

# Establishment, Development and Market Sharing of Islamic Banking in Pakistan : An experience of Meezan Islamic Bank

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## Preface :

This study is an analytical overview of Islamic Banking in Pakistan, a special attention or specific reference is opted on the experience of Meezan Islamic Bank ; propagated as Pakistan's first full-fledged and pioneer Islamic Bank. We will analyze and evaluate the measures taken ; both at governmental and non-governmental level, for the transformation of economy, and will allocate the factors involved in the retardation of this transformation. After depicting the response of courts of Pakistan on these measures, we will make an overview of re-launching and establishing measures of Islamic banking in Pakistan. We also observe the development of Islamic banking industry of and market sharing of Meezan Islamic Bank in Pakistan. The sixty years old history is divided into six sections. Section 1 highlights the measures for Islamization in an historical perspective, while section 2 examines the evaluation of these measures and judgments of the courts of Pakistan. In Section 3 we analyze the post judgment measure for the re-launching of Islamic banking, and role of State Bank of Pakistan for the development of Islamic banking, while in section 4 we will examine the performance of Meezan Islamic bank. The followed section 5 describes and highlights the factors supporting Islamic banking in Pakistan. In section 6, we essayed the conclusion of the study and some suggestions regarding the experience of Islamic banking in Pakistan.

## 1 . Historical Perspective of Islamization Efforts

Pakistan got independence from British rule and separated from Indian subcontinent in the name of Islam. The freedom movement (partition from India) of Pakistan was based on the two-nation philosophy, which states that Hindus and Muslims are two different nations each

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nation have different religion, customs and different life style. Pakistan was created so that the people can spend their lives in accordance to Islamic principles and teachings.

While the world is now recognizing the significance of Islamic finance industry, in Pakistan, as early as in 1948, Mr. Muhammad Ali Jinnah (Founder of Pakistan) emphasized the virtues of Islamic principles and in his address at the inauguration of the State Bank of Pakistan (Central bank of the country), he said :

*“I shall watch with keenness the work of your Organization in evolving banking practices compatible with Islamic ideas of social and economic life. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice.”*<sup>1)</sup>

### 1.1 Measure taken at Constitutional Bodies

The first Constituent Assembly, created under the Indian Independence Act 1947 adopted the *Objective Resolution* on 12<sup>th</sup> March 1949. The Objective Resolution envisaged clearly that *“Pakistan will be state wherein the Muslims of Pakistan shall be enabled to order their lives in accordance with the teachings and requirements of Islam as set out in Holy Qur’an and Sunnah”*. Along with the Objective Resolution, the Articles 2, 2A, 31, 37, 38 (F), 227 of the Constitution of 1973 make it obligatory for the government to take steps for enabling the Muslims of Pakistan to order their lives in accordance with the injunctions of Islam.<sup>2)</sup> Other constitutional institutions in the context of introduction of Shari’ah are the Council of Islamic Ideology (CII) and Federal Shariat Court (FSC) of Pakistan. The Council of Islamic Ideology was established in 1962 with the objective to advise the government about the measures for bringing the laws and provisions thereof into conformity with the injunctions of Islam.

In 1976, the Council of Islamic Ideology amended its questionnaire (regarding the doctrine of Interest or *Riba*) of 1966 and mailed it to well-known Islamic Scholars, Islamic Laureates, Economists and Researcher of State Bank of Pakistan and economic organizations of other Muslim countries. This task was incomplete till 1977 when CII was entrusted by the president of Pakistan with the task of preparing a blue print for interest-free economic system. The Council of Islamic Ideology (CII) appointed a Panel of Economists and Bankers in November, 1977 to assist the council in the delicate task of finding the ways and means to eliminate interest from the financial institutions and re-model (Islamize) the Pakistani

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1) M. A. Jinnah. *Speech at the foundation laying stone of the State Bank of Pakistan*, 1<sup>st</sup> July 1948

2) Ayub, M. 2002: 263

economy.<sup>3)</sup> CII submitted a number of reports and made several recommendations to transform the socio-political and economic system into a system confirming to the tenets of *Shari'ah*. Some specific developments around this period are noteworthy:<sup>4)</sup>

1. In 1979, two Government-owned mutual funds, NIT and ICP, started to eliminate interest from their operations by eschewing investment of their funds in interest bearing securities. Investor scheme of ICP was substituted as from 1<sup>st</sup> October 1980, by a new scheme based on profit and loss sharing.
2. The state-run House Building Finance Corporation (HBFC) also started to eliminate interest from its operations from 1<sup>st</sup> July 1979.
3. In June 1980, legal framework was amended to permit issuance of a new, interest-free instrument of corporate financing called Participation Term Certificate (PTC).
4. Introduction of *Zakat* (wealth tax) in June 1980. After implementation through Supreme Court of Pakistan it was called *Zakat* Ordinance.
5. A new law, namely, the *Mudarba* Companies and *Mudarba* Ordinance, 1980 along with the *Mudarba* Companies and *Mudarba* Rules, 1981 was promulgated to introduce *Mudarba*, as a two-tier fund structure, for undertaking Shariah compliant businesses.
6. Introduction of *Usher* (Tithe) Ordinance in March 1983.
7. From 1<sup>st</sup> January 1981, separate interest-free counters started operations in all the nationalized commercial banks to mobilize deposits on profit and loss sharing basis. Concurrently, banks were prohibited from specified interest based transactions, which resulted in development of Islamic modes of financing.
8. SBP issued BCD Circular No. 13 of 1984 that called for elimination of Riba from the banking system and in January 1, 1985 all financing to Federal and Provincial Governments, public sector corporations and public or private joint stock companies was directed to be only through interest-free modes.
9. From 1<sup>st</sup> July 1985 all commercial banking in Pak. Rupees was declared interest free. Resultantly, Profit & Loss sharing (PLS) deposits, as a percentage of total deposits, rose from 9.2% at the end of 1981 to 61.6% by end of 1985.
10. Elimination of interest from the operations of Specialized Financial Institutions from July 1979 to July 1985 and elimination interest from the commercial banks from January 1981 to July 1985. All nationalized commercial banks opened special counter in their 7000 domestic branches for accepting deposits on the basis of Profit and Loss Sharing (PLS) in

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3) Council of Islamic Ideology, 1980 (2002), pp. xiv

