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Economic Evaluation of Islamic Banking in Pakistan

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Abstract. The term *Islamic* in Islamic banking naturally raises the question of what this word adds to the concept and practice of banking? The early literature on Islamic economics raised the bar of expectations and envisioned Islamic banking as distinct from conventional banking by avoiding interest in letters and spirit. Interest-based banking was thought to suffer from exclusion, inequality, injustice, misallocation of capital resources and concentration of capital. It was thought that Islamic banking, while avoiding interest, would be more inclusive, equitable, and fair and would result in a broad allocation of resources without the exclusionary criterion of a fixed cost of capital. It was also thought that this new banking system would reduce income and wealth inequalities and control the concentration of wealth. Today, after two decades of Islamic banking in Pakistan, it is pertinent to assess the progress and performance of these ideals. This study evaluates Islamic banking in terms of inclusiveness, competitiveness, and equity. The economic assessment shows that Islamic banks have secured financial inclusion for those who wish to avoid ribā. However, concerted efforts are needed to improve competitiveness and distinction regarding distributional impact of Islamic financial products.

Keywords: Islamic Banking, Competitiveness, Fairness, Performance of Islamic Banking

JEL Classification: G21, N25, O16
KAUJIE Classification: B4, I21, J32

1. Islamic Banking in Pakistan

1.1. Early Years Since Independence and First Phase

Islamic Republic of Pakistan got independence in 1947 after a socio-political movement to achieve a homeland for Muslims in Muslim majority region where the Muslim population could live their lives in accordance with their faith and culture and where there can be achieved a conducive environment to fully operationalize certain socio-economic institutions in the faith of Islam.

First constitution of Pakistan was adopted in 1956 which incorporated Islamic principles in Article 25. Article 29(f) compelled the State to eliminate "Riba as early as possible". 17 years later, Article 38(f) in 1973 constitution of Pakistan had to reiterate the same thing. The 1973 constitution of Pakistan in Section 38(f) also states that "Riba should be eliminated as early as possible".

Khan (2015) describes that there had been tension over Pakistan's essential character ever since independence. On one hand, there were modernists who were 'Islamic Minimalists'. Then, there were those who favored an 'Islamic Maximalist' interpretation that aspires to see Pakistan as a model Islamic state. In the 1960s, under the rule of Gen. Ayub Khan, the modernists got an opportunity to engage in reinterpretation of Islamic institutions and injunctions in ways so that it matches with contemporary realities. But they were (or at least perceived to be) not as much careful in keeping the essence and spirit of Islamic injunctions and institutions intact.

In that era, a debate was instigated on whether bank interest is Riba or not. Continuing from the opinions attributed to Rashid Rida and Muhammad Abduh, Rahman (1964, p. 6) and later on Saeed (1996, p. 15) in Pakistan argued that bank interest is not Riba. On academic front, Mawlana Maududi (1960) and Mufti Shafi Usmani (1993) provided effective and strong academic rebuttal to this standpoint.

In further development on legislation side, Council of Islamic Ideology in its report in 1980 on the elimination of interest explicitly provided definition of Riba as follows:

> "The term Riba encompasses interest in all its manifestations irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of a personal nature or of a commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is low or high."

Soon the banks started Islamic banking through profit and loss sharing deposit accounts and by providing finance through Islamic modes of financing. However, the first phase of Islamic banking was not quite successful due to the lacking in regulatory framework for Shari'ah compliant product development and to ensure Shari'ah compliance with strong oversight of resident Shari'ah advisors. For instance, Murabaha Muajjal was not used carefully by meeting all the Shari'ah compliance requirements. Instead, buyback transactions with mark-up were used which are not Shari'ah compliant. There was no strong mechanism for Shari'ah audit and supervision.

The equity based modes of financing proposals suggested by Mawlana Maududi (1961) and Uzair (1978) were not taken seriously by the industry due to risk aversion while some proposals did not quite meet the Shari'ah compliance requirements like Time Multiple Counter Loan (TMCL) proposal put forward by Ahmad (1989).

On the regulatory front, attempts were made to take away the privileged advantage which conventional banks had due to it being allowed to operate despite the constitutional requirement that Riba should be eliminated from the economy as soon as possible.

The Federal Shari'at Court (FSC) of Pakistan announced a historic judgement in December 1991 in which it prohibited interest in financial transactions and termed bank interest as Riba. In 1999, the Shari'at Appellate Bench (SAB) upheld the FSC judgment, and directed the government to transform the economy based on Shari'ah principles by eliminating all forms of interest-based banking within the next few years.

In 2000, a review petition was filed by the staff of a private bank and the case was referred to SAB again. Then in 2002, the FSC declaration of 1991 and SAB declaration of 1999 was set aside and the case was referred back to FSC for reconsideration. Then, there was a deadlock on this front with subsequent governments showing no interest to move away from interest based conventional banking.

1.2. Second Phase of Islamic Banking in Pakistan

Amidst the setback on the regulatory front, Islamic banking industry leaders and scholars behind the Islamic banking movement decided to work in the parallel or dual system of banking in order to provide Riba-free finance to the individual and corporate customers who want to avoid Riba. In the second phase of Islamic banking, the regulatory framework was strengthened and Islamic banks were given official licenses to offer Islamic banking products and services in the country.

Meezan bank was the pioneer Islamic bank which was established in 2002. Soon, other full-fledged Islamic banks also came to the scene in the first decade of the new millennium following a booming economy, higher incomes among consumers and increased incentives for private sector to enter in Pakistan's denationalized banking sector. Conventional banks also started Islamic banking divisions and the steady growth followed.

After the great financial crisis of 2008, Islamic banks got more prominence with a lot of experts appreciating the resilience and quality risk management framework which was inherent in Islamic banking due to the asset backed nature of financing transactions in Islamic banking. Now, Islamic banking in Pakistan is an established industry with 19.5% market share in total banking assets as at June 30, 2022. Table 1 shows the stylized facts about Islamic banking in Pakistan.

