Evolution & Development of Islamic Banking – The Case of Pakistan

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Abstract— **The paper attempts to explore the roots of Islamic Banking in the world in general and in Pakistan in particular to assess the evolution and development/growth of Islamic Banking worldwide and especially in Pakistan. The paper highlights the chronology of Islamic Banking globally and in Pakistan and also traces the progress of Islamic Banking internationally with special reference to Pakistan. The facts reflect an encouraging global Islamic Banking outlook. The findings also show that the progress of Islamic Banking in Pakistan has been consistent and quite encouraging. As the time passed the quantum of Islamic Banking in the country expanded and is continuing to move in the right direction. From a new initiative in the 1970s, Islamic Banking is now a force to reckon with, the annual growth rate of more than 16% proves this fact.**

Keywords- Islamic Banking, Islamic finance, Pakistan, Evolution, Development, Growth

I. Introduction & Overview of Islamic Banking

Islamic economic and financial system is based on the idea of collective welfare which is driven by virtue and goodness of both worlds. This idea of Islamic economic system is greatly in contrast to the modern interest based economic system which is driven by the principles of capitalism, unbridled resource consumption and materialism. Islamic system of finance emphasizes risk sharing which provides Islamic financial methods like murabaha, mudaraba, ijarah, musharakah, salam and istisna – guided by the Islamic principles derived from Holy Quran and the Sunnah (sayings and acts) of the Holy Prophet (SAW) to eventually facilitate trade and business in the society and to consequently bring economic well-being and prosperity. This is incredible to note that Islamic sacred texts from the times when paper money was not even invented offered guidance on intricate financial issues. Besides this, Islamic principles also provide guidance on the architecture of a system that is economically just and fair and is based on the schema of socio-economic welfare of all and not just certain wealthy individuals or groups. (Zaman 2013) Whereas, the conventional economic system, emphasizes on the principles of time value and money. This is explicitly mentioned in the second chapter of the Glorious Quran that dealing in Interest is tantamount to waging war against God and His messenger PBUH. Islamic mode of business financing is laid on the tenant that the use of Riba (interest) is forbidden in all transactions (Gerrard and Cunningham, 1997). This prohibition is based upon Sharia guidelines and laws which are derived from two divine sources i.e. Quran & Hadith. According to the fundamental divine rulings of Islam, Muslims can neither collect nor disburse Riba (Interest), so they are incapable to deal and transact with conventional financial institutions and including both banking and non-banking financial organizations. (Jaffe, 2002). To cater to the needs of this segment that represents those Muslim clients, who avoid Interest because of their religious beliefs, which forms a massive market, Islamic banking and non-banking organizations have developed a diverse group of shariah-compliant and riba-free banking and financing products that fulfill the relevant Shariah rulings, and hence, are suitable to their Muslim customers. (Rammal, 2004).

II. Tracing the Roots of Islamic Banking in the World

The Islamic system of economy – long established approximately 1400 years ago is a broad structure of principles, institutions and clearly defined injunctions. Holy Prophet Muhammad PBUH himself was a trader by profession and hence he knew the importance of trade and business along with other economic issues. Islamic mode of partnership finance i.e. Mudarabah was one of the driving forces of business and trade in the medieval times. With the passage of time, industrialization and institutionalized commercial banking reached the Muslim populations, where at that time; it was not somehow practically possible for the Muslims to reject the interest-based banking system, as there was no pragmatic and concrete alternative available. Islam forbids interest or Riba in all its facets and warns those who deal in interest. (Aqib Ali 2012) It was in the 19th century that Muslims started to realize that the current system of banking and economy was based on Riba that is interdicted in Islam and is categorically forbidden in all its shapes whether commercial or non-commercial; and there should be an alternate system which conforms to the principles of Shariah. The primary project that paved way for a promising future of Islamic banking was *"Mit Ghamr"* in Egypt. In the meantime, another initiative was taken in the shape of *"Tabung Haji" in* Malaysia (Laldin 2008). A major challenge in the establishment of Islamic banking set-up was to develop Shariah compliant products and services, for which Islamic banks established Shariah Advisory Committees and Religious Boards, who authenticated the products and services of the Islamic banks and whose main objective was to judge, whether these products and offerings conform to the tenets of Shariah. These boards comprised of Islamic scholars who came from diverse backgrounds and belonged to various schools of thought. This was a positive prospect as banks could benefit from the vast knowledge and innovative ideas of these scholars. There was also difference of opinion among these scholars but mutual consultation was the guiding force to finalize the decisions. As the time passed, Islamic financial institutes grew in numbers and magnitude. The first international Islamic financial institute was the Islamic Development Bank (IDB) in 1975. This was a landmark in the history of Islamic banking. Some countries including Pakistan, Iran, Sudan, Malaysia and Bahrain initiated efforts to implement Islamic banking at larger scales in their respective countries during 1980s. In the next decade some of the conventional banks also introduced Islamic banking products and services by operating separate Islamic banking units and divisions.