4) Hussain, I. 2006 : 75

1981.<sup>5)</sup>

These measures resulted in a country-wide recognition of Islamic banking. However, the premature and sudden conversion of banking system to Islamic system coupled with the lack of preparedness and understanding among financial institutions and public posed difficulty in implementation. The Federal *Shariat* Court challenged some emerging products and processes and declared them un-Islamic. The Shariat Appellate Bench of the Supreme Court upheld the decision of the Federal Shariat Court and offered guidelines to address the issues involved, setting a timeline for implementation. All Commercial banks were obliged to transform their nomenclature during January 1981 to June 1985 according to 12 modes, prescribed by SBP. From 1<sup>st</sup> July 1985, for all banking companies it was prohibited to accept Interest-bearing deposits except foreign currency deposits and all commercial banking in Pak Rupees was declared interest-free. However, foreign currency in Pakistan and on lending of foreign loans continued as before. However the Federal Shariat Court (FSC) declared this procedure un-Islamic in November 1991.<sup>6)</sup>

Another measure for the development of Islamization process at constitutional front was the introduction of *Shariat Bill*, and the establishment of Islamization Commission. Due to this commission's lack of enthusiastic diligence towards the reformation of Islamic economic system, the president of the country dismissed this commission along with the government of that time and set up the "Permanent Commission on Islamization of Economy" in 1988.<sup>7)</sup> However, this commission too could not work in accordance to its mission. Political change in the country was being considered the main reason behind the failure of this commission. Again, in pursuance of the enforcement of *Shariat Act* 1991, another "Commission for the Islamization of Economy" was set up in July 1991 under the Chairmanship of the Governor of State Bank of Pakistan. The commission was assigned the responsibility to recommend measures and suitable alternatives to interest based transactions, by which the economic and banking system could be Islamized.

## 1.2 Measures taken at State Bank of Pakistan

During the first decade of the establishment of State Bank of Pakistan, no substantive research work could be done for the promotion or development of Islamic economy.<sup>8)</sup> There was

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5) Zaidi, N. A. 1988 : 23. Also see in Zubair I. and Abbas M. 1987 : 15

6) State Bank of Pakistan, "Annual Report", 2001-2002 : 190

7) Ayub M., 2002 : 262

no economist in the country that was well acquainted with both the basic principles of Islamic fiqh and the contemporary economics.<sup>9)</sup> In 1963, the state bank prepared a comprehensive note for the benefit of the Council of Islamic Ideology (CII) on the various issues related to the problem of Riba. The council gave its views in 1969, stating that the modern “interest” falls in the Riba and was therefore must be abolished from the banking and financial institutions.<sup>10)</sup> In 1978, the Islamic Economics Division of State Bank of Pakistan had completed an in-depth study of various ingredients of the Islamic financial system including Mudarba, Shirkah, Salam, Murabaha, Zakat & Usher and other related issues. The Division practically served as a hub of the national effort in chalking out an overarching scheme of financial system compliant with Shariah principles. It serves as secretariat of the meetings of the Council of Islamic Ideology (CII), Panel of Economists and Bankers, and the six Working Groups that were entrusted the job of working out details for the transforming the financial system.

(a) Formation of working groups at State Bank

In a meeting on the April 8<sup>th</sup> 1979, six working groups were formed to study in-depth the issues for the abolition of Riba and to transform the financial institutions. These Working Groups were to cover the following fields of finance :

- (1) Government Transactions.
- (2) State Bank of Pakistan : Domestic Transactions and Bank Monetary Policy.
- (3) Bank Deposits, Inter-Bank Relations and Bank management.
- (4) Loans for Fixed Investment in Industry, Agriculture, Construction, etc.
- (5) Financing of Working Capital Requirements.
- (6) Co-operative Credit System.

In February 1980, the Panel of Economists and Bankers, established under the supervision of State Bank of Pakistan, gave its detailed final report which was submitted to the government, through the CII, in June 1980. This report prescribed, *inter alia*, a time frame according to which the process of elimination of interest in Pakistan was to complete by July, 1982.<sup>11)</sup>

(b) Permissible Modes of Finance

For conducting Islamic banking operations in practice, State Bank of Pakistan vides its circu-

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8) State Bank of Pakistan, “Annual Report”, 2000 : 609

9) Ibid.

10) Ibid : 610

11) Ibid : 615

lar No. 13; dated June 20<sup>th</sup> 1984 and approved the following twelve modes of finance to be used by all banks carrying a banking business in Pakistan. These financial techniques or modes can be classified into three categories :

A. Trade Related/Type Modes of Financing

1. Mark-Up/Cost plus Sale, 2. Mark-Down, 3. Buy-Back, 4. Leasing,
5. Hire-Purchase, 6. Development Charges

B. Investment related/Type Modes of Financing

1. *Musharka*, 2. Equity Participation, 3. Participation Term Certificate (PTCs),
4. Rent Sharing

C. Loan related modes OR Financing by Lending

1. Loans Carrying Service Charges, 2. *Qard-ul-Hasan* (Beneficiary Loan)

### 1.3 Implication of above modes of Finance and Practices of Conventional Banks

The council of Islamic Ideology has pointed out that the ideal alternatives to interest in an Islamic economic system are *Musharka* and *Mudarba* (participation in profit and loss) modes of finance along with the *Qard-ul-Hasan*. However, keeping in view the difficulties in the practical application of the system of profit and loss sharing in certain spheres it had endorsed the recommendations of the Panel of Economists and Bankers those certain other modes like leasing, hire purchase, Bai Muajjal financing on the basis of actual operating results may also be used in interest-free banking operations, and with cautioning against the danger that these modes could be misused as a means for opening a back door for interest as pointed out by Siddiqi in his book *Banking without interest* (1988). Evaluating the present conventional banking system in terms of its Islamicity the following borne out that :

1. Interest-free counters were operating on the previous interest bearing basis.
2. Deposits received were used on the basis of "Mark-up and Mark-up over Mark-up" that is similar to interest.
3. Saving Schemes (e.g. Special Deposits, National Certificates, Monthly Income Certificates, Participatory Term Certificate, etc.) based on interest were more attractive than interest-free approaches of investment.
4. A number of features of *Musharka* agreement also were conflict to Shariah.
5. Interest has been labeled as 'Profit' by the financial institutes. And the depositors under the Profit and Loss Sharing (PLS) were neither informed in which venture their money have been invested, nor any separate balance sheet of their accounts was pre-

pared. The method of calculation of profit on PLS accounts was also not indicated. On the analogy of interest bearing accounts, a greater margin of “profit” is offered on deposits of longer duration.<sup>12)</sup>

The underlying principle behind the opening of Separate Interest-free counters in banks besides or along with interest bearing counters is itself objectionable as it tends to give the impression the Riba is something which is to be avoided by only the pious Muslims who may conduct business from the interest-free counters whereas the illegality of Riba is applicable to all the Muslims without the degree of piouness.

