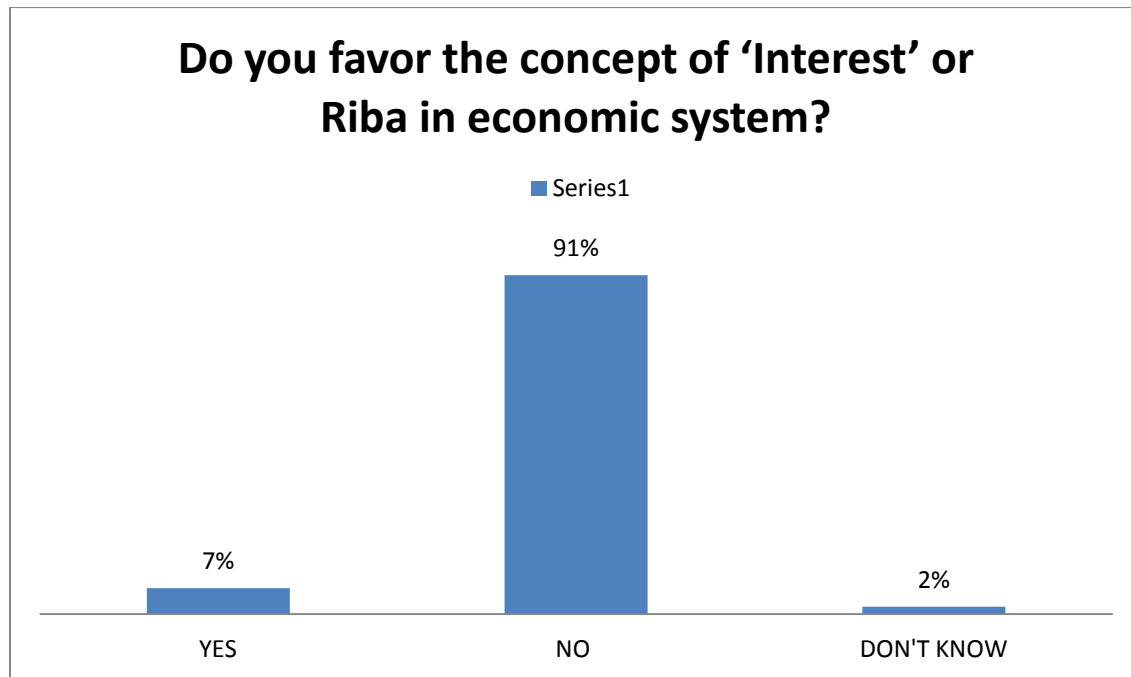
Chart 3 Issues for limited growth of Islamic banking



Islamic Banking – Concept of Riba?

In assessing the responses to the question that ‘do you favor the concept of ‘Interest’ or Riba in economic system’, We have received 91% responses where respondent mentioned reason as ‘No’ whereas, 7% said ‘Yes’ and remaining 2% said don’t know. Please refer the details in following bar chart.