After the foundations of Islamic banking in countries like Egypt and Malaysia, it became evident that Islamic banking will have a vivid future. Swiftly after the introduction of Islamic financial services by the conventional banks, Islamic banking started to make its mark on the global financial landscape. (Khan & Bhatti 2008) Several Islamic investment and holding companies were established and many international and large-scale financial institutes introduced Islamic financial services. With the passage of time, Islamic finance flourished, innovative and diverse products and services like sukuk, Islamic mutual funds, and takaful fortified Islamic finance at international level. The rapid expansion of Islamic finance and the discovery of new and innovative Sharia compliant products and services facilitated Islamic finance to compete at a global scale with the competitive interest based banking and financial set-up. A number of international and large-scale entities like Islamic Development Bank, The Islamic Finance Services Board (IFSB), Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and International Islamic Rating Agency are making their due contribution in the growth and development of Islamic finance at a global scale. Today Islamic finance is a thriving and dynamic force in the global financial setup.

Islamic Development Bank established in 1975, being the first international Islamic financial institution played a role of a pioneer to make Islamic banking and finance a global phenomenon. The bank played a vital role in the economic growth and development of its member countries keeping in view its primary objective of narrowing the gap between the rich and the poor member countries. The IDB is distinguished from other similar institutions like the World Bank or the Asian Development Bank in a way that it is committed to follow the tenets of Shariah in all its operations and is dedicated to avoid Riba or interest in all its dealings. The IDB plays a crucial role in the economic development of member countries and Muslim communities around the world by performing key functions like financing the public and private sectors of member countries; raising, operating and maintaining various funds like trust funds, special funds and other specific funds; accepting deposits and capital contributions; making investments and trade financing; providing technical assistance, co-operation and training facilities to member countries; promoting and assisting foreign trade among member countries; insurance, information and other ancillary services; facilitating research and training in areas of Islamic economics, banking and finance by providing scholarships etc. Other functions which guarantee the IDB, a distinctive Islamic character, are the participation in the equity capital of projects in member countries and the investment in social infrastructure projects in member countries. The IDB has proved its mettle at the international level as the first developmental-aid institution operated in accordance to Shariah principles. The role played by the bank in the economic development of its member countries has been momentous. The IDB has transformed from a single unit into a group of five entities, its capital has increased manifold and the credit ratings and financial position of the bank, even during the recent global economic and financial crisis, has been phenomenal. Today the IDB is one of the few multilateral development financial institutions with excellent credit ratings, which confirms its financial stability and progressiveness. The IDB continues to play the critical role in its member countries, by reducing poverty and fostering economic development.

Islamic finance industry has expanded swiftly in the past thirty years expanding its horizon in terms of operations and territory by reaching out to many parts of the world from Arab countries to Middle-East to Asia and Europe. The dynamics of Islamic finance industry as discussed earlier emerged with the establishment of the Small Savings Association of Mitghamr (Egypt) in 1963. The capacity and vigor of the industry has now reached to more than 500 banking and financial entities having operations in over 90 countries with the aggregate gross assets approximately more than 1.6 trillion US dollars which is likely to double by 2016. (Humayun 2013). The growth rate stands at a staggering more than 16% a year. According to Kapur (2008), most of the large Islamic finance entities including Islamic banks have outperformed and outpaced their conventional counterparts – the conventional interest based banks with the assets growth rate of more than 26.6 per cent with assets growth standing at an amazing 350 billion US dollars approximately, as compared to the mainstream banks who stood at an asset growth rate of 19.3 per cent. This performance as reflected in the growth rates shows the great potential and amazing progress of Islamic finance institutions when we match these rates with the estimated rates of 15-20%