It also transpires from the experience of banks that banks provide more than 80% of the financing under the Buy-Back agreement with mark-up in price.<sup>13)</sup> The mechanism of conducting mark-up transaction is similar to that followed under the interest based system. It is unfortunate to note that despite the fact that mark-up as a device was to be used in unavoidable cases, has been made the pivot of the new arrangements. It is also important to note, that the government is still mobilizing resources from the public through National Saving Scheme on fixed return basis by changing the name of return from interest to profit. One can easily infer from the experience of non-interest banking system in Pakistan that other than change in name (the term interest is merely replaced with profit) the essences has remained similar to interest-based banking in government owned conventional banks in Pakistan.<sup>14)</sup> The steps taken by the government for the elimination of interest from the country’s economy proved to be spotty and uneven. In the word of Justice Tanzilulrehman, (Chairman of CII) :

*“ . . . the whole approach was characterised by dualism and half heartedness.”<sup>15)</sup>*

## 2. Judgments of Federal Shariat and Supreme Courts of Pakistan on the Practices of Conventional Banks

The procedures adopted by banks in July 1985, based largely on a ‘mark-up’ technique with or without ‘buy-back arrangement,’ were eventually declared un-Islamic by the Federal Shariat Court (FSC) in a judgment in November 1991.

The government appealed the ruling with the Shariat Appellate Bench (SAB) of the Supreme

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12) Rahman, T. 1997 : 8

13) Inayat, N. 1993 : 43

14) Ibid.

15) Rahman, T. 1997 : 7

Court of Pakistan. But Supreme Court of Pakistan in its historic judgment on December 23, 1999, rejected the government appeals and asked it to remove all laws involving interest before June 30, 2001. The Court declared many of prescribed modes of investment and finance designed by SBP, and the practices of the commercial banks by using these modes as un-Islamic. The judgment of the court concluded that :

1. All prevailing forms of interest, either in banking transactions or in private transactions falls with in the definition of Riba.
2. Any interest stipulated in government borrowings acquired from domestic or foreign sources are Riba and clearly prohibited by the Holy Quran.
3. The Present financial system, based on interest, is against the injunctions of Islam as laid down by the Holy Quran and Sunnah, and in order to bring it in conformity with Shariah, it has to be subjected to radical changes.<sup>16)</sup>

The court said that the present financial system had to be subjected to radical changes to bring it into conformity with the Shariah. It also asked the government to set up, within a specified time frame, a Commission for Transformation of Financial System (CTFS) and two task forces to plan and implement the process of the transformation. Thus, the CTFS were constituted in January 2000 by the SBP under the Chairmanship of Mr. I. A. Hanfi, a former governor of the SBP. A task force was set up in the Ministry of Finance to suggest ways in which interest could be eliminated from government financial transactions. Another task force was set up in the Ministry of Law to suggest amendments to the legal framework to implement the court's judgment. But the government, through a public sector bank, went to court asking for an extension of the date by 2006. The court gave only one year extension to its earlier deadline of 30<sup>th</sup> June 2001.

The Islamization of economy efforts received a serious blow when on 21<sup>st</sup> June 2002, on a review petition by United Bank Limited (UBL), the Supreme Court's *Shariat* Applet Bench set aside all the previous judgments in this regard, including its own historic decision of 23<sup>rd</sup> December 1999, and the decision of the Federal Shariat Court of 14<sup>th</sup> November 1991. The *Shariat* Applets Bench (SAB) of the Supreme Court asked the FSC to re-hear the original case. Since then, the case has been lying in a long queue of cases. Hence, a new turn came in the transformation of banking and financial institutions of Pakistan, which later foster the State Bank and other authorities to chalk out the strategy to alter the present practice of the financial institutions. The commandments and views of Holy *Qur'an* on the prohibition of

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16) *Shariat Law Reports* PLD publishers Lahore 2000 : 468 ; also in Usmani, T. M. 2000 : 160

*Riba* are clear and unequivocal. The constitution of Pakistan 1973, in its article 227 providing that all existing laws shall be brought in conformity with the injunctions of Islamic as laid down in the Holy *Qur'an* and *Sunnah*. Article 37 of the same (1973) constitution deals with the Principle of Policy states that it is the duty of State to eliminate *Riba* early as possible. There is complete unanimity among all schools of religious thought that term *Riba* covers interest in all its manifestation.

Supreme Court declared that all interest-bearing transactions are in contrary to the injunction of Islam and laws involving interest would cease to have effect until 30<sup>th</sup> June 2001. However *Shariat* Appellate Bench gave exemption for dealing with foreign parties on the basis of interest. The government constituted a high level commission and number of tasks forces and committee to study the prospects of transformation of financial system from interest based to Shari'ah compliant and to lay out the transformation plan. However the conclusion came into obvious that the transformation of the financial system as a whole was not possible in short term due to variety of factors. Complex network branch network of national, foreign and state-owned and private commercial banks along-with the absence of committed and sustained efforts, and lack of genuine support from the different segments of society made this transformation unsuccessful.<sup>17)</sup> Developing a successful, practicable and complete model of Islamic banking was complex and difficult task for the government, especially in the case a developing country. Therefore, it was decided to promote Islamic banking on parallel basis with conventional banking system in the year 2001.

## 2.1 Evaluation of Islamization efforts and their implications prior to the Supreme Court's Judgment

The Islamization of banking and Financial Institutions process suffered a serious retardation in August 1985, when banks were allowed to invest their Profit&Loss Sharing (PLS) deposits in interest-bearing government securities. The ultimate earnings from these investments (PLS deposits) obviously contains substantial element of interest. Since 1984-85, government has not pronounced any policy regarding the elimination of interest from the governmental transactions.

