

Development of Islamic Banking in Pakistan; Challenges and Prospects

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Abstract

This research examines the evolution and progress of Islamic banking in Pakistan, identifying key challenges and assessing future prospects within the sector. The study adopts a qualitative methodology, drawing on both primary and secondary data sources, including historical reports, statistical data, and interviews with key stakeholders in the Islamic banking industry. Specifically, it includes insights from regulators at the State Bank of Pakistan (SBP) and experts from Shariah Supervisory Boards (SSBs) within the sector. Interviews were conducted with nine officials from the SBP and twelve Shariah supervisors, making this study unique in its focus on industry regulators and Shariah scholars, unlike previous research that predominantly centered on customers and bankers. The findings reveal that while the development of Islamic banking in Pakistan has faced significant challenges, it has nevertheless gained traction over time. Addressing these challenges is essential for the continued growth and success of the sector. As of 2023, the Islamic banking industry in Pakistan has expanded to PKR 6.8 trillion (approximately USD 40 billion), capturing a 28.4% share of the total banking market (SBP, 2023).

Keywords: Islamic Banking, Islamic Finance, Pakistan, Prospects, Development, Challenges.

Introduction

The banking industry plays a crucial role in the economic development of any country. One specific area of focus within the banking industry is Islamic banking, which operates under the principles of Shariah law. The emergence of Islamic banking (IB) in the 1970s marked a significant development in the global financial landscape. Initially gaining traction in predominantly Muslim regions like the Middle East and Asia, IB gradually expanded its reach to non-Muslim territories in Europe, the UK, and Africa. Over time, it evolved into a global phenomenon, penetrating major financial markets worldwide. As of Jun 2023, the Islamic financial services industry boasted assets worth approximately PKR 8,118 Billion (SPB – 2023), with Islamic banking constituting 72% of this total (IFSI, 2023). Islamic banking in Pakistan has faced its fair share of challenges and obstacles, but it also holds immense potential for further growth and prosperity. Despite its remarkable growth, the journey of Islamic banking has been beset with challenges. In Pakistan, for instance, where five fully operational Islamic banks, including MCB Islamic Bank, Al-Baraka Bank, Meezan Bank, Bank Islami, and Dubai Islamic Bank, currently operate, the sector encountered hurdles along the way. As of Jun 2023 (According to SBP), the country boasted a total of 4,534 Islamic banking branches, with dedicated Islamic banks accounting for 1,834 of these branches. Despite its growth, Islamic banking faces challenges. In Pakistan, the sector has encountered hurdles, with Islamic banking assets holding a market share of 28.4% and deposits comprising 21.9% of the banking industry as of June 2023. Past research has extensively explored various theoretical, ideological, developmental, and operational aspects of Islamic banking, covering topics such as product structures, objectives, strategic issues, and customer satisfaction. This study aims to provide a comprehensive overview of the evolution of Islamic banking in Pakistan, incorporating perspectives from Shariah experts and regulatory bodies, notably the State Bank of Pakistan. Despite numerous studies assessing Islamic banking perceptions, a significant research gap remains, particularly in evaluating the viewpoints of stakeholders beyond customers and bankers. Therefore, this research endeavours to bridge this gap by examining the perspectives of regulatory authorities from the State Bank of Pakistan and Shariah supervisors serving on Shariah Supervisory Boards (SSBs) within the Islamic banking industry of Pakistan. Previous studies, such as those conducted by Gerrard and Cunningham (1997),

Ahmad and Haron (2002), Dusuki (2007), Dusuki and Abdullah (2007), Dusuki (2008), Loo (2010), Rustam et al. (2011), Lee and Shakir (2011), Saeed et al. (2012), Riaz (2014), Ringim and Yussof (2014), Buchari et al. (2015), Khan and Ramzan (2015), Akhtar et al. (2016), Shah et al. (2016), and Belwal and Maqbali (2018), (Muhammad Khalil Rehman and Muhammad Nazmul Hoque (2023) have primarily focused on assessing the perceptions of various stakeholders regarding Islamic banking. However, there remains a dearth of research analyzing the viewpoints of other stakeholder groups. This study aims to fill this gap by examining the perspectives of Islamic banking sector regulators from the State Bank of Pakistan and Shariah supervisors serving on Shariah Supervisory Boards (SSBs) in Pakistan.