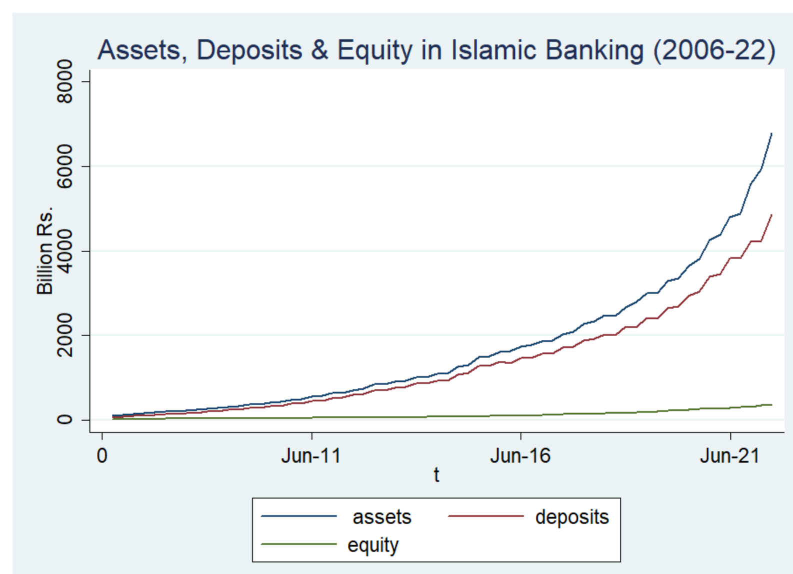
Table 1: Stylized Facts about Islamic Banking in Pakistan

Islamic Banking Indicators	Values (As on June 2022)
Assets (in billion Rs.)	**6,781**
Deposits (in billion Rs.)	**4,856**
Net financing (in billion Rs.)	**2,961**
Market share (%)	**19.5**
Number of branches	**4,086**
Number of Islamic banking institutions	**22**

Source: Data from Islamic Banking Bulletin, June 2022

During the 16-year period from September 2006 to June 2022, Islamic banking assets, deposits and equity has increased consistently. The growth has happened organically as well as inorganically. Besides organic growth, MCB's launch of separate Islamic bank, Meezan Bank's acquisition of stake in HSBC, Bank Islami's acquisition of Citibank's mortgage portfolio and recent transformation of Faysal Bank into a full-fledged Islamic bank has contributed to the expedited growth as well. The recent judgement given by Federal Shariat Court in April 2022 endorsing the historic judgement on interest given in 1991 bodes well for the future growth of the industry.

Figure 1: Assets, Deposits and Equity in Islamic Banking



Source: Data from Various Issues of Islamic Banking Bulletin

There is steady increase in the branch network which has surpassed the 4,000 mark by June 2022. With financial inclusion still at a dismal level, extension in branch network is crucial for growth in deposits and assets.

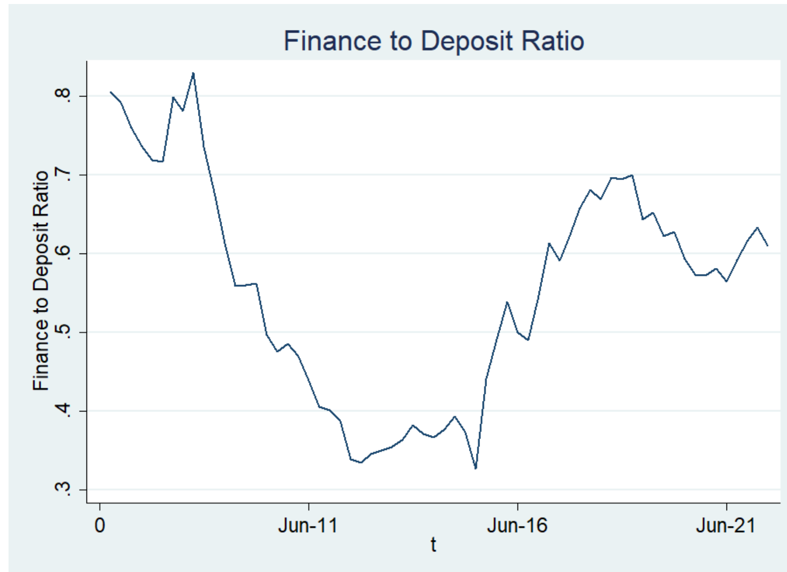
In 2002, Meezan Bank was established as the first full-fledged Islamic bank in Pakistan. From a 2.5% market share in September 2006, the share of Islamic banking in assets has gone up to 19.5%. However, after reaching the 10% mark in 2014, the market share was expected to go up even higher in the next eight years that followed, especially given the Strategic Vision for Islamic banking shared by the State Bank of Pakistan (SBP) for the industry.

Nonetheless, despite support from acquisition and transformation of Faysal bank into a full-fledged Islamic bank, the market share has gone up, but at a slower pace since 2014. Going forward, SBP in its Strategic Plan for 2021-25 has set forth a plan for Islamic banking to achieve 30% market share in overall banking assets and deposits.

Financing in Islamic banking has also grown from Rs 53 billion in September 2006 to reach Rs 2,961 billion by June 2022. In the credit crunch following the global financial crisis of 2007-09 whose repercussions were also felt in Pakistan, the finance to deposit ratio of Islamic banking stood tall during the crisis and early recovery period.

Nonetheless, due to limited products for short term financing and liquidity management, the finance to deposit ratio declined to less than 35% in post-crisis period. The launch of Running Musharakah product provided stability to the finance to deposit ratio and it revived to reach the level of 70% by 2018. Challenging macroeconomic conditions have resulted in further pressure on finance to deposit ratio since 2019 as can be seen in Figure 2.

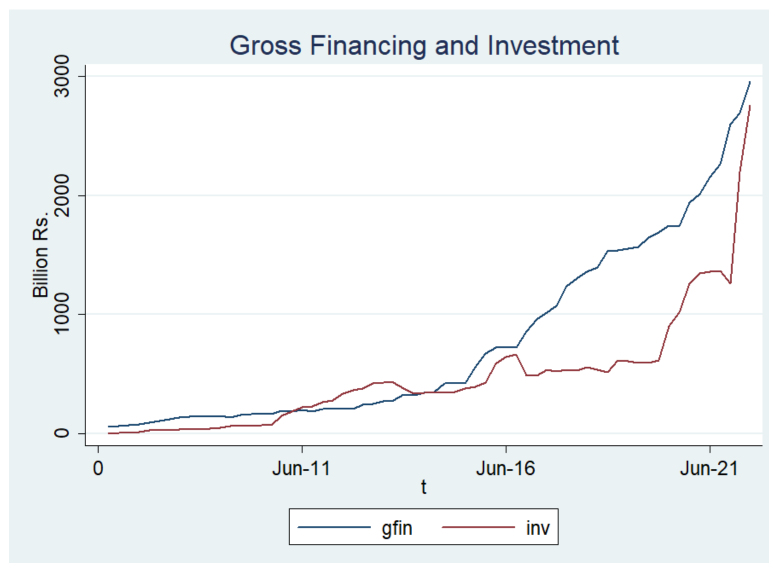
Figure 2: Finance to Deposit Ratio in Islamic Banking



Source: Data from Various Issues of Islamic Banking Bulletin

During the initial years, with limited range of products for short term financing, Islamic banks were parking their surplus liquidity more into investments as compared to extending their financing portfolio. With no lender of the last resort facility until recently, Islamic banks were hesitant to take as much exposure to agriculture and Small and Medium Enterprises (SME) sector as compared to conventional banks. The investments surpassed financing during 2011-2014. But, i) launch of Running Musharakah product, ii) increased use of Diminishing Musharakah and iii) inorganic growth fuelled by acquisition of portfolio of HSBC and Citibank and establishment and transformation of MCB Islamic and Faysal Islamic bank respectively has resulted in a reversal of trend. The wedge between financing and investments since 2016 has increased as reflected in Figure 3. As of June 2022, Islamic banks lead the mortgage financing market and have also achieved price competitiveness in this segment to cement their growth.