Second serious weakness in this process was the absence of proper constitutional mechanism (SBP started took serious steps towards the development of Islamic banking from year 2001) for continues observation of Shariah compliances, security of bank/customer relationship and

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17) Mansoor and Bhatti, 2006 : 146

legislative supervision of Islamic Banking operations. Individual scholars have pointed out several deviations in Musharka and Diminishing Musharka mode of finance, where the actual banking practices shows deviations from Shariah compliances.<sup>18)</sup> In the sound idea of issuance Participatory Term Certificates (PTCs), no legislative framework was provided for standardizing the features of this financial instrument according to the Shariah compliances. The CII report had provided a broad outline of the feature of such financial institutions but the actual form in which PTCs have been issued does not fully confirm to the suggested outline.<sup>19)</sup>

Among the 12 allowed modes of financing, 'Mark-up' is the most popular, which takes two forms; (a) a client approaches to the bank and ask to purchase a certain good for him, the bank purchase and sell it to the client at higher price payable in future; (b) the buyer pays back the agreed price in installments and the transaction comes to an end. The second form of above transaction, where the buyer pays an agreed price, involves a buy-back (interest-based) agreement. There was no corresponding change either in the legal or regulatory framework of bank; no consequent or bank operations were changed. The only change was superficial a merely change in nomenclature, the term "*Interest*" was replaced by the term "*Service Charges, Mark-up or Profit*".<sup>20)</sup>

The Shariah scholars and Federal Shariat Court have criticized the above practice. Though the *Mudarba* and *Musharka* are the ideal substitutes for interest, no special policies (efforts) have been made to adopt these modes into the financial transactions.

## 2.2 Factors involved in the retardation of Islamization Process in Pakistan

After scrutinized the Islamization process of Banking and Financial institutions of Pakistan several reasons can be summed up in the following order :

### 1. The Government Administration

The significance of government's to establish and success of new Banking and financial system cannot be underestimated. Thought the efforts of Islamization of the economy were initially started under the constitutional umbrella, but the constitutional authorities (government) never persuade the implications of these efforts seriously. On the one side the government took initial suppression and subsequent emergence of Islamic law in Pakistan in superior

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18) Ibid : 73

19) Ibid : 73

20) Tariq, H., 2002. 05. 04

courts and declared on 10<sup>th</sup> February 1979, that the enforcement of interest-free Islamic economic system will be completed in next three year time, but it was the same government who on 25<sup>th</sup> June 1980 excluded the jurisdiction of Federal Shariah Court for a period of three years for entertaining any petition to consider the fiscal issues including bank interest. The deprivation of jurisdiction to Shariah Court was subsequently extended twice by one year each. Again on 2<sup>nd</sup> March 1985, the late president of Pakistan promulgated the President's Order No. 14 of 1985 whereby this period was extended by 10 years.

It is note worthy that neither the government nor the central bank of the country (SBP) provided strong leadership to motivate the bank and other financial institutions to take bold initiative to get rid from the traditional interest-based banking.

## 2. Absence of Authentic political Support

Provision of Islamic way of life to its citizens and establishment of Islamic economic and societal environment is the constitutional and legal responsibility of the government of Pakistan. With the exception of establishing the Council of Islamic Ideology, government did not devise any brisk policy for the Islamization of economy. On the one hand government assure its intention to eliminate interest from the economy, but on the other hand, it put ten year ban (1980-90) on the FSC to issue any verdict against the interest based transaction.<sup>21)</sup> The later government headed by Mr. Nawaz Sharif also had the similar attitude except establishing the Commission of Islamization of Economy (CIE) in June 1991 to promote Islamic Banking. However it challenged the 1991 FSC judgment on Riba in the Supreme Court. The government contended the bank interest is not Riba and it is utterly impossible to run economy without interest in present day circumstances.<sup>22)</sup>

## 3. Lack of Professional Management in Central Bank of Pakistan

The problem of developing alternative techniques for interest-based banking, without any dislocation or chaos, is a very sophisticated job thus requires a long term planning and sustained efforts. Having seen no genuine interest from the government, the SBP did not take pains to devise any prudent policy for adopting interest-free financial system. It did not establish any internal Islamic Shariah board (until year 2001) for seeking guidance on Islamization policies. It did not take any serious measures for providing proper training to bankers on adopting the interest-free banking.

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21) FSC Judgment on Riba 1991 (Presidential Order No. 14, 1985)

22) Mansoor and Bhatti, 2006 : 146

### 3. Post Judgment Measures taken for the re-Launching of Islamic Banking

Since the measures took for the transformation of state owned banks from conventional to Islamic discipline could not matured, it was decided to establish an independent statutory body for this purpose. The Commission for Transformation of Financial System (CTFS) was constituted in January 2000 in the State bank of Pakistan.<sup>23)</sup> A task force was set up in the Ministry of Finance to suggest the ways to eliminate interest from government financial transactions. Another Task Force was set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CTFS constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system. The first Interim Report of the CTFS submitted in October 2000 identified a number of prior actions, which were needed to be taken to prepare the ground for transformation of the financial system. The second Interim Report submitted in May, 2001 identified major Shariah compliant modes of financing, their essentials, draft seminal law captioned 'Islamization of Financial Transactions Ordinance, 2001', model agreements for major modes of financing, and guidelines for conversion of products and services of banks and financial institutions. While the final report, by joining together the above two reports, was sent to the Government in August 2001.<sup>24)</sup> The Commission also dealt with major products of banks and financial institutions, both for assets and liabilities side, like letters of credit or guarantee, bills of exchange, Term Finance Certificates (TFCs), State Bank's Refinance Schemes, Credit Cards, Interbank transactions, underwriting, foreign currency forward cover and various kinds of bank accounts. The Report contained recommendation for forestalling willful default and safeguarding interest of the banks, depositors and the clients. According to the Commission, prior/preparatory works for introduction of Shariah compliant financial system briefly included creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and training program for bankers and their clients and an effective campaign through media for the general public to create awareness about the Islamic financial system.