per annum, which were forecasted by most of the analysts globally. Nearly all of the major interest based conventional banks have either already developed their Islamic banking units and divisions or are in the process of establishing their Islamic banking groups to tap the new and great emerging market. The greatly speedy and encouraging increase in the growth rate of Islamic banking and finance around the world, beyond any doubt proved to be a wave of fresh breathing air for those who wished to be a part of modern banking and economic organizations including both banks and non-bank institutes, to participate in the economic process and to reap the benefits in shape of Shariah compliant returns and profits. The industry growth provided a great opportunity to Muslims to be a part of modern market economy while also being in conformity with their religious beliefs by not dealing in interest and speculation businesses, directly or indirectly. (Usmani, Taqi, 1999). It was in the year 1973 that a meeting of foreign ministers and delegates of almost all the major Muslim states decided to set-up an Islamic monetary authority in shape of Islamic Development Bank with the purpose and intentions of nurturing financial prosperity and socio-economic development of Muslim countries in consonance with the tenets of Islamic Shariah. The event actually signaled the major initiative collectively taken by Muslim countries to facilitate Islamic finance sector (Saad, 1998). As time passed, many Muslim countries strengthened their own Islamic banking and finance structures. The magnitude of success in this regard differed but progress on this account was surely made by many countries particularly by Bahrain, Oman, Malaysia, Egypt, Pakistan, Saudi Arabia & UAE.

III. Origin of Islamic Banking in Pakistan

The Islamization process in Pakistan concurred with the movement of Islamic finance in the world in the second half of 1970s. But it had its genesis in the very creation of the country. Pakistan came into being by partition of the India in 1947 in response to the demand of the Indian Muslims to establish an independent homeland where they could practice Islamic teachings. As a result, successive constitutions of the country have reiterated the intention of implementing the law and culture of Islam in true spirit. The foremost expression of the will to practice Islam had been to find a viable solution to re-fashion the financial institutions of the country on interest-free basis. It had always been in the subconscious of the ordinary Muslims that Islamic way of life naturally meant an interest-free economic system; though very few even understood the vast implications of such a belief. But the intelligentsia of the country had a sizeable number of such people who sincerely believed that the prevalent commercial interest was not the *riba* prohibited by the Qur'an. The main conclusions of the Islamization were as follows. First, the Islamization of banking in Pakistan had not met with a success. Most of the finance are still being provided by the savers and the bankers on interest although different terms were being used to camouflage it. Second, the early days of Islamization did see some genuine but inadequate efforts to eliminate interest from the economy but in a period of less than five years most of these efforts had either been reversed or, at least, further progress on them had been halted. Third, a genuine attempt to eliminate interest from the economy would require plugging in all holes for interest-bearing finance. So long as avenues for interest-bearing investment were open, the possibility of a successful transition to Islamic system of finance would be well-nigh difficult. Four, a true Islamic system of finance would require the savers desirous of earning a return on their savings to assume risk as well. The principle of no-risk-no-return will have to be strictly enforced. This will mean a structural change in the role of financial institutions. Five, the macro-economic management of the economy will also need to be in conformity with the Islamic principles to make the experiment of Islamic finance a success. The conceptual debate on the meaning of *riba* in Pakistan revolves around two important points of view. The first, and by far the most influential, is the one propagated by the religious scholars and commonly believed by the general public. According to this, the prevalent commercial interest in financial institutions is the *riba* prohibited by the Islamic law. The other view propagated by some modernist scholars such as Fazalur Rahman, Ja'afar Shah Phalwarwi, Mirza Ahmad Ali, Syed Yaqub Shah in sixties of this century argued that the prohibited *riba* pertained to interest on consumption loans and not on commercial loans as in vogue in the financial institutions.