Figure 3: Financing and Investment in Islamic Banking

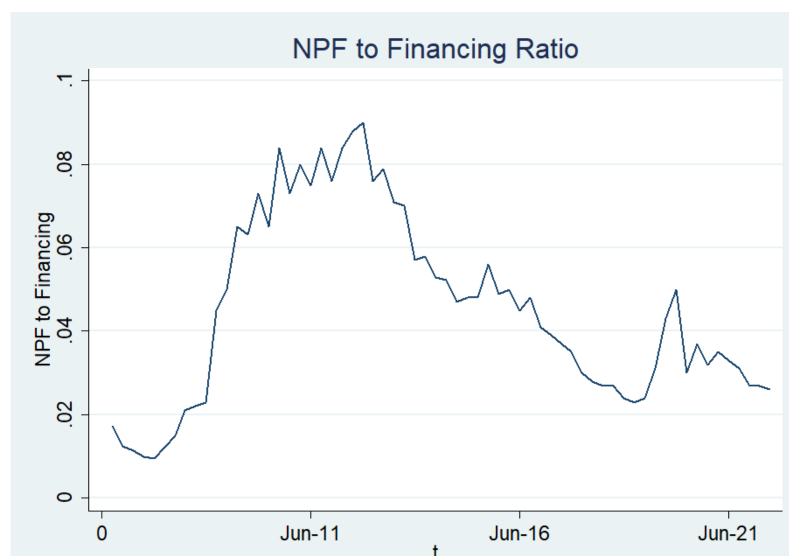


Source: Data from Various Issues of Islamic Banking Bulletin

When it comes to non-performing financing, Islamic banks have an edge over conventional banks both from the viewpoint of structure and portfolio composition. Islamic banking financing assets are by and large real asset-backed. This provides a cushion against credit risk. Secondly, due to liquidity constraints (no lender of the last resort facility from SBP until recently) and re-pricing constraints in restructuring and rescheduling trade based contracts, Islamic banks put together a much solid and robust risk management framework. This results in better risk management in Islamic banking as compared to conventional banking.

Figure 4 reveals that non-performing financing to gross financing ratio for Islamic banks did go up during 2008-2012 period. It happened primarily because of security and energy crisis which hurt the manufacturing sector severely. Islamic banking provides asset backed financing and manufacturing and commodity sectors are usually the main target market for Islamic financing products. However, having obtained an opportunity to provide short term financing solutions to established corporates through Running Musharakah, Islamic banks were able to reduce the overall credit risk in their portfolio which resulted in declining non-performing financing to gross financing ratio.

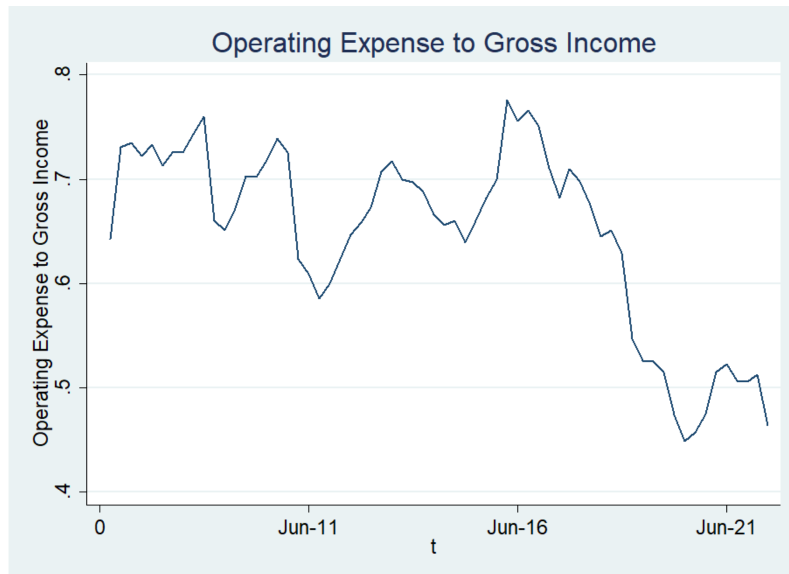
Figure 4: Non-Performing Financing to Gross Financing



Source: Data from Various Issues of Islamic Banking Bulletin

When it comes to efficiency, Islamic banks have taken time to achieve efficiency. It is understandable since gaining market share from scratch is difficult in an industry dominated by big players which are all conventional and who have several advantages of economies of scale and scope. Nonetheless, as conventional banks themselves look for penetration in Islamic banking, market cannibalization is happening to an extent. As size and market share grows, there are already signs of improving efficiency as indicated by decline in operating expense to gross income ratio since 2016 in Figure 5. Decline in this ratio is an indication of improved efficiency. Since 2016, operating expense to gross income ratio is exhibiting a decreasing trend which bodes well for future growth and competitiveness of Islamic banking sector in Pakistan.

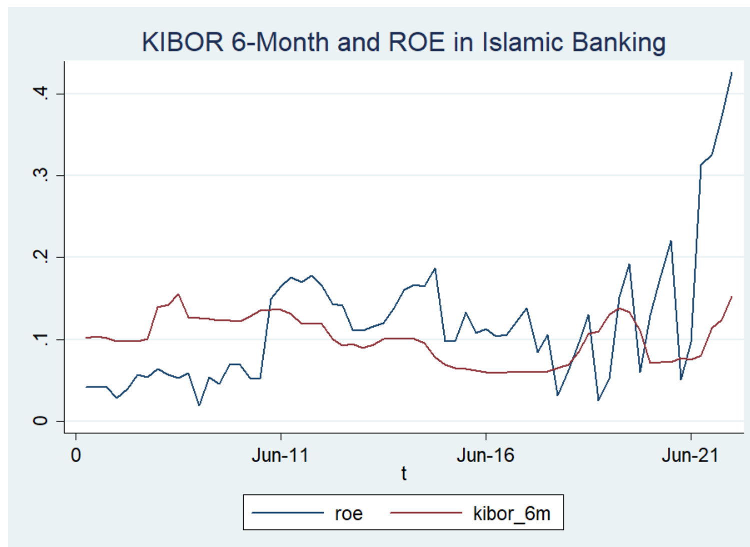
Figure 5: Operating Expense to Gross Income



Source: Data from Various Issues of Islamic Banking Bulletin

In addition to that, it will be worthwhile to see how Islamic banks respond to macroeconomic environment. Figure 6 shows the trend in return on equity along with changes in inflation rate and interbank rate, i.e. 6-months Karachi Interbank Offered Rate (KIBOR). It can be seen that the profitability moves in the same direction as the interbank rate. Due to regulatory compulsions and limited size of Islamic money market, Islamic banks also use the interbank rate in pricing their contracts and financing products. Increase in interbank rate is positively associated with profitability. One plausible reason for this is that depositors in Islamic banking are loyal and less sensitive to the profit rate. Hence, deposits are much less responsive to changes in policy rate and interbank rate as compared to the largely floating rate based financing portfolio. Spread in Islamic banking is generally higher than conventional banks in Pakistan. Thus, increase in interbank rate swiftly raises the payoffs to banks in floating-rate financing contracts while the profit shared with depositors does not increase that swiftly nor significantly.