#### 3.1 Measures taken by the Finance Ministry

The Finance Minister in his budget speech for the fiscal year 2002, declared that :

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23) State Bank of Pakistan, *Annual Report* Fiscal Year 2002 : 192

24) Ibid : 192

“Government is committed to eliminate Riba and promote Islamic banking in the country”. For this purpose following measure were taken:<sup>25)</sup>

1. A legal framework is designed to encourage practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations ;
2. Consultations and exchanges are undertaken with brother Islamic countries and renowned institutions of Islamic learning such as Middle Eastern countries and Al-Azhar University of Egypt, to learn more about their experiences and practices ;
3. Amendments in HBFC Act are being made in line with the directive of the Supreme Court. With these changes, HBFC would be fully Shariah compliant institution, which will play an effective role both in promotion of Islamic financing method but also in the development of the important housing sector ;
4. Shariah compliant modes of financing like Musharaka and Mudaraba will be encouraged so that familiarity and use of such products is enhanced and their adoption at a wider scale made possible.
5. The transformation commission established in the State Bank of Pakistan will continue to function and its recommendations whenever finalized will be considered by the government for appropriate action.

It is government’s intention to promote Islamic banking in the country keeping in view its linkages with the global economy and existing commitments to local and foreign investors. A Committee was constituted in the Institute of Chartered Accountants, Pakistan (ICAP) for the development of accounting and auditing standards for Islamic modes of financing.<sup>26)</sup> The Committee is reviewing the standards prepared by the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) with a view to adapt them to our circumstances and if considered necessary, to propose new accounting standards. The State Bank has also reviewed its forms of financial statements for banks in the light of AAOIFI standards. A new Islamic Banking Division has been established in Banking Policy Department of SBP for regulation and promotion of Islamic banking. Existing prudential regulations for banks have been reviewed by SBP for their application on Islamic banks.

### 3.2 Measures taken by S. B. P

Valuable experience and lessons learned by the policy makers and the industry helped in the

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25) Finance Minister’s Budget Speech of Fiscal Year 2002

26) State Bank of Pakistan, *Annual Report* Fiscal Year 2002 : 192

re-launch of Islamic banking in Pakistan. In recent years, a notable element of SBP's financial sector strategy was the introduction of Islamic Banking Policy in December 2001. Under this policy, Islamic banking is being promoted in parallel to the development of conventional finance industry in an integrated, gradual and steady manner.

It was decided that the shifting towards interest free economy would be made in a gradual order without causing any disruptions. State Bank of Pakistan took the initial steps and adopted following strategy to promote Islamic Banking in Pakistan:<sup>27)</sup>

1. Permission (license) for the establishment of Islamic banks in the private sector SBP issued a detailed criteria for obtaining the permission (license) for the establishment of new scheduled Islamic Commercial Bank for conducting business based on the principles of *Shariah* in the private sector;
2. Permission for setting up subsidiaries for Islamic Banking by existing commercial Banks In order to promote Islamic Banking, the existing scheduled commercial banks were allowed to open subsidiaries for Islamic banking operations; and
3. Allowing stand-alone branches for Islamic banking in the existing commercial banks With the objective of promoting Islamic banking SBP prepared a detailed guideline for the opening of Stand-alone Islamic Banking branch by existing commercial banks.

Furthermore, SBP took following initiatives since the judgment:<sup>28)</sup>

1. A detailed set of criteria for establishment of Islamic commercial banks in the private sector was issued in December 2001.
2. A License was given to Meezan bank limited for conducting banking business according to *Shari'ah* compliances.
3. In order to allow existing banks to set up subsidiaries for Islamic banking, amendments in section 23 of banking companies ordinance of 1962 were made and submitted to Government for approval.
4. A new Islamic banking division was established in the Banking Policy Department for regulation and promotion of Islamic banking.
5. Existing prudential regulations have been reviewed by SBP for their application on Islamic banks and revised regulations are being prepared.
6. Export finance scheme of SBP is being revised in accordance to *Musharaka* rules.
7. Courses on Islamic economics, banking and finance have been included in the curricula of the institute of bankers in Pakistan.

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27) SBP. *Policies for the Promotion of Islamic Banking*, in Annual Report 2001-2002: 194

28) Ibid.

8. International Islamic university Islamabad has conducted a training course for trainers on Islamic financial system in April 2002. SBP staff along with staff of other banks attended the course.
9. SBP has reviewed its forms of financial statements for banks in the light of newly developed accounting standards.
10. A *Shari'ah* board, comprising two *Shari'ah* scholars and three experts in the profession of banking accounting and legal framework, was established in the SBP to advice about the modes, procedures, laws and regulations for Islamic banking in accordance of *Shari'ah* compliance.

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

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

### 3.3 Present Picture of the Islamic Banking in Pakistan

At present there are six full-fledged Islamic Banks and 13 conventional banks conducting Islamic banking in Pakistan. The names of these banks are: Meezan Islamic Bank, AlBaraka Islamic Bank, Dubai Islamic Bank, Bank Islami Pakistan Limited, Emirates Global Islamic Bank Limited and First Dawood Islamic Bank. According to the quarterly report of State Bank of Pakistan, the total assets of these Islamic Banks now stands PRS 136 billion, the assets growth rate of Islamic banks is estimated 10.5% over the period.<sup>29)</sup> The assets share of Islamic banking in overall banking system is estimated 3.2% at present. Total of number of Islamic

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29) State Bank of Pakistan, "Quarterly report", July, 2007.

**Table 1** Name of Islamic banks and number of Islamic banking branches in Pakistan

Name of bank	Category	No. Branches
AlBaraka Islamic Bank	Islamic Bank	11
Bank Islami Pakistan Limited	”	13
Dubai Islamic Bank Pakistan	”	15
Emirates Global Islamic Bank	”	6
First Dawood Islamic Bank	”	1
Meezan Islamic Bank	”	69
<b>Total</b>	<b>A=6</b>	<b>115</b>
1. Askari Commercial Bank	Conventional Bank	6
2. ABN AMRO Bank Limited	”	1
3. Bank Al-Habib	”	3
4. Bank Al-Falah	”	23
5. Bank of Khyber	”	5
6. Habib Bank Metropolitan	”	4
7. Habib Bank Limited	”	1
8. MCB Bank Limited	”	6
9. National Bank of Pakistan	”	1
10. Prime Commercial Bank Limited	”	2
11. Soneri Bank Limited	”	2
12. Standard Chartered Bank	”	3
13. United Bank Limited	”	1
<b>Total</b>	<b>B=13</b>	<b>58</b>
<b>Total</b>	<b>A+B=19</b>	<b>173</b>

