

# The evolution of Islamic finance in Pakistan and its impact on the region

Pakistan's vibrant Islamic funds industry is reflective of a healthy Islamic finance industry. **AYAZ MUSTAFA ZUBERI** gives his insight into the country's development thus far.

**Pakistan's identity as an explicitly Islamic republic has always made the country more inclined towards economic reforms geared towards greater Shariah compliance. Efforts to Islamize the economy of Pakistan started in the mid-1960s.**

A significant attempt was made in the mid-1980s to convert the banking system to an Islamic banking system. It was a bold and comprehensive exercise, making Pakistan one of the few countries in the world to try to implement interest free banking at the national level. However, it was not successful due to certain constitutional and regulatory constraints at that time.

Nonetheless, that attempt was a significant step in the evolution of the Islamic banking system in the country. Technically, it was the most advanced model compared to any other model being practiced anywhere in the world at that time, and provided an important reference point for other countries looking to introduce Islamic banking systems.

In 2002, policymakers and stakeholders decided to try again to re-launch Islamic banking in Pakistan, taking into account not just the lessons learnt from the failure in Pakistan in the 1980s, but also the experiences of other countries currently known for their lead role in Islamic finance sector.

The State Bank of Pakistan's drive to promote Islamic banking as a parallel system, operating on a level playing field with conventional banking, is aimed at building a broad-based financial system in the country to enable all segments of the population to access financial services and play their due role in the overall economic development.

The authorities in Pakistan focused upon two key elements as the building blocks of Islamic finance's success in the country. Firstly, a sound regulatory framework that is flexible, market-driven and in

line with best international practices. Secondly, a sound Shariah compliance mechanism which is comprehensive, flexible, multi-layered and acceptable both locally and internationally.

This Islamic system was first implemented, then tried and tested, and it proved its merit. The roll-out was market-led rather than through legal means or as a religious dictate.

Despite the financial crisis, the fundamentals of the Islamic finance sector have remained strong. Islamic finance represents a small but growing segment of the finance industry worldwide.

**“ A common view is that the difference in opinion among scholars is a blessing that promotes ultimate progress ”**

Pakistan's performance compared to other global players has been favorable. The regulatory agencies are constantly striving to develop Islamic banking as banking of first choice, capable of providing leadership to the global Islamic finance industry and facilitating equitable economic growth.

There have been significant positive developments in Pakistan during the last five years, including growth in the number of institutions and market share; expansion of branch networks; an increase in total assets, deposits and profits; and a decrease in non-performing financing. The growth experience to date has been quite remarkable.

A growing trend of movement towards fixed/term deposits compared to traditional savings accounts shows that customers are now entering into long-term relationships with Islamic financial institutions in Pakistan, evidencing the industry's credibility and reputation.

On the other hand, Islamic banks prefer low-risk modes of financing, i.e. those which usually generate a stable return. Among these, Murabahah (cost plus mutually agreed profit margin), Ijarah (leasing) and diminishing Musharakah are the most attractive and popular modes of financing.

However, lately the share of Mudarabah, Istisnah and Salam has also shown growth at a satisfactory pace, leading towards diversification of the Islamic banks' financing portfolios. In Pakistan, Islamic financial institutions are also very aggressive in the capital markets.

A common view is that the difference in opinion among scholars is a blessing that promotes ultimate progress. The scholars get rewarded for their honest efforts, even if their views turn out to be inappropriate and need to be revisited.

This offers much greater flexibility for Islamic banking transactions. However it also highlights the need for standardization/harmonization of Shariah rulings, especially where cross-jurisdiction acceptability is concerned.

To introduce world class regulations in Pakistan and be part of the global Islamic banking industry, regulators along with Shariah scholars and experienced professionals are constantly coordinating and moving towards integrating the regulations of Islamic finance industry across all areas and sectors of this industry: including banks, Takaful companies, mutual funds and other Shariah compliant institutions.