Figure 6: KIBOR 6-Month and ROE in Islamic Banking



Source: Data from Various Issues of Islamic Banking Bulletin and State Bank of Pakistan

2. Review of the Literature on Economic Assessment of Islamic Banking

Contemporary literature looks back at the aspirations of the Islamic economics literature at the level of conception of Islamic finance. Asutay (2013, p. 55) feels that Islamic finance has given more emphasis to commercialization rather than sticking to the moral economy principles. The initial experience of social finance has been engulfed by the proliferation of Islamic commercial financial institutions in banking, asset management and insurance.

Jan and Asutay (2019, p. 3) think that Islamic banking and finance has been successful in transactional accumulation, but it has not developed any strategy for IME's transformational objectives. Mansour et al. (2015, p. 68) agree that Islamic banking has not realized its vision to enhance equitability, social well-being and justice. While there is much to show when it comes to growth and penetration of Islamic banking and finance, but such remarkable growth has been achieved by overshadowing the social aspirations. Hence, if Islamic banks and financial institutions are criticised for their social failure, there is some merit in it.

Cebeci (2012, p. 179) attribute underachievement on social front to the product structures, which are primarily debt-based in which cash flows use conventional interest based benchmarks strictly. Hence, the final outcome from the cash flows and cost perspective is identical or even worse for the client with higher spreads in Islamic banking. On the other hand, Baki and Uthman (2017, p. 262) think that the reason for social failure lies with external environment which is not conducive for fostering social goals even if they are deemed to be desirable. Such defence takes cover in the argument that Islamic banks are small part of a large industry and they cannot be price leaders in a dual banking system dominated by conventional banking.

Islamic principles lay great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots (Mohieldin et al., 2011, p. 2). Scholars who are economists-cum-Shari'ah advisors explicate three specific ends (Maqasid) which are important in Islamic finance, i.e. i) wealth circulation, ii) fair and transparent financial practices and iii) justice at the micro and macro level (Laldin & Furqani, 2013, p. 278). Some add equitable income redistribution and circulation of wealth to the list as well (Chapra, 1979, p. 18). Social justice requires that financiers and those who require finance share rewards as well as losses in an equitable fashion (Iqbal, 1997, p. 43).

Fulfilling only the necessary conditions of Shari'ah compliance in product structuring is insufficient to make progress towards circulation of wealth and distributive justice (Laldin and Furqani, 2013, p. 287). Islamic finance industry in essence remains delinked from the real economy in terms of cash flows, and hence its distributional impact is similar to conventional banking (Ibrahim et al., 2014, p. 16).

Due to the overemphasis on the form over substance, Dusuki and Abozaid (2007, p. 145) argue that Islamic banks are just an exercise in semantics. Khan (2010, p. 806) also concedes that Islamic banking provides suitable Islamic jargon for de facto conventional banking. Balz (2008, p. 14) thinks that Islamic finance is experiencing a "formalist deadlock". Even Mansoori (2011, p. 392-398) who is an academic as well as advisor to some Islamic financial institutions admits that there are certain contracts in which the stratagems used do not conform fully to the strict principles of Shari'ah. Zubair (2014, p. 164) also thinks that Islamic banks have adopted the path of unfair subterfuges to convert a wrongful thing into allowed.

Choudhury (2012, p. 194) thinks that Islamic banking is good for the rich shareholders and only narrowly avoids financial interest, with no fundamental, epistemological and economic distinction. Haniffa and Hudaib (2010, p. 89) argue that Maqasid-e-Shari'ah have been unduly used to

justify the innovation of financial products to compete and converge with conventional banking. Sharing the same concern, Dusuki and Abozaid (2007, p. 155-156) reveal that there are also cases of overstretching Maqasid-e-Shari'ah to validate financial transactions which are not in conformity with the Shari'ah principles.

In financial economics, Diamond (1996, p. 64) explains bank as a financial intermediary which can centralize costly monitoring. He explains that banks monitor debt (loan) contracts, and issue unmonitored debt (deposit) contracts. In this context, Islamic banks seem to work similar to conventional banks when one compares capital to assets, finance to deposits and deposits to equity and such ratios.

Hence, in the light of extant literature on aspirations and the early general disappointment felt by one group of scholars on underachievement in Islamic finance practice from the social perspective, there is a need to have fresh and objective evaluation. The case of Pakistan is interesting since it is a country where the constitution specifically asks for eliminating Riba and where commercial interest had been illegalized through apex court judgements. It is also a country which is struggling with issues of poverty and underdevelopment. It is also a country where several notable scholars have contributed to the aspirational literature in Islamic economics.

Therefore, Islamic financial institutions, especially banks in such a context and environment have a serious task and opportunity to develop and showcase an egalitarian financial system. With two decades into the second phase of Islamic banking development in Pakistan, it is worthwhile to conduct an objective assessment of performance of Islamic banking in enhancing financial inclusion, promoting competition and achieving egalitarian financial intermediation and redistribution.

3. Research Methodology for Micro-Economic Assessment

This study aims to assess Islamic banking on three aspects, i.e. access to finance, competitiveness and redistributive impact. Besides avoiding Riba and ensuring Shari'ah compliance, extant literature in Islamic finance also promises to achieve distinction in these three aspects in comparison to conventional banking.

There are few studies which evaluate Islamic banking in Pakistan on social aspects. Study by Irfan (2021) employs content analysis on financial reporting and study by Majeed and Zainab (2017) conduct an exploratory survey of employees and customers. However, content on internal reporting and surveys on perceptions may not reveal objective data that is universally valid. Some banks may show and report their CSR activities more prominently than others and it will not tell much about the scale and impact of such activities unless some measurable and quantitative indicators are used which can be compared across banks in a standardized way. Small sample surveys exploring perceptions also tell one side of the story and may not be revealing objective and impersonal information that can be used for comparison. Study by Siddique (2021) has some issues with regards to the choice of indicators and arbitrary benchmark values. Furthermore, Siddique (2021) applies the benchmarks on few Islamic banks rather than the whole industry in aggregate.