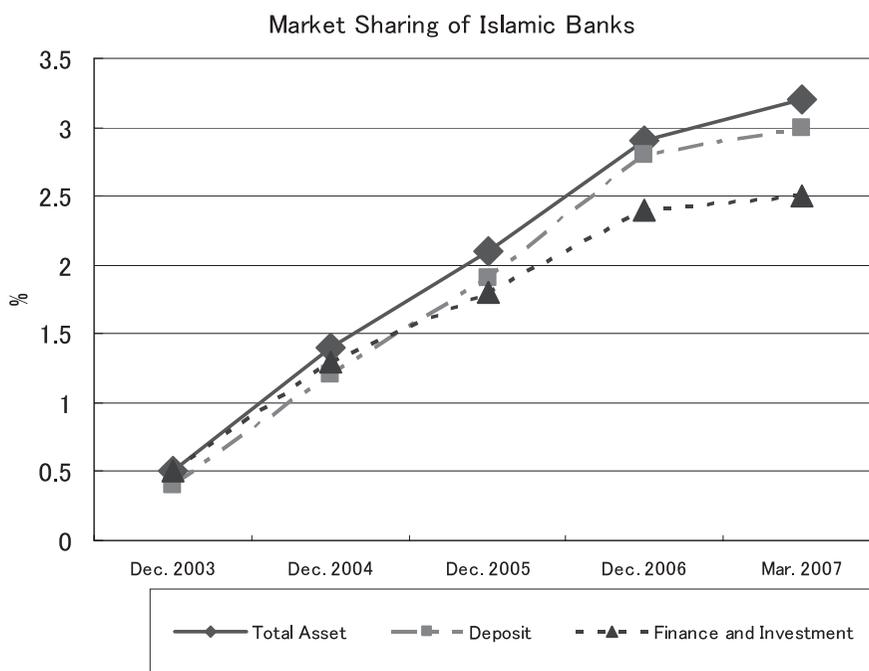
Source : State Bank of Pakistan Quarterly Report July, 2007.

**Table 2** Progress of Islamic Banking Industry and its growth of market share in Pakistan

(Pak Rupees in Billion)

Description	March-07	Dec-06	Dec-05	Dec-04	Dec-03
Total Assets	136	118	72	44	13
% Of Banking Industry	3.2	2.9	2.1	1.4	0.5
Deposits	93	83	50	30	8
% Of Banking Industry	3.0	2.8	1.9	1.2	0.4
Finance & Investment	78	72	48	30	10
% Of Banking Industry	2.5	2.4	1.8	1.3	0.5

Source : State Bank of Pakistan quarterly report July. 2007



Growth of Market Sharing of Islamic Banks in Pakistan

banking branches at Islamic banks and conventional banks rose up to 173.

#### 4. Establishment of Meezan Islamic Bank and Its contribution for the development of Islamic Banking in Pakistan

Meezan Bank Limited was a publicly listed company incorporated on 27<sup>th</sup> January 1997, as Meezan *Mudarba* Company. It started its operations as an Islamic investment bank in August of the same year. 2002, the *Shari'ah* Supervisory Board was established at Al-Meezan investment Bank led by Justice Taqi Usmani. On 31<sup>st</sup> January, 2002 Meezan Bank was granted the Nations first full-fledged commercial banking license by the State Bank of Pakistan. As the result of SBP7s dedication for the development of Islamic Banking in Pakistan, State Bank of Pakistan issued the first Islamic commercial banking license to Meezan Bank in 2002. Since its modest beginning in 2002 Meezan Islamic Bank has witnessed a tremendous growth in all segments, e.g., demand, acceptance, and development. Soon after obtaining the license, Meezan Islamic bank became the core component of the country's Islamic Banking & Financial market and is pioneer and leading Islamic bank in the country. The bank stands today at

a noteworthy point along the evolution of Islamic Banking in Pakistan. The whole Islamic banking sector now showing a significant paradigm shift away from traditional means of business. Meezan Bank bears the critical responsibility of leading the way forward in establishing a stable and dynamic Islamic Banking system in the country.

In 2003, SBP in coordination with Meezan bank designed a *Musharaka*-based Export Refinance Scheme in order to provide export finance to eligible exporters on the basis of Islamic modes. Efforts are underway to develop Islamic money market instruments like *Ijarah Sukuk* to facilitate the banks in respect of liquidity.

Pakistan's first *Shari'ah* compliant mortgage facility was launched by Meezan Bank. After approved, by the *Shari'ah* supervisory board, the product enables home purchase, home construction, renovation, as well as replacement of any existing mortgage. Al Meezan Investment Management Limited (AMIM), a group company of Meezan Bank, introduces Meezan Islamic Fund (MIF). MIF is an open-end mutual fund that is *Shari'ah* compliant. Meezan Bank's asset management arm, Al Meezan Investment Management Limited (AMIM), launches the Meezan Balance Fund (MBF).

In March 2005, to provide further strengthen and to ensure strict Shariah compliance in bank's operation a full fledged Product Development & Shariah Compliance (PDSC) department was formally setup in Meezan Bank. The role of this research department is the centralization of Product development activities; to develop new Shariah based products, Islamic banking training and Shariah Compliance functions. The department works under the guidance & supervision of bank's Shariah Advisory team. PDSC now plays a very critical and vital role at the bank by actively supporting new product development activities, refining existing products menu, preparing product policies & standardize agreements, imparting Islamic banking knowledge at various levels to new & existing staff members, corporate customers and general public, coordinating with bank's Shariah Board, conducting regular Shariah audits & reviews

During 2005, Meezan Bank launches the Meezan Islamic Institution Deposit Account (MIIDA), a unique product tailored exclusively for Islamic Financial Institutions (IFIs). The facility is the first of its kind in Pakistan, whereby Islamic Banks (including dedicated, as well as conventional Islamic windows) now have the opportunity to manage excess liquidity by maintaining a checking account with Meezan Bank specifically designed for this purpose. Meezan Bank becomes the first customer of Islamic Insurance (*Takaful*) by signing the first Memorandum of Understanding MoU with Pak Kuwait Takaful Company Limited (PKTCL). The signing of this MoU has ushered Pakistan into a new era of Islamic Insurance (*Takaful*).

## Vision

The vision of Meezan Islamic banks is to establish Islamic banking as banking of first choice to facilitate the implementation of an equitable economic system, providing a strong foundation for establishing a fair and just society for mankind.

## Mission

To be a premier Islamic bank, offering a one-stop shop for innovative value added products and services to our customers within the bounds of Shariah, while optimizing the stakeholders value through an organizational culture based on learning, fairness, respect for individual enterprise and performance.