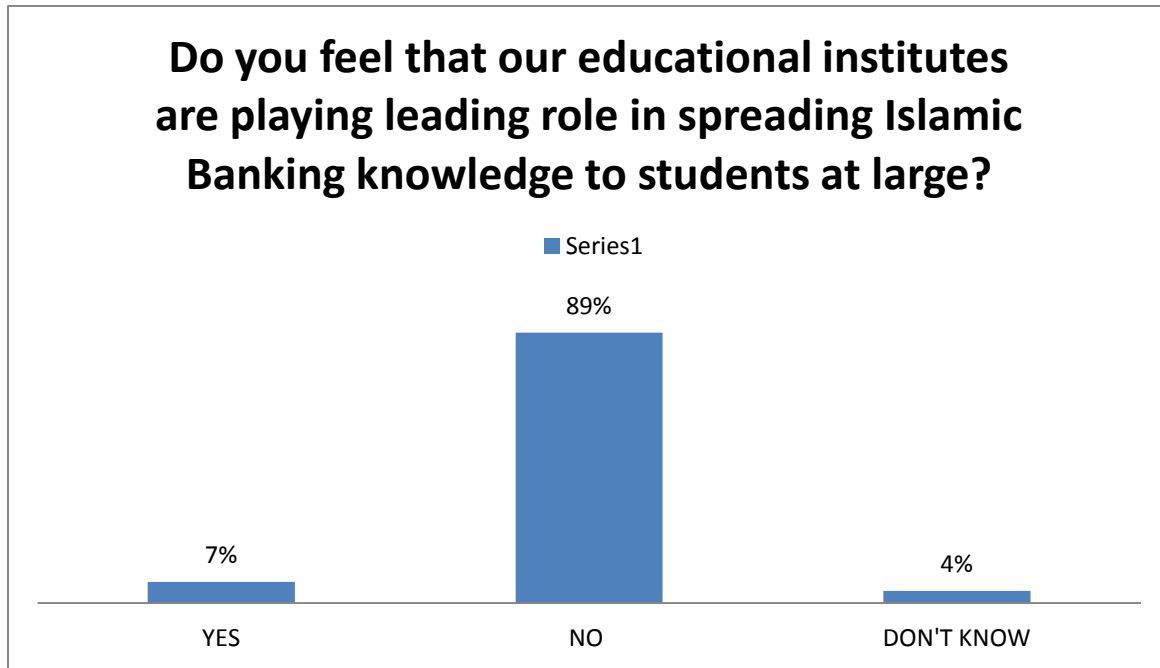
Chart 4 Concept of Riba and Islamic banking



Role of Educational institutes in promoting Islamic Banking?

In assessing the responses to the question that ‘do you feel that our educational institutes are playing leading role in spreading Islamic Banking knowledge to students at large’, We have received 89% responses where respondent marked ‘No’ to this question. Whereas, 7% said ‘Yes’ and remaining 4% were have no idea to this question. Please refer the details in following bar chart.

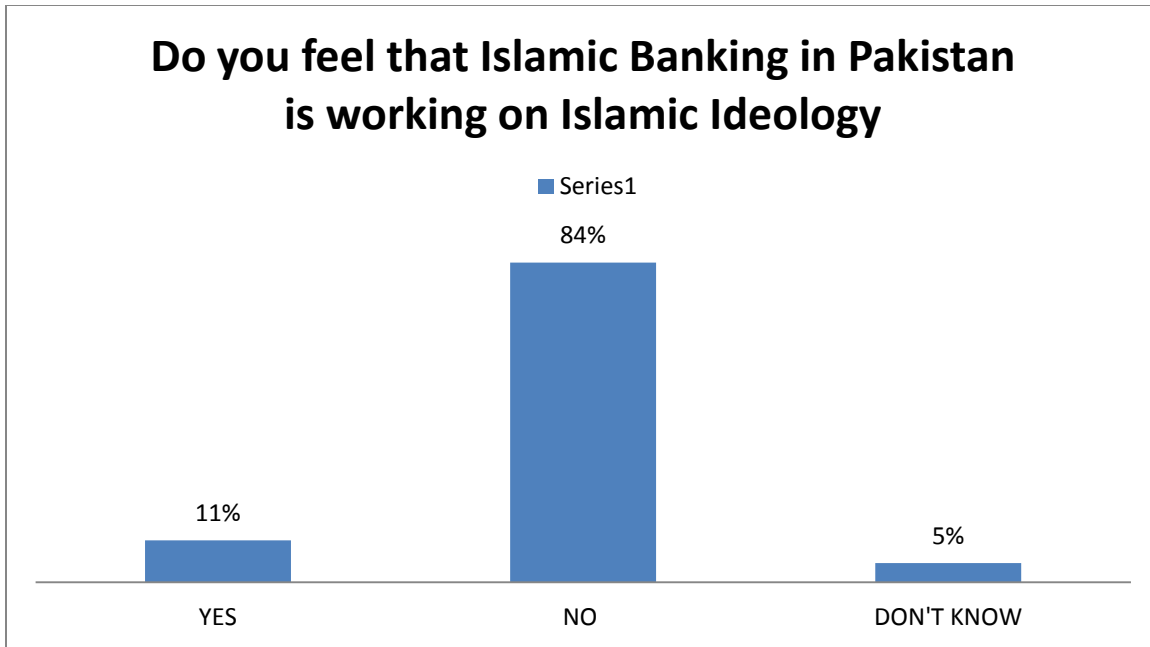
Chart 5 Role of educational institute in spreading Islamic banking knowledge