This creates uniformity in the market and aligns it with international best

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practices, thus making our policies acceptable internationally. Pakistani Shariah scholars are very well known for their contributions in Islamic finance and are positioned in various reputed Islamic financial institutions not only in Pakistan but all over the world.

Bankers view Islamic finance as a major growth area, although they acknowledge that it's not for everyone. Some investments still have no interest-free equivalent or have certain Shariah restrictions: such as derivatives employed by conventional banks for risk reduction, hedging and speculation, and involving forwards/futures, options, and swaps, which may slightly inhibit the sector's growth.

Plus, while profit margins on Shariah compliant products are comparable with interest rates on non-Islamic investments, they often cost more to set up. However at the same time, given a choice, many Muslims do opt for Shariah compliant banking. This may eventually eat into traditional financial services, which is one reason western banks are very active in the Muslim world and are so eager to enhance their Shariah credentials.

Despite several challenges within Islamic finance, it is believed that Islamic banking can grow at a much faster pace than conventional banking. The comforting and encouraging fact is that the Islamic world has collectively launched Islamic finance with a considerable degree of commitment and with adequate capital backing.

In Pakistan, all regulatory agencies and qualified professionals are currently playing a vital role in the development of the Islamic finance industry globally, and the country is becoming one of the main hubs for attracting international Islamic investments.

The 2008 global financial crisis has also precipitated a shift from conventional to Islamic banking. The Islamic industry certainly has funds. Islamic investors are cash-rich and the Sukuk market remains both resilient and relatively stable. Assets held by Muslims, led by Arabs, in all banks - Islamic and otherwise - are growing at a rapid pace, and are likely to see a further significant boost due to volatility in international oil prices.

Similarly western banks, no longer content to leave the market to Islamic lenders, are competing for a slice of the business. Most of them have now trained their staff to provide Islamic mortgages and other products to Shariah-conscious clients.

The Islamic investment opportunities usually available to investors are bank deposits, direct investment in Shariah compliant equities and investment in various categories of Shariah compliant mutual funds.

**“ The industry offers a complete product suite for wholesale, consumer, corporate and SME segments. A few banks are also offering Takaful plans and Islamic credit and debit cards ”**

In Pakistan, besides the above, there is also more to Islamic finance than alternatives to simple products such as home loans, savings, current and term accounts. The industry offers a complete product suite for wholesale, consumer, corporate and SME segments. A few banks are also offering Takaful plans and Islamic credit and debit cards.

In addition, commodity Murabahah, Wakalah, Salam, Musawamah and short-term Sukuk (an Islamic alternative to commercial paper) are also very acceptable in the market. Islamic banks are also very aggressive in foreign exchange and money markets including debt and Sukuk.

The government and corporate sectors in Pakistan have also issued significant medium to long-term maturity Sukuk. Some of the more sophisticated Islamic debt investments include asset-backed

securities. Another product now available is a convertible bond that morphs into shares of Shariah compliant companies at a given strike price.

In Pakistan, Islamic banking and finance has moved into the mainstream. Pakistan has several comparative advantages in the Islamic banking space. We have a large population of over 180 million people with approximately 97% population being Muslim. This provides a huge domestic market base.

However, Pakistan's Islamic banking offering has also received international acceptance, as evidenced by the oversubscription of Sukuk floated in the international market and the number of international investors who have applied for Islamic financing licenses in the country: including multinational banks, investment and Takaful companies.

The Islamic banking system of Pakistan is constantly offering opportunities for financial innovation and flexibility in order to structure different types of financial products. This is also encouraging a shift from a debt-based financial system to an equity-based partnership system.

Islamic finance has the potential to channel wealth through alternative avenues for savings and investments, as well as offering the financial inclusion of devout Muslims. This argues well for establishing Pakistan as a good destination for belief-sensitive foreign direct investment, especially from countries with significant Islamic finance-conscious investors. (2)

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