The Council of Islamic Ideology of Pakistan (formerly Advisory Council on Islamic Ideology) is a constitutional body and consists of scholars of all shades and schools of jurisprudence. The Council in its historic decision of 23 December 1969 categorically pronounced that all forms of interest were *riba,* irrespective of the purpose, parties, rates and duration involved. It also declared that discounting of bills of exchange, prize on Prize Bonds, interest on Provident Funds, and interest on loans to employees of the government, all fell within the purview of *riba.* The Federal Shari'ah Court of Pakistan, in November 1991, decreed that *riba* included all forms of interest including the prevalent system of mark-up. The decision struck from the statute book all those clauses of various laws which had a mention of the term "interest". It asked the Federal Government to devise new laws to replace the existing ones in the light of the Islamic law by 30 June 1992 beyond which date the existing laws will cease to have effect, so far they are related to payment and receipt of interest. But the Federal Government, instead of implementing the decision of the Federal *Shari'ah* Court, filed an appeal in Supreme Court of Pakistan's *Shariah* Appellate Bench. In the meantime, the Supreme Court had issued a questionnaire to solicit opinion of scholars and practitioners on various issues involved in transforming the existing financial system. The questionnaire showed that the Supreme Court would, in all probability, re-examine the whole issue once again. In June 1992, the Commission for Islamization of the Economy issued its first report. The Report on Banks and Financial Institutions was based on the work done by a Working Group appointed by the Commission and consisted of senior bankers and an Islamic scholar. The Report also categorically took the position that all forms of interest were *riba* and prohibited by the Islamic law.

Akram Khan 1994 states that besides all these authoritative decisions and the earlier writings of the scholars and overwhelming opinion of the Muslim *Ummah* all over the world that all forms of interest were *riba*, there still remained a powerful lobby in the bureaucracy and financial circles which tried to confuse the issue. On and off, one could see articles being published in the popular media that the prevalent interest was not prohibited and that there was nothing wrong in the existing financial system. There was a strong need for disseminating the various aspects of the debate and to argue out the whole case in the popular media. The Council of Islamic Ideology gave the conceptual lead and the Islamization of financial institution was initiated with an order by the then President to the Islamic Ideology Council on 29th September, 1977 to design a plan for a riba-free Islamic system of economy. The Council assigned this task to a panel of Economists and Bankers who submitted its report in February 1980. The Council examined this Report and with several modifications issued its own *Report on the Elimination of Interest from the Economy* on June 15th 1980. This report proved to be a milestone in the endeavors for Islamizing of financial institutions in Pakistan. It set out in sufficient detail a complete blueprint for elimination of interest from Pakistan's economy. Another landmark was achieved when the State Bank of Pakistan prescribes banking operations on Islamic lines. Based on the report of the Council of Islamic Ideology the State Bank of Pakistan started issuing circular to the banks for transforming their operations on the Islamic lines. From 1st January 1981, Islamic windows were opened in all nationalized Commercial Banks. During 1981-85, the State Bank of Pakistan issued several instructions. Very briefly, it prohibited the banks to accept any interest-bearing- deposits and provide finance by interest-bearing lending. For deposits, it introduced the concept of Profit-Loss Sharing (PLS) for various durations, besides current accounts as already practiced. The PLS depositors were now to share in the profit or loss of the banks. The State Bank prescribed maximum and minimum ranges of this sharing and also the formula to work out the banks' management fee. For financing, the State Bank prescribed twelve modes of finance. These modes of finance included *musharaka, mudaraba, ijara, ijara wa iktina,* equity participation, rent- sharing, mark-up financing for purchase of goods, purchase of property with buy-back agreements, purchase of participatory term certificates, purchase of trade bills, and interest-free loans on the basis of service charge. These modes of finance provided a wide variety of menu to the banks. Other Financial institutions also introduce Islamic schemes. Simultaneously, other financial institutions also started transforming their operations. For example, the Investment Corporation of Pakistan (ICP), an investment bank, introduced a Profit-Loss Sharing Investment Scheme. Under this scheme, the ICP accepted deposits and added its own share in proportion to 40:60. The funds thus collected were invested on the stock exchange and the profit was shared with the depositor in proportion to 60:40 but the loss was shared in proportion to capital invested by both the parties. Similarly, the House Building Finance Corporation started providing finance on the basis of rent-sharing. The National Investment (Unit) Trust was also advised by the State Bank to invest its funds on interest-free basis. In brief, during early days there was a lot of enthusiasm for Islamization of the financial institutions. In the beginning the banking entities were reluctant to an extent, to adapt with the newly established interest-free system and endeavored to devise some ways to eliminate interest from their dealings. But very soon they started operating on the basis of mark-up and buy back arrangements. The mark-up and buy-back transactions, as practiced in Pakistan were two very similar techniques. These techniques were in fact camouflaged forms of interest. In the garb of fresh terminology and slogans, the banks kept on operating on the lines of old ways of interest-bearing finance. The Islamic forms of finance such as mudaraba, musharakah, ijarah, ijarah wa iktina,etc were not embraced by most of the banks and financial institutions. But even in those cases where, these Islamic modes of finance were adopted, the banks introduced such changes in their application that the matter became dubious and some form of interest was introduced. (Akram Khan 1994)