### 4.1 Functions and Services offered by Meezan Islamic Bank

- Personal Banking and Finance
- Corporate Finance
- Commercial Finance
- Structured Finance
- Treasury
- Car Ijarah - Car Financing
- Easy Home - Home Financing
- Asset Management

### 4.2 *Shari'ah* Supervisory Council

With the establishment of Meezan Islamic Bank in 2003, the bank also set up its own *Shari'ah* advisory council to supervise its operations with respect to their compliance with *Shari'ah*. Product Development & *Shari'ah* Compliance (PDSC) is one of the important departments of the bank that reflects strong commitment of the bank towards Islamic banking and research. PDSC works directly under the supervision of bank's *Shari'ah* advisor. The function is vital in ensuring strict *Shari'ah* compliance in all area of bank's operations. PDSC role is manifold and comprises of facilitating new Product Development activities, refining existing products & procedures, providing Islamic Banking training to new recruits and existing staff members, conducting regular *Shari'ah* Audit & reviews of branches & departments, coordinating with Bank's *Shari'ah* board and providing Islamic Banking advisory services to local and foreign financial institutions. In product development, the bank has initiated Islamic *Sukuk* transac-

tions, and developed a new investment avenue of local commodity *Murabaha* to manage excess liquidity. The bank is also conducting research on several new Islamic products in the areas of consumer, corporate & retail banking level. PDSC has played a vital role in imparting Islamic banking training to bank employees, customers, scholars throughout Pakistan. The department regularly carries out training sessions ranging from basic to in-depth specialized workshops. During the year 2006, a comprehensive Islamic Banker Certification (IBC) program was introduced in Pakistan. The bank has also provided product development advisory services to different financial institutions interested in offering Islamic banking products & services around the world via its research department. The main objective of Meezan bank's advisory function is to help financial institutions for developing Islamic banking products by sharing the experience and research.

#### 4.3 Islamic Investment & Financial products and services of Meezan Bank

The development of various Islamic banking products and services is critical to ensure that the Islamic Financial system can stay competitive to modern conventional banks. With an aim to be equally viable the range and nature of Islamic investment modes or products should reflect this goal. Meezan Bank offers a vast range of Islamic investment and financial products to meet the various financial needs of Muslims and non-Muslims of the country. These modes and products can be classified into followings categories :

##### Deposits

- Rupees Current (Saving) Account
- Foreign Currency (US Dollar) Savings Account
- Karobari Munafa (Business Profit) Account
- Islamic Investment Certificate
- Meezan Amdan (Income) Certificate
- Monthly Mudarba Certificate
- Meezan Bachat (Saving) Account
- Meezan Providence Certificate

##### Investment

- Musharka
- Istisna
- Ijarah
- Murabaha

Salam

#### Financing

Murabaha Financing

Ijarah Financing

Export refinancing

Musharkah Financing

Diminishing Musharkah

#### Other Services

Zakat Collection

Qarzul Hasan

Letter of Credit

Letter of Guarantee

Issuance of Sukook

Foreign Currency dealings

#### 4.4 Growth and development of Meezan Bank

Since its establishment Meezan Islamic Bank showed a continue growth, which is reflected both in financial terms and in branch network. Starting from one branch in 2003, Meezan Islamic Bank now has 75 branches as on September 2007. As on September 2007 the bank's total assets were more than Sixty Four Billion Rupees, which stood more than 50% of the total Islamic Banking industries of the Pakistan. The total assets growth rate of the Meezan bank is more than 65% as compared to 61% of total Islamic banking industry of Pakistan.

#### 5. Factors Supporting the Development of Islamic Banking in Pakistan

After reviewing the Islamic Banking in Pakistan following factors can be summed up :

##### 1. Decentralization of Administrative Power

The adaptation of market economy and decentralization or privatization of loss running state owned financial enterprises and the task of establishing Islamic banks was transformed to State Bank of Pakistan. State Bank of Pakistan took the initiative strategies to launch Islamic banking at gradual phases. The emphasis was on the establishment of new full-fledged Islamic banks rather than transformation of existing conventional banks toward interest-free. Since the year 2000, SBP is following various strategies to promote

Islamic Banking such as; (a) establishing independent Islamic bank, Islamic banking branch or subsidiary of existing commercial banks; (b) Formation of Islamic banking division at State Bank of Pakistan and; (c) Establishment of *Shari'ah* scholar board at State Bank of Pakistan. All these above measures imparted a positive impact on the development and effective working of Islamic banking.

## 2. Religious Background of the Pakistan's Population and Revival of Islamic Values

Pakistan is a Muslim state, which came into exist in the name of Islam. 97% of 159 million inhabitants of Pakistan are Muslim. These people adheres Islam as their religion and code of life, and are reluctant to Islamic believes and teachings. Islam prevents its believers from interest-bearing dealings; therefore Muslim of the Pakistan needed such institutions that provide them banking facilities according to their religious commands. Islamic revival movement is gaining popularity worldwide today - a revival aiming to rebuild the individual and society and recompose the nation's thought and politics based on Islam - is making progress. The Islamic movement has been able to discover new areas in economics, philosophy, and politics. Today Islam is progressing rapidly while secularism is falling. While Islam attracts people who are looking for justice, secularism is loosing major footholds and has lost its ability to defend itself except by violence. Islam is progressing both vertically and horizontally, its idea deepens daily, spreading to all fields such as politics, economics, art, human resource development, and institution building. Same trend is being seen in Pakistan; people prefer Islamic banks over conventional because of these banks' commitment to Islam.

## 3. Commendable Progress of Pakistani Economy after the year 2000.

Despite a series of domestic and external shocks of unprecedented nature, Pakistani economy has made commendable progress after the year 2000. It is well-established fact that the decade of 1990s was lost decade for Pakistan. While many developing countries made substantial economic progress Pakistan lurched from one economic crisis to another mainly of its own making.<sup>30)</sup> Commercial banks and other financial institutions became the instruments of political patronage and profit for certain sub-section of society. Average economic growth was between 3-4% per annum. During the years 2000-2005 the average economic growth rose up to 7-8% per annum. Depth and efficiency of financial intermediation in Pakistan has improved. Bank assets to GDP ratio rose from 49.1% in 1997 to 55.6% in 2005 and deposit to GDP ratio — an indicator of the level of financial

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30) Ashfaq, H. Khan, "Pakistan Observer" 2004-08-28

savings-rose from 38.7% in 1997 to 43.1% in 2005. More significantly, equity market capitalization grew from merely 10.3% of GDP in 2000 to 37.1% of GDP in 2006.