Siddique and Iqbal (2014) introduced a framework for evaluating Islamic banking from 'Within'. It focused on the greater use of equity based modes of financing, more access to SMEs, provision of zero-interest rate finance (Qard-e-Hasan) and refraining from luxurious consumption finance and use of discouraged and prohibited modes of financing. In a later study, Siddique (2021) came up with another framework to evaluate Islamic banking by classifying the benchmark indicators into procedural and consequential.

However, there are some problems in both frameworks.

First, procedures are means to achieve an end, but not an end in themselves. Running Musharakah and Musharakah Mutaniqasa are used in financing, but, the real essence of risk sharing is absent in the contemporary application of these modes in Pakistan. Eventually, the cost of finance becomes similar or more as compared to running finance or mortgage finance in conventional banking since interbank rate is used as the benchmark rate for pricing.

Second, Siddique (2021) mentions that to score high on Maqasid-e-Shari'ah based index, Islamic banks shall not be using Bai Inah and conventional derivatives. However, such structures are not used in Pakistan anyways by Islamic banks.

Third, Siddique (2021) also mentions that if Islamic banks remain apologetic to the use of prohibited or discouraged modes of financing, it will still be considered that Islamic banks are not deviating from the 'ideal'. However, there is no operational and official way to authenticate apology and it is still hypocritical that an institution does not walk the talk and remains merely apologetic and yet be considered ideal.

Fourth, the framework proposed by Siddique (2021) uses an arbitrary benchmark. For instance, he mentions 10% financing on the basis of Qard-e-Hasan, 25% financing to the SMEs, and 25% financing to the low income group. However, there is no authentic Shari'ah basis for these numbers and benchmark values. Fifth, Siddique (2021) uses the word Maqasid-e-Shari'ah, but which Maqasid need to be adhered to and how Islamic banks are failing in them is not explained.

Lastly, the framework proposed by Siddique (2021) unnecessarily expects compulsory performance on certain performance indicators from commercial institutions, such as 10% share of Qard-e-Hasan.

To overcome some of these limitations, this research proposes multiple indicators to assess the economic performance of Islamic banks. These indicators include:

1. Geographical presence outside urban high income regions
2. Financing to priority sectors like SME and agriculture vis-à-vis industry average
3. Competitive sharing of returns with depositors vis-à-vis industry average
4. Competitive pricing in financing products
5. Utilizing risk sharing modes for distinctive distributional outcomes
6. Element of social finance to include marginalized segments

First two indicators are related to inclusiveness. The next two relate with competitiveness and the last two relate with redistributive impact. For access to finance, micro-level data on presence of Islamic banking branches at provincial and city level is taken to study outreach, geographical concentration and rural-urban divide. Moreover, financing portfolio composition is also evaluated to assess priority access to significant sectors of the economy which together employ 84% of the labour force.

In evaluation of competitiveness, the profit rates on conventional banks and Islamic banks including Islamic banking branches are compared by taking monthly average data of four years 2019-2022 in different deposit categories. Since Islamic banks use the same benchmark for pricing, which is Karachi Interbank Offered Rate (KIBOR) in financing products, there is no need to look for any element of distinction in pricing in financing products.

Finally, the redistributive impact is assessed by looking at the share of risk-sharing based versus risk-shifting based modes of financing. Risk shifting based modes of financing cannot achieve any

differential impact as compared to conventional banking loans since risk-shifting based modes of financing are priced using the same interbank benchmark rate which is used by conventional banks.

4. Assessment of Islamic Banking: Access, Competitiveness & Redistributive Impact

4.1. Islamic Banking and Financial Inclusion

Naceur et al. (2015, p. 6) disclose that the share of excluded individuals citing religious reasons for not using bank accounts is noticeably greater in Muslim majority countries than in other countries. Kumru and Sarntisart (2016, p. 1) explicate that for financially excluded Muslims, Islamic banking provides an alternative to use banking services. By reducing financial exclusion due to religious reasons, Islamic banking can potentially increase the rate of savings. Since these savings are employed in asset backed financing, there is increased potential for capital formation and economic growth in the presence of Islamic banking.

Knowledge Attitude and Practices study in Pakistan which was a nation-wide survey reveals that out of non-banked respondents, 93% consider conventional interest as Riba (State Bank of Pakistan, 2018, p. 28). Furthermore, out of non-banked respondents, 98.77% considered this statement as important that Islamic products and services provide religious satisfaction. In this regard, of course, Islamic banking has provided access to banking to those customers who would not bank primarily for the religious reason. Those who consider Riba as prohibited and who want to avoid it, they would voluntarily exclude themselves from banking. Islamic banks have provided an option of doing banking to those who are voluntarily excluded.

However, it is also interesting to see whether Islamic banks have been able to widen their outreach beyond large cities or not so that involuntary financial exclusion due to outreach constraints is also minimized. Table 2 provides data on access to physical Islamic banking branches across provinces and capital cities. It is observed that in Sindh, out of 1,107 branches, 904 are in Karachi and 67 are in Hyderabad. Together, these two relatively developed cities with greater proportion of urban population host almost 88% of total branches in Sindh. The other regions of Sindh with branches in excess of 10 also include urban areas with greater per capita income and urban population, such as Sukkur (20), Shaheed Benazirabad (19), Sanghar (14) and Mirpurkhas (14).

On the other hand, Baluchistan only hosts 155 Islamic banking branches, more than half of which are in provincial capital city Quetta (75). Similarly, in Gilgit-Baltistan, out of total 32 branches, almost half (15) are in Gilgit city. Mirpur (22) and Muzaffarbad (13) together host 35 out of total 58 branches in AJK region.

It is revealed that in Punjab, the 5 larger cities like Lahore (618), Rawalpindi (197), Faisalabad (164), Multan (118) and Gujranwala (98) host 1,195 out of 2,025 branches with a share of almost 60%. Likewise, in KPK, the distribution across cities other than provincial capital Peshawar is relatively more balanced and less skewed towards urban cities as compared to Sindh and Baluchistan.

Table 2: Branch Network in Islamic Banking

Region	Branches (no)	Branches in Capital City	Share % in Total
Sindh	1,107	904	81.66
Punjab	2,025	618	30.52
KPK	505	127	25.15
Baluchistan	155	75	48.39
Islamabad	204	204	100.00
AJK	58	13	22.41
Gilgit-Baltistan	32	15	46.88
Total	4,086	1,052	25.75

Source: Data from Islamic Banking Bulletin, June 2022

In terms of access to finance, Table 3 shows that like conventional banking dominated banking industry, Islamic banks are also majorly financing the corporate sector as reflected in latest statistics published in June 2022. More than two-thirds of the total financing in Islamic banking goes to the corporate sector, i.e. 68%. SMEs and agriculture get a small share of 1.9% and 0.8% respectively, which is even worse than the overall banking industry share of 4.1% and 3.6% respectively.