IV. Growth/Development & Quantum of Islamic Banking in Pakistan

Islamic banking initiative in Pakistan in a true sense was categorically taken in 1979 when the government preliminarily decided to transform interest based non banking financial organizations like; Investment Corporation of Pakistan (ICP), Bankers Equity, House Building Finance Corporation (HBFC) on Riba free basis. At the same time the government also approved and encouraged commercial conventional banking institutions to provide depository accounts on the basis of profit and loss sharing, these were termed as PLS accounts. From the mid of June 1985, the government barred all the banks from offering interest-based services and products. Nevertheless, all interbank dealings and government linked dealings and the foreign currency accounts were permitted to continue operations on present basis i.e. on interest basis. (Ahmad & Abdul Wajid, 2009). This signaled a new era of Islamic finance in the country as the Supreme Court also issued a ruling against Riba-based transactions and Islamic Ideological Council of Pakistan proposed a system of economy without interest. After the Islamization steps by the Zia regime in mid to late 1980s, strong footing was laid for the enactment of Islamic finance entities in the country. The gradual and steady progress of Islamic banks continued and the industry of Islamic finance thrived as time passed.

Islamic banking is among the swiftest progressing components in the world's financial systems; the market distribution of assets in the Islamic finance industry has risen from 2% from the late 1970s to an astounding 15% up to the middle of 1990s (Yousef, 1996). Presently, according to estimates, over 500 (Sania & Shehla 2012) Islamic financial institutions, in more than 90 countries are involved in the funds management of more than roughly 500 billion US dollars in assets. Moreover, over the last decade, the Islamic finance and banking industry achieved an amazing growth rate of 15 to 20 percent per year (Bose & McGee 2008). The Islamic finance entities are not only functioning in the Muslim countries but these are also playing their vital role in other countries where Muslims are a minority, for instance, in the major countries of the world including the United States of America, the Unite Kingdom, China, Australia, and France. Furthermore the products and services offered by these Islamic finance institutes are not only accepted and availed by the Muslims but as well by the people from other religious beliefs and backgrounds. The reason behind the acceptability and attraction towards these Islamic banking products and services is the compliance of Shariah principles that prohibit ambiguity, confusion, exploitation, deceit and fraud and hence these have a great appeal to numerous non-Muslims as well (Venardos, 2006). Islamic banking industry experienced a large-scale boom in many countries around the globe in the last 30 years (from 1980's). The performance and this encouraging growth-rate was dominated and driven by the variables such as the introduction and effective implementation of large-scale macroeconomic reforms; refined and systematic framework policies in financial structure and systems, the global-scale coordination, integration and liberalization of financial and capital markets, privatization and the presentation of creative and diverse Islamic finance products. All these factors now see Islamic finance attaining new levels of sophistication and making it a reckoning force against the powerful conventional and interest based systems and markets. (Cornelisse and Steffelaar, 2008). As Islamic finance has been able to win worldwide acceptance generally and in Muslim majority regions particularly; by the early 2003 the number of Islamic banks around the globe was 176 with deposits of more than of 147 billion US $. (Ghanadian & Goswami, 2004). Besides many hurdles, Islamic banks in Pakistan grew progressively driven by the motives of Shariah compliance, higher returns and service quality. The role of all the stakeholders including the central bank – The State Bank of Pakistan has been very positive. For this reason Pakistan has been one of the fastest growing Islamic finance industries in the world having superior statutory and legal framework, Shariah governance experts and governmental support to a reasonable extent. According to Kabir (1999), Pakistan has an effective framework for better Islamic banking regulation and control. The number of fully dedicated Islamic banks operating currently in the country is five with branches in all the 16 major city-centers of the country. They include Meezan Bank (313 Branches) topping all others in terms of branch network; Al-Baraka Islamic Bank, Burj Bank, BankIslami Pakistan and Dubai Islamic Bank Pakistan. In addition to these Islamic banks having a total of 660 branches, there are fourteen non-Islamic banks (conventional banks) that have fully operating Islamic banking branches across the country numbered 440, taking the total number to an amazing figure of 1100 branches nation-wide as stated by the Banking Policy & Regulations Department, State Bank of Pakistan. The growth of IBDs (Islamic Banking Divisions) of conventional banks is also rapid and they are making strides to vie with the dedicated Islamic banks to win maximum customers. The maximum progress banks include Bank Alfalah & Standard Chartered among other foreign conventional banks.