Islamic Banking - Is it according to Islamic Ideology?

In assessing the responses to the question that ‘do you feel that Islamic Banking in Pakistan is according to Islamic Ideology’, We have received 84% responses where respondent marked ‘No’ to this question. Whereas, 11% said ‘Yes’ and remaining 5% were have no idea to this question. Please refer the details in following bar chart.

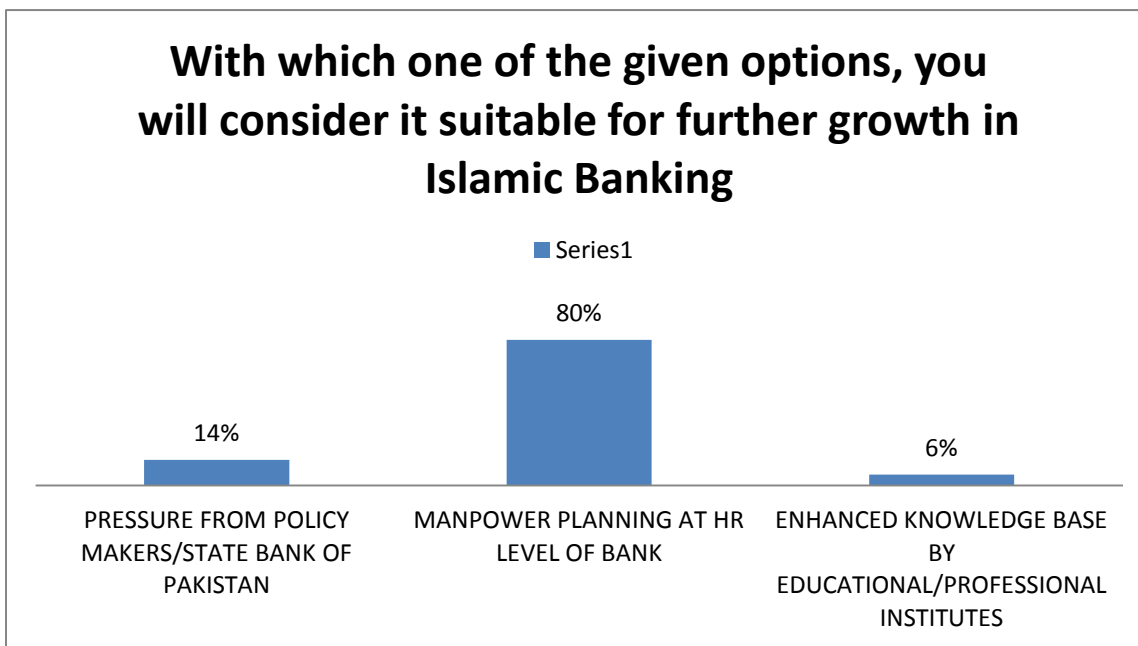
Chart 6 Islamic banking and Islamic ideology



Islamic Banking – Positioned for growth?

In assessing the responses to the question that ‘what is the unique selling point for Islamic Banking in Pakistan’, We have received 80% responses where respondent marked ‘Manpower planning’ to position Islamic banking for further growth. Whereas, 14% said ‘follow up from regulators and policy makers’ can make position of Islamic banking better in future. 6% were however, of the opinion for ‘enhanced educated base’ for Islamic banking growth in future. Please refer the details in following bar chart.