Pakistan Labour Force Survey 2017-18 statistics suggest that 39% of labour force is engaged with agriculture (Pakistan Bureau of Statistics, 2018). Around 45% of labour force is engaged with informal sector in the non-agriculture segment. It implies that 84% of the people seek employment in agriculture and informal sector. However, Islamic banking is much less focused on agriculture and SMEs when it comes to financing.

Not only the current footprint is concerning in itself, it is even behind conventional banking. While conventional microfinance institutions exist, there is no microfinance bank setup by any of the commercial Islamic banks. Even though Akhuwat had provided Qard-e-Hasan based loans to 5 million people with a recovery rate of around 99%, but Islamic banks or their sponsors had not ventured in providing micro financial services by establishing a microfinance bank even though the Securities and Exchange Commission of Pakistan (SECP) and State Bank of Pakistan (SBP) had provided flexible legislation to enter in that sector. Islamic banks can boast about their investment arm in the form of asset management companies, but none of them have any subsidiary and presence in microfinance.

Table 3: Financing Mix Segment Wise

Segment	Islamic Banking Share %	Overall Banking Industry Share %
Corporate	68.0	69.8
SMEs	1.9	4.1
Agriculture	0.8	3.6
Consumer	10.9	7.7
Commodity	16.8	10.4
Others	1.6	4.4
Total	100	100

Source: Data from Islamic Banking Bulletin, June 2022

4.2. Islamic Banking and Competitiveness

The deposit mobilization picture in Islamic banking in Pakistan suggests that their reliance is majorly on non-remunerative current accounts. Hence, they could have provided subsidised financing to critical

sectors of the economy like agriculture and SMEs sector given that Islamic banks source almost Rs 1.9 trillion in current accounts, out of a total of Rs 4.856 trillion of total Islamic banking deposits from customers. As at June 2022, current account and saving account deposits of almost Rs 3.51 trillion constitute almost 80% of total deposits.

Even on saving accounts, Islamic banks pay much less returns to the depositors than conventional banks. Not only they have much less cost of deposits than conventional, but they also fall short of expectations when it comes to outreach to economic sectors like agriculture and SMEs and even when it comes to pricing. Lebdaoui and Wild (2016, p. 201) substantiate that in countries with greater share of Islamic banking, the competition intensifies and results in lower spreads and margins. Nonetheless, in the case of Pakistan, Islamic banks are struggling with higher spreads implying costly inefficient intermediation with a narrower outreach and inclusiveness.

Even globally, Leon and Weill (2018, p. 54) show that Islamic banking development has overall no impact on credit constraints. However, their results show that Islamic banking development exerts a positive impact on access to credit when conventional banking development is low. That is why; there is increased focus on rent seeking than on ensuring internal efficiency to achieve competitiveness. Interestingly, while conventional banking is demonized and cursed, Islamic banking is not able to penetrate in agriculture sector, SMEs and microfinance as much as conventional banking. Even where Islamic banking does provide financing solutions to the corporate sector and upper income class urban population, it does so at an equal or higher cost of finance than conventional.

One may expect that in such a case, Islamic banks will be able to provide better returns on investment deposits. Panel A in Table 4 presents the average profit rates declared for different maturities of investment in 5 full-fledged Islamic banks during the months falling in the four-year period 2019-2022. The names of Islamic banks are Meezan Bank, Bank Islami, Dubai Islamic, Bank Al Baraka and MCB Islamic.

Panel B in Table 4 illustrates the average interest rate paid by 5 conventional banks that have the largest market share in conventional banking like full-fledged Islamic banks have the largest chunk of market share in Islamic banking. The comparison is provided for profit rates on different maturities of investment products during the months falling in the four-year period 2019-2022. The names of conventional banks are Habib Bank, United Bank, MCB Bank, Allied Bank and Bank Alfalah.

Table 4: Profit Rates on Islamic and Conventional Remunerative Deposits

Panel A: Profit Rate on Deposits (%) in Islamic Banking						
Bank Name	**Average for Months in Period**	**Savings**	**TD 1 Year**	**TD 2 Years**	**TD 3 Years**	**TD 5 Years**
Meezan Bank	**2020-2022**	**4.18**	**6.53**	**7.24**	**7.24**	**7.24**
Bank Islami	**2019-2022**	**5.77**	**5.67**	**5.75**	**5.89**	**6.49**
Dubai Islamic	**2019-2022**	**3.53**	**4.79**	**5.76**	**6.02**	**6.33**
Bank AL Baraka	**2019-2022**	**4.29**	**7.18**	**7.80**	**8.50**	**8.85**
MCB Islamic	**2019-2022**	**4.33**	**4.76**	**4.83**	**4.89**	**4.93**
Average		**4.42**	**5.79**	**6.28**	**6.51**	**6.77**
Panel A: Interest Rate on Deposits (%) in Conventional Banking						
Bank Name	**Average for Months in Period**	**Savings**	**TD 1 Year**	**TD 2 Years**	**TD 3 Years**	**TD 5 Years**

Habib Bank	2019-2022	8.91	9.49	9.54	8.88	9.20
United Bank	2019-2022	8.91	9.49	9.54	8.88	9.20
MCB Bank	2019-2022	8.60	7.67	7.47	7.46	7.61
Allied Bank	2019-2022	7.67	5.39	5.39	5.39	5.39
Bank Alfalah	2019-2022	9.90	10.95	10.43	10.53	10.60
Average		8.80	8.60	8.47	8.23	8.40

Source: Websites of Banks

It can be seen that the profit rates offered by Islamic banks are far lower than conventional banks. This is despite the fact that Islamic banks charge much higher cost of finance on their financing side products. Furthermore, there are also some reservations shown by experts on inexactness in average based profit distribution on daily-product basis (Minhajuddin et al., 2020, p. 181).

Intermediation function performed by Islamic banks is costlier, yet inferior from the distributional perspective since they have much less exposure to agriculture sector, SME sector and nothing when it comes to microfinance sector. From the economics perspective, depositors in Islamic banking obtain much less profits as compared to depositors in conventional banks. Therefore, on the grounds of competitiveness, Islamic banks have still a long way to travel.

It is ironic that in marketing campaigns and public discourse, practitioners of Islamic banks project conventional banking as evil while Islamic banks pay much less profit rates despite charging customers higher cost of finance than conventional banks. This relatively high cost of intermediation as compared to conventional banks is paid by the society. Yet, there is no universal agreement on Shari'ah compliant nature of contracts like Tawarruq based personal finance, Tawarruq based credit cards, and Salam in currency, for instance. Some scholarly circles in Pakistan are even critical of combining a separate Murabaha and Muajjal sale as a mode of financing to closely mimic the cash flow stream of conventional interest based loans (Jamia Uloom-ul-Islamia, 2008, p. 113).