Literature Review

The establishment and progression of Islamic banking in Pakistan have been deeply influenced by historical, socio-political, and economic factors. Initiated in the 1980s as part of Zia-ul-Haq's Islamisation process, Islamic banking's integration into the financial landscape faced initial scepticism and challenges from various quarters. The pivotal decision by the Supreme Court of Pakistan in 1991, following discussions highlighted by Zaidi (2003), solidified the formal incorporation of Islamic finance into the country's banking system. Islamic banking in Pakistan is not merely a financial endeavour but carries significant ethical and religious implications, setting it apart from conventional banking practices. Scholars such as Dusuki (2008) have debated the fundamental objectives of Islamic banking, with divergent viewpoints on whether it should prioritize socio-economic development alongside profit maximization or adhere strictly to Shariah principles while operating similarly to conventional banks. Despite its growth, the Islamic banking sector in Pakistan faces a multitude of challenges, as outlined by Haneef and Mirakhor (2014). These challenges include the absence of specific regulatory frameworks tailored to Islamic finance, over-reliance on debt-based financing structures like Murabaha and Bai Muajjal, and a shortage of qualified human resources, as noted by Akhtar et al. (2016). Moreover, there is a significant lack of awareness among both customers and banking staff regarding Islamic banking products and services, as highlighted by Aqib and Hussain (2017). Education and skills development emerge as critical components in addressing the challenges faced by Islamic banking in Pakistan. Nafukho et al. (2014) emphasize the importance of investing in human capital to improve productivity and create employment opportunities. However, there is a significant gap in Islamic finance education, with only a limited number of institutions offering relevant courses, as observed by Thecityuk (2015). This shortage of qualified professionals is further exacerbated by the disconnect between traditional madrasas and modern Islamic finance techniques, as discussed by Siddiqui (2018). Efforts to bridge this gap and enhance Islamic financial literacy are imperative for the sustainable growth of the Islamic banking sector in Pakistan. As emphasized by Al-Awlaqi and Mohamed Aamer (2022), the production of well-qualified Shariah scholars is essential to meet the demands of the Islamic finance industry. Therefore, comprehensive reforms and investments in education and skills development are necessary to ensure the alignment of Islamic banking with Shariah principles while contributing to socio-economic development in Pakistan. In conclusion, while Islamic banking has made significant strides in Pakistan, addressing persistent challenges and investing in human capital development are crucial for its continued success and sustainability. This literature review provides a comprehensive overview of the historical development, challenges, and potential solutions within the context of Islamic banking in Pakistan.

Origin and Progress of Pakistan's Islamic Banking Initiatives

The roots of Islamic banking in Pakistan can be traced back to the late 1970s, with significant progress aligning with the global surge in Islamic finance during that era (Aqib, 2014). The concept gained traction in 1977 when President Zia ul Haq tasked the Council of Islamic Ideology (CII) with devising an interest-free economic system, aiming to eliminate riba (interest) from financial transactions (Khan and Bhatti, 2008). Following the CII's recommendations, detailed in a 1980 report, various amendments were made to relevant banking laws, including the Banking Companies Ordinance 1962, the State Bank Act of 1956, and the Negotiable Instruments Act of 1881, to accommodate Islamic banking from a regulatory standpoint. However, the progress faced a significant setback in 1991 when the Federal Shariat Court (FSC) declared that all banking transactions in the country were infused with riba and called for a comprehensive overhaul to establish a Shariah-compliant financial system (Shah and Niazi, 2019). Despite government efforts to implement an Islamic banking framework as recommended by