Chart 7 Growth of Islamic banking



Analysis of data collected through detailed interview

While reviewing the responses received through detailed interview with three different Islamic bankers of middle management level and customers of these banks We have classified the observations in nine broad areas i.e.

- Basic understanding of Islamic banking
- Difference between Islamic and conventional banking
- Sharia compliance
- Product development
- Role of stakeholders
- Challenges in Islamic banking
- Awareness and market competition
- Level of present progress
- Future growth

After analyzing the results received through detailed interview, We have merged each of the 15 questions (asked from bankers¹⁷ and customers¹⁸) in 09 broad categories (as mentioned earlier) and is defined in table 3 below. To measure the quantitative aspect and draw conclusion We have split the quality of responses in three categories and assigned each level a numeric value¹⁹and separately find out mean of all responses from both categories of interviewees. As a result following findings are extracted:

Table 3 Quantitative analysis of detailed interview responses received from 03 Islamic bankers and 03 Customers of Islamic Bank.

Questions	Input From Islamic Bankers				Input from Islamic Banking Customers			
	B1	B2	B3	MEAN	C1	C2	C3	MEAN
Basic understanding of Islamic banking	3	2	3	3	2	2	3	2
Difference between Islamic and conventional banking	2	3	3	3	1	3	2	2
Sharia compliance	3	3	2	3	2	2	3	2
Product development	2	2	2	2	1	1	2	1
Role of stakeholders	2	2	2	2	1	1	2	1
Challenges in Islamic banking	3	2	3	3	2	3	3	3
Awareness and market competition	2	3	1	2	1	1	2	1
Level of present progress	2	2	2	2	2	1	1	1
Future growth	3	3	2	3	2	3	3	3

¹⁷ Defined as 'B' in Table 3. B1 stands for Banker 1, B2 for Banker 2, and B3 for Banker 3.

¹⁸ Defined as 'C' in Table 3. C1 stands for Customer 1, C2 for Customer 2, and C3 for Customer 3.

¹⁹ 1, 2, and 3. For High it is 3, for Moderate it is 2, and for Low it is 1.

Based on interview results, both from Islamic bankers and their customers it is evident that people have basic understanding of Islamic banking, they know the difference between Islamic and conventional banking. However, concerns were noted in terms of present growth, lack of awareness, limited knowledge base, casual role of stakeholders and low capacity of product base. On the contrary, every interviewee believes that Islamic banking is positioned for growth although it is facing several challenges in past and present both.

Conclusions

Primary focus is made through this Research paper to determine the understanding level of general public about concept of Islamic banking, its present progress and future expectations. Through Research study it is identified that there is limited knowledge base of Islamic bankers and customers, for which educational institutes, and banks themselves should take lead and arrange courses for Islamic bankers and customers. Once level of awareness will increase the market share of Islamic banking will automatically shift to double digit from present position at single digit. Islamic Scholars should also require enhancing their capacity and producing more scholars in the banking industry. Proper research and development is also required to flourish the Islamic banking industry.

We can make out following conclusions:

- Islamic banking is coming out of embryonic stage and growing at its normal momentum. Although, growth rate was 5% during the years 2006 to 2009 but it is forecasted that it will be growing at the rate of 12% in next three years.
- Islamic Banking is more concerned about the viability of a project as compared to conventional banks. It is also stimulating economic growth and trade activities. Therefore, we can say that Islamic banks are more like enterprising.
- Islamic banking is presently focusing on short term activities both at their asset and liability sides.
- Islamic Banks needs to spread its wings on corporate side and equity financing, although short term financing is less risky and good for early period of existence.
- Proper training should be given to resources in banks and educational institutes should also provide guidelines to fresh blood for quick promotion of Islamic banking.
- Back up arrangements of Islamic banking should be arranged like secondary capital market.