One of the reasons for apprehensions about Islamic banking practice among masses is that people give due emphasis to both form and substance (Minhas, 2021, p. 81). In many cases, people fail to understand and appreciate the subtle differences in form, but experience first-hand the profit they receive from the Islamic bank as depositors and cost of finance which they pay as financing side clients. When they experience that they are underpaid when it comes to profits and that is when Islamic banks are charging same or more cost of finance in similar economic transactions, their reservations remain or rather increase overtime.

Given that outreach is limited majorly in urban areas and market segmentation is concentrated in corporates, Islamic banks have still a lot of work to do in improving their outreach geographically and in diverse and critical sectors of the economy including agriculture, SMEs and microfinance.

Siddiqui (2012) thinks that competitive pressures in a dual banking system dominated by conventional banks would not allow Islamic banks to eliminate the inequities and injustices caused in conventional banking system. Nonetheless, Siddiqui (2012, p. 38) also criticizes Islamic banks that they even fail to be competitive in returns and cost, let alone be superior in eliminating inequities and financial exclusion. Islamic banking proponents offer their defense by pointing to variety of risk management tools, active and liquid money market and the facility of lender of last resort, available in an advantageous way to conventional banks.

4.3. Islamic Banking and Distributional Impact

From the distributive justice perspective, the studies in Islamic banking criticize conventional banking on the ground that it is a highly leveraged institution in which most of the funds are contributed by the depositors

and from which financing is provided to the large industrialists. However, only a small portion of industrial profits go to the depositors of the bank and in case of default, it is the depositors who suffer. The industrialists add their cost of finance in pricing their products and eventually they recoup all their costs including the financing costs from the pockets of consumers (Usmani, 2014, p. 17-18).

Let us see do Islamic banks work any differently from the economics perspective. Currently, Islamic banks also operate within the same fractional reserve banking system where the capital to assets ratio is smaller and major portion of the financing is provided from the depositor's funds.

Onus is also on Islamic banks to ensure more significant distinction from conventional banks. Currently, in the lease and mortgage based financing, the client is made the legal owner in books right away as per the asset and property registration documents in many cases. In trade finance, this is even harder to avoid. Article 5 of the Uniform Customs and Practices for Documentary Credits (UCP) states: "Banks deal with documents and not with goods, services or performance to which the documents may relate."

Again, Islamic banks cite unfavorable tax framework as the reason due to which multiple transfers of asset or property is avoided in legal documentation in order to avoid duplication of taxes. Nonetheless, in non-Muslim majority jurisdictions, Islamic banks themselves plead for tax neutrality by proving their economic substance as similar to conventional banks. Thus, as suggested by the respected scholar, Mufti Muhammad Taqi Usmani, there is a need for paradigm shift in Islamic banking. In his book, 'Introduction to Islamic Finance', the respected scholar, Mufti Muhammad Taqi Usmani (2004, p. 72) writes:

"It should never be overlooked that, originally, Murabaha is not a mode of financing. It is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where Mudarabah or Musharakah are not practicable."

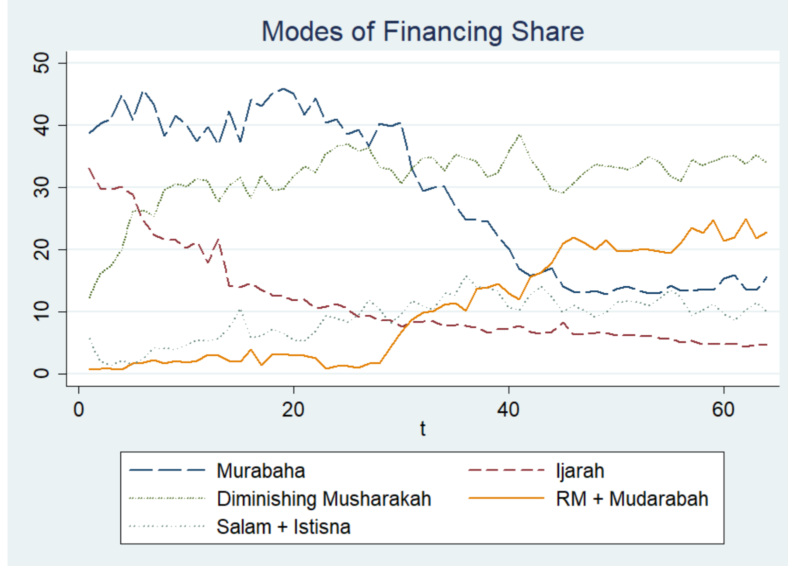
Ahmed et al. (2017, p. 479) give reasons why Islamic banks prefer to use debt based modes of financing more prominently. One of the reasons is that if both equity and debt based modes of financing are vetted as Shari'ah compliant by Shari'ah advisors and the legal and governance framework does not distinguish between them on the basis of consequential impact on income redistribution and inequities, then Islamic banks are going to choose between them by looking at other market and competitive factors. Since Islamic banks are profit-based institutions working as small players in the industry dominated by conventional banks, they will tend to use debt based modes of financing as safer options to cater to risk-averse account holders and since they also have limited variety of instruments and arrangements to manage their liquidity risk in the money market.

Nonetheless, Muhammad (2014, p. 135) thinks that reason to overlook equity based modes of financing is more because the top management and sponsors of Islamic banking institutions are risk-averse and complacent when it comes to the higher goals of Islamic finance and its strategic positioning in the overall financial system.

In Figure 7, it is appreciable to note that in financing mix, the share of Murabaha and Ijarah has fallen while the share of Diminishing Musharakah and Musharakah has increased in Pakistan overtime. However, it is important to note the structure and application of Diminishing Musharakah and Running Musharakah.

In Running Musharakah, the concept of risk-sharing is neutralized through i) cost sharing in only specific heads, ii) skewed profit sharing towards the client beyond achievement of target level of return by the bank, and iii) using the prevailing interbank rate as benchmark (Ayub, 2016, p. 13-15). Furthermore, calculation of profit on daily product basis and the capital contribution from the aggregate reported numbers in consolidated accounts remains unable to determine true profitability and even the true level of investment capital.

Figure 7: Financing Mix (%) Contract wise in Islamic Banking



Source: Data from Various Issues of Islamic Banking Bulletin

All Islamic banking financing products are linked with conventional interbank rate, known as KIBOR. Even in Running Musharakah, target profit rate used is KIBOR. The product structures also have resemblance and precedents in conventional banking. For instance, from the cash flows and finance perspective and not strictly from a Shari'ah compliance perspective, Diminishing Musharakah in real estate is similar to mortgage, Ijarah is similar to hire purchase, Sovereign Ijarah Sukuk is similar to sale and leaseback structure and Salam Sukuk is similar to zero coupon bills or commercial paper. Without ownership transfer in Ijarah Sukuk to the Sukuk holders genuinely, the structure merely remains asset-based or asset-light rather than asset-backed.