According to a report, up to 2006, registered Islamic banks in Pakistan were six with 99 branches nationwide. (State Bank of Pakistan Islamic Banking Bulletin 2007) The amount of assets held by these Islamic banking institutions was approximately estimated at 1.3 billion US dollars with the total operations at an estimated 2.2% of the aggregate financial and capital markets of the country. The recent statistics of Islamic banking industry in the country speak volumes about robust growth of the system as depicted by the amazing facts and figures in the latest SBP Islamic Banking Bulletin (2013) which states that the total number of Islamic banking branches in the country is 1100 (till March 2013) as compared to only 99 in February 2006; the total deposits of Islamic banks stands at an encouraging figure of 9.7% out of total bank deposits and net finance and investment operations percentage is 8.5%. The trend was accurately forecasted in 2006 by Al-Refai who projected that the aggregate Islamic banking deposits will be estimated to be at staggering 13 billion US$ approximately 10% of the total bank deposits in the country by 2014. The progress is still taking place as all the industry stakeholders are playing their role in the strengthening of Islamic finance including the central bank of Pakistan, the State Bank of Pakistan (SBP). SBP recently started a massive media campaign in the country to enhance awareness and to promote acceptance of Islamic finance, its products and services. The campaign is part of an initiative that also includes a proposal to establish a country level Shariah Board to supervise the activities of Islamic financial institutions and to ensure greater levels of Shariah compliance in the products and service offerings of Islamic banks and other Islamic financial institutions. (Bernardo 2013)

V. Conclusion

Islamic banking has shown an outstanding potential and has gradually grown from strength to strength in the last five decades, globally. An annual growth rate of over 16% demonstrates the phenomenal expansion of Islamic banking and finance paradigm in the world. When we specifically survey the progress of Islamic banking in Pakistan, this can be said that it has been quite encouraging and consistent. The facts and statistics support the splendid growth of Islamic banking initiative in the country; for instance in the initial years of Islamic banking in Pakistan i.e. from the late 1970s to 1990s, a growth rate of 13% was observed while it has been more than 30% according to the latest estimates (Dawn 2014). Apart from the positive progress, there are also some challenges and issues like Shairah compliance, negative perceptions of people towards Islamic banking, and mighty conventional/interest-based system ,that act as hurdles to the overall expansion of Islamic banking in Pakistan. These issues must be addressed discreetly and effectively to make sure that Islamic banking keeps on the right track and continues to progress in the right direction. The potential and vision of Islamic banking can only be realized if it favorably impacts all of the relevant stakeholders, principally its customers, and this can be achieved through greater focus on research, innovation, product diversity, customer satisfaction & awareness.

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