Recommendations and Future Strategy

Based on primary and secondary research it is felt to submit following recommendations for future growth of Islamic banking in Pakistan:

Strategy: Going forward Pakistan need to take more aggressive role in promoting Islamic Banking in line with the uniform standards being promoted by Islamic Financial Services Board (IFSB). Core purpose however, should remain unaltered, i.e. bringing financial innovation to cater the need of industry, corporate sector, country's infrastructure and population; with the objective to nurture the faith based system of financing consistent with the Sharia principles.

Mobility of Deposits: Since deposit works as life blood for any bank's progress. Therefore, in order to promote Islamic banking, it is also fundamental for Islamic banks to offer good products for mass majority in order to induce them to place their deposits with Islamic banks. Banks can capture large deposits by employing good marketing

techniques. May be spreading Islamic education through mass media prove to be a leading advantage for banks to hold the attention of majority of population who are Muslims.

Innovative Products: Islamic Banks need to offer good financing products as per the need of individuals, entrepreneurs and industrialist. This will not only be helpful for banks to improve their profitability but, also make them eligible to meet the social and economical responsibility. Ex-Governor State Bank of Pakistan Dr. Shamshad Akhtar²⁰ mentioned that Islamic banks should develop more innovative products to cater the needs of business industry.

Promotion of product to underserved region: Instead to focus big groups for financing in their initial phase, Islamic banks should focus on small groups of people. Possibly, for this purpose Islamic banks need to make joint venture with micro finance banks to meet their objectives.

Promotion of Liquidity Management: Sharia Compliant Treasury bills need to be launched for making secondary market for Islamic banks to create lines for sale and purchase of contracts or to offload their short term liquidity. Although, SLR (Statutory Liquidity Requirement) requirements for Islamic Banks have been launched by SBP, therefore, it is assumed that to address the issue of excess liquidity with Islamic banks, T-bills will be introduced together with structuring Islamic Repos. Of course, it requires changes / amendments in SBP Act and setting up specific assets of public sector by the Government.

Promotion for best practices: In addition to regulatory requirements and guidelines given by SBP, Islamic banks need to adopt Islamic Financial Services Board (IFSB) and Accounting and Auditing of Islamic Financial Institutions (AAOIFI) as per their local / domestic requirements.

Promoting principles of good corporate governance: Islamic banks have been given responsibility to not only practice and promote sharia based principles of Islamic economic system, but also the sound risk management principles by following good corporate governance framework in conformity with guiding principles of Islamic Financial Services Board (IFSB).

Capacity Building Measures: In addition to promote capacity building for mass majority, Islamic banks need to inculcate the importance of training and development for effective implementation of standards promulgated by Islamic Financial Services Board (IFSB) and Accounting and Auditing of Islamic Financial Institutions (AAOIFI). It is not appreciating that still banking industry is facing shortage of trained resources in the field of Islamic Banking.

Suggestions for further Research

This research is made on qualitative basis to show the history of Islamic banking, its origin, present progress and future growth, particularly in Pakistan. Concept of interest, its draw back on economy and alternate in terms of Islamic economic system is also discussed in details. I am sure that indicators of this research are showing that Islamic banking is reflecting healthy sign of growth and future expectations from Islamic banking is also positive. I also found qualitative approach as best approach to determine the understanding of professional, Islamic bankers, and customers about Islamic banking.

²⁰ Speech on 'Islamic Banking: Past, Present and Future Outlook' dated September 11, 2007 and is available on internet.

We suggest further research in this area may prove to be beneficial for Educational Institutes to design or re-design their syllabus, Stakeholders to improve or form their strategies, Government to intervene and participate in promoting Islamic banking, Sharia Advisors to learn the experience from past and plan their future course of action, Islamic bankers to invest their time to learn more and more about their area of working and Customers to invest their savings with Islamic banks and refer to them for their financial requirements. We are sure if Islamic banking institutes overcome the challenges through careful planning and investing in training and development it will really helpful to promote Islamic banking in coming years also.

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