Even when the payoffs are linked with assets, they accrue not on the basis of how productive the asset turns out to be, but on the basis of prevailing interbank rates. In a pandemic like Covid-19, when lockdown happens, the Ijarah rentals or the accrued Murabaha price is not going to be affected by the fact that machinery remains idle in lockdown. Rafay and Farid (2017, p. 43) think that the contemporary Islamic banking paradigm does not significantly contribute towards the development of Muslim countries and communities.

Interestingly, most state owned enterprises are running in losses, while Islamic banks demand issuance of more sovereign Sukuk where the rentals or payoffs are going to be linked with policy interest rate rather than actual productivity of assets or projects. In the recently issued 'Asset-Light Sukuk Framework' issued by Ministry of Finance in September 2021, there are different Sukuk structures proposed. In these structures, the same inefficient Government which is unable to run state owned public monopolies profitably in industries with inelastic demand

or utilize its idle public infrastructure effectively is entrusted as ‘investment agent’ in Wakalah Sukuk, ‘selling agent’ in Salam and Istisna Sukuk or ‘working partner’ in Mudarabah and Musharakah Sukuk to engineer returns equivalent to policy interest rate.

Maududi (1970, p. 242) writing on the mindset of financial capitalists charging interest states that the financial capitalist wants the cow to give milk to him, but fetch its own food from somewhere else. In current Islamic financing product structures, it is hard to confidently claim that this mindset has been completely transformed.

While derivatives are derided a lot, Wa’ad based sales where Wa’ad (promise) is binding, achieve the aims of derivatives contracts. In the infamous commodity Murabaha transaction, multiple asset sales are involved one after the other to achieve transfer of equivalent cash flows as in repo transactions wherein no financial party is interested in buying physical assets genuinely.

In summary, Islamic banks provide Shari’ah compliant approved products, but they have to improve in certain areas in the light of these observations which are put forward by critics who envision and expect a lot more out of Islamic banks.

i. Average financing cost in Islamic banking is generally higher than conventional banks.
ii. Average return on investment in Islamic banking is generally lower than conventional banks.
iii. Agriculture and SMEs provide employment to majority of the population in Pakistan, but they only get around 2.7% share of all financing provided from Islamic banks, which is lower than conventional banks comparatively (7.7%).
iv. Regional concentration of Islamic banking branches is restricted mostly to urban areas as compared to even conventional banks.
v. Microfinance, health finance, education finance, start-up finance, agriculture finance and SME finance hardly features in financing mix in Islamic banking as compared to even conventional banks.
vi. Apparently, from the economic standpoint, one of the major differences is the higher spread in Islamic banking as compared to conventional. This inefficiency seems to stem from the Shari’ah compliance cost which includes additional documentation cost, monitoring cost, fees of Shari’ah compliance officers and advisors and increased labour hours needed in physical assurance of timely identification, delivery, possession and sale of assets in both legs of the transaction.
vii. However, beyond achieving Shari’ah compliance, it is hard to count too many distinctive economic merits in current practice of Islamic banking as compared to conventional banking. In cases where even the ownership of the asset or property is directly transferred to the client right away in legal documentation by some banks, even this much distinction diminishes further.

Summary and Conclusion

This paper assessed Islamic banking on three aspects: inclusiveness, competitiveness and fairness. Analysis shows that Islamic banks have been able to enable financial inclusion of those who want to avoid Riba, but fall short of expectations in competitiveness in pricing and returns, coverage, product variety, affordability and distinction with regards to distributional impact.

Islamic banks need to provide competitive returns to their loyal depositors rather than relying on ‘faith premium’ alone. For showcasing the contribution in achieving distributive justice, Islamic banks can take a

lead in offering microfinance products and services. Islamic banks can use their existing resources, capacity and infrastructure to integrate financially excluded micro-borrowers into the financial system.

To provide incentives, government can offer them incentives like it offers in export refinancing scheme and the one it offered during Covid-19 to refinance the wages and salaries bills. Furthermore, the central bank can also offer relaxation in cash reserve ratio if a certain percentage of non-remunerative demand deposits are used to provide interest free loans to agriculture and SMEs.

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تقييم اقتصادي للمصرفية الإسلامية في باكستان

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المستخلص. تطرح كلمة "إسلامي" في مصطلح "المصيرفة الإسلامية" بشكل طبيعي سؤالًا مفاده ماذا تضيف هذه الكلمة إلى مفهوم وممارسة العمل المصرفي؟ لقد رَفَعت الأدبيات المبكرة في الاقتصاد الإسلامي من سقف توقعات وتصورات أن تكون الخدمات المصرفية الإسلامية متميزة عن الخدمات المصرفية التقليدية من خلال تجنب الفائدة الربوية شكلًا ومضمونًا. وكان ذاك الطرح يُشير إلى أن الخدمات المصرفية القائمة على الفائدة تواجه الإقصاء، وعدم المساواة، والظلم، وسوء تخصيص الموارد المالية، وتركيز المال. في مقابل ذلك ساد الاعتقاد أن العمل المصرفي الإسلامي الخالي من الفائدة سيكون أكثر شمولًا وإنصافًا، وعدلًا، مما يؤدي إلى تخصيص أمثل وشامل للموارد المالية إذْ أنه قائم على معايير استبعاد التكلفة الثابتة لرأس المال. كما كان يعتقد أن هذا النظام المصرفي سيقلل من عدم المساواة في الدخل والثروة والتحقق وسيُسهم في التقليل من التركيز الشديد للثروة. بعد مضي أكثر من عقدين من العمل المصرفي الإسلامي في باكستان، من المناسب والمعقول جدًا تقييم التقدم والأداء بشأن هذه المثل العليا التي حددتها تلك الأدبيات. تُقدم هذه الدراسة تقييماً اقتصادياً للعمل المصرفي الإسلامي في باكستان من خلال ثلاثة معايير هي: الشمولي المالي، والتنافسية، والعدالة. يُظهر التقييم أن البنوك الإسلامية كانت قادرة على تمكين تحقيق الشمول المالي لأولئك الذين يريدون تجنب الربا، لكنها بحاجة إلى جهود متضافرة لتحسين التنافسية، والتميز على مستوى التأثير التوزيعي لمنتجات التمويل الإسلامي.

الكلمات الدَّالة: المصارف الإسلامية، التنافسية، العدالة، أداء المصارف الإسلامية

تصنيف JEL: G21, N25, O16
تصنيف KAUJIE: B4, I21, J32