#### 4. Success of Islamic or Religious Political Parties

Soon after the independence, The Ulema (Religious leaders Or Muslim Scholars) did not wait long to demand their share of power in running of new state. Jamat-i-Islami made the achievement of an Islamic Constitution its central goal.<sup>31)</sup>

In February 1948, Maulana Maududi, while addressing the law College Lahore, demanded that the Constitution Assembly should unequivocally declare that :

- 1 . The sovereignty of the state of Pakistan vests in *Allah* and the government of Pakistan shall be only an agent to execute the Sovereignty's Will.
- 2 . The Islamic *Shari'ah* shall form the inviolable basic code for all legislation in Pakistan.
- 3 . All existing or future legislation which may contravene, whether in letter or in spirit, the Islamic Shariah shall be null and void and be considered ultra vires of the constitution ; and
- 4 . The powers of the government of Pakistan shall be derived from circumscribed by and exercised within the limits of the Islamic *Shari'ah* alone.

On 13<sup>th</sup> January 1948, *Jamiat-al-Ulema-i-Islam*, led by Maulana Shabbir Ahmad Usmani, passed a resolution in Karachi demanding that the government appoint a leading *Alim* (scholar) to the office of *Shaikh al Islam* (the leading scholar of Islam) with appropriate ministerial and executive powers over the qadis throughout the country. On 9<sup>th</sup> February 1948, Maulana Shabbir Ahmad Usmani, addressing the *Ulema-i-Islam* conference in Dacca, demanded that the Constituent Assembly "*should set up a committee consisting of eminent Ulema and thinkers... to prepare a draft for Islamic state*", and present it to the Assembly.<sup>32)</sup>

The declaration of Pakistan as an Islamic Republic in 1953 was also the result of the struggle of these Islamic political and religious parties. All of the above and other Islamic parties also take-part in politics actively, and their share in administrative power is increasing gradually. The struggles of these parties to establish an Islamic state is bringing fruit now. The Islamization Program of Zia-ul-Haq, Islamization amendments in Pakistan Constitution, and Islamization of Economy are the result of the efforts of these Islamic or Religious Parties.

#### 5. Prudential Performance of Islamic Banks and Risk taking Attitude of Investors

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31) <http://www.islamic-world.net/islamic-state/pakistan.htm> ; Access on June 4<sup>th</sup> 2007

32) Ibid

As compare to conventional banks the performance of Islamic banks is more commendable. Islamic Banks distribute higher profit as compared to conventional banks in Pakistan (80.9% respondents said Islamic Banks distribute higher profit as compared to conventional Banks).<sup>33)</sup> Furthermore, in same study we found that the attitude of investor changed from Risk-Avert to Risk-Taker in the case of Islamic banks (88.48% respondents said “Yes they will continue to deal with Islamic Banks, even the risk with these banks higher than the conventional Banks”).<sup>34)</sup>

## 6. Conclusion and Suggestions

Soon after the independence of Pakistan several efforts were made to Islamize the economy, such as :

1. The efforts to introduce the Islamic principles in the constitution.
2. At a theoretical level, elimination of the interest or Riba from the economy held the central point for the debates ; there has been some unanimity on the views of Riba.
3. At operational, a number of constituent bodies such as Federal Shariat Court, Islamization commission and working groups were developed to formulate the recommendations.

Some key lessons emerge from Pakistan’s experience of Islamization efforts of 1980’s. First, it is true that the policy of transformation of financial and banking sector at once could not bring desired results. Most of the measures either had been reversed or, at least, further enhancement of Islamization process for the economy was stopped. But the failure of this process is failure only when this process is viewed as end in itself. Seen in the continuity of historical process at world level, these measures were inevitable stages of Islamic movement. Like scientific methodology, in which failed experiments contribute as much to the investigation as successful ones, this process of Islamization contributes much more than its share in the advancement of Islamic banking. Second, liberalization of economy or privatization of state owned banks and financial institutions along with establishing market economy policy helped government to concentrate on the Islamization of the economy process. Third, an evolutionary process, rather than a revolutionary approach, in order to nurture acceptability and development of Islamic finance industry was succeeded. State Bank of Pakistan adopted a gradual approach for the establishment of Islamic banking in Pakistan. Under this policy, Islamic banking is being promoted in parallel to the development of conventional finance

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33) Hassan, M. 2007 : 210-17

34) Ibid : 206

industry in an integrated, gradual and steady manner. In addition, SBP allows conventional banks to set up Islamic banking subsidiaries or dedicated Islamic banking branches to offer range of financial services. SBP has put into place a comprehensive and robust multi-tiered Shariah compliance mechanism to lend customers and investors confidence in the Islamic banking industry. Shariah compliance mechanism has three main pillars : (i) a Shariah Board at SBP which approves policies and guidelines as well as the fit and proper criteria for Advisors ; 4 (ii) Shariah Advisors in all banks to provide guidance to banks and comfort to customers on Islamic financial services ; and (iii) a Shariah audit system.

Though the process of re-launching of Islamic banking in Pakistan started just four years ago the assets share of Islamic Banks in overall banking sector of Pakistan is remarkable. Now Islamic banks in Pakistan have more than 3.2% of total deposits of the country's banking and financial sector. Islamic banks have more than 25000 borrowers now ; these figures are enough to state the prudential performance of Islamic banks because the risks of Islamic banks are relatively different than conventional banks. Investors in Islamic banks face more risk as compared to investor at conventional banks. The progress of Islamic Banks indicates that Islamic banks are more popular and investment in Islamic banks is more attractive in Investors. On the product side, Islamic banks developed and offer 75% of the products available at conventional banks. At present the emphasis of Shariah Advisory board and business development managers of the Islamic banks is more on Shariah compliances. Keeping in view the future strategy of Islamic banks it is suggested that the emphases of Islamic banks on invention of new product and development of new modes of investment & finance will increase the share. Meezan Islamic Bank is operating exclusively in mega cities and big business centers of the country, it is absent in urban and rural areas where potential customers need Islamic banking in great. It is suggested that operating in secondary and rural areas will foster the Islamic banking development prospects.

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