the CII, the country's legal, tax, regulatory, and socio-economic environments posed significant challenges, resulting in a fragile and unsustainable system (Khan & Bhatti, 2006). Renewed efforts to revitalize the Islamic banking initiative began after the FSC's 1991 ruling, which led to the formation of the Commission for Islamization of the Economy (CIE). The commission was responsible for developing a framework for an interest-free economy and submitted its first report in 1992, followed by another in 1998, in collaboration with the International Institute of Islamic Economics (IIIE). The second report offered practical solutions and alternatives to conventional banking practices, tailored to modern financial needs. However, the focus on finding conventional substitutes rather than adhering to the Shariah's spirit and principles led to the creation of an unstable Islamic banking structure at that time. The FSC's 1991 ruling was subsequently challenged in Pakistan's Supreme Court (SC). In a landmark 1999 judgment, the SC declared all forms of interest prohibited under Shariah, mandating the government to revamp the financial system accordingly. The court ordered the establishment of the Commission for Transformation of Financial System (CTFS) within the State Bank of Pakistan (SBP) to lead the efforts to eliminate interest from the banking sector (Janjua, 2004). The CTFS made several recommendations, including the creation of new institutional setups and the introduction of a legal statute titled "Islamization of Financial Transactions Ordinance" to govern interest-free transactions (Shah and Niazi, 2019). By 2001, after extensive deliberations between government officials, the SBP, and other stakeholders, a comprehensive strategy for developing Islamic banking in Pakistan was formulated. This culminated in the SBP issuing the first Islamic commercial bank license to Al Meezan Investment Bank in 2002, which was later renamed Meezan Bank, the pioneer of Islamic banking in the country (SBP, 2002). Following the establishment of Meezan Bank, the Islamic banking industry in Pakistan saw significant growth, with several other Islamic banks, such as Bank Islami and Dubai Islamic Bank, entering the market. The SBP also encouraged conventional banks to establish Islamic subsidiaries and branches alongside their traditional operations, contributing to the rapid expansion of the Islamic banking sector. As of June 2023, there were six dedicated Islamic banks operating in Pakistan, with a total of 4,534 Islamic banking branches (IBBs) across 131 districts (SBP, 2023). The current state of Islamic banking in Pakistan is robust, as evidenced by the presence of five fully-fledged Shariah-compliant banks, including Al-Baraka Bank, Meezan Bank, Dubai Islamic Bank, Bank Islami, and MCB Islamic Bank. Additionally, there are 16 Islamic banking windows and 1,834 Islamic sub-branches across the country. The market share of Islamic banking assets and deposits in the overall banking industry reached 19.9% and 21.9%, respectively, by the end of June 2023, with total assets amounting to PKR 8,118 billion (SBP, 2023).

Chronology of Pakistan's Islamic Banking Initiative

The journey of Islamic banking and finance paradigm in the country has seen many milestones and has been an eventful one in terms of its success and sustainability. All the major landmark happenings with reference to Islamic banking setup in Pakistan are mentioned in the following Table 1, which presents these events in a chronological order to comprehensively cover Pakistan's Islamic banking history from developmental and progressive perspectives.

Table 1: Pakistan’s Islamic Banking Chronology (Source: Researcher’s Compilation)

Year	Developments/Events/Milestones Pertinent to Islamic Banking
1947	Pakistan was established as an independent state on 14 th August.
1948	The State Bank of Pakistan, the central bank of the country, was established on July 1st, with an inaugural speech by Pakistan's founder, Quaid-e-Azam Muhammad Ali Jinnah, emphasizing the vision of creating a banking system aligned with Islamic principles
1949	On March 12th, 1949, Pakistan's first Constituent Assembly adopted the Objectives Resolution, declaring that all laws, rules, and regulations in the country should be formulated in alignment with the principles of the Quran and Sunnah
1956	Pakistan's first constitution was enacted on February 29th, officially declaring the country as an Islamic Republic.
1962	Islami Nazriaati Council i.e. The Council of Islamic Ideology (CII) is formed to offer advice/recommendation to the government on Shariah matters.
1974	Pakistan’s banking sector was nationalized and Pakistan Banking Council (PBC) was created.
1977	President Zia ul Haq assigns the task to rid economy of <i>Riba</i> (interest) to the Council of Islamic Ideology (CII).
1979	Pakistan’s government declared three years’ timeline to eliminate Riba from the country’s financial system and economy.
1980	The Federal Shariat Court (FSC) was established on May 26th, tasked with evaluating whether existing laws were in accordance with Islamic or Shariah principles. In the same year, the Council of Islamic Ideology (CII) submitted a report advocating for an interest-free financial system and recommended amendments to various banking laws, including the Banking Companies Ordinance of 1962 and the State Bank Act of 1956
1981	In its meeting on November 11th, the Council of Islamic Ideology (CII) commended the government's initiatives to eliminate interest in the operations of institutions such as the House Building Finance Corporation (HBFC), National Investment Trust (NIT), and Investment Corporation of Pakistan (ICP). However, the CII also expressed concern over the mark-up system in banking, criticizing it as merely a rebranded form of interest
1985	Pakistan’s government accepts its failure to eliminate interest from the financial system within the declared deadline.
1991	The Commission for Islamization of the Economy (CIE) was established to oversee the elimination of Riba from the financial system. The Federal Shariat Court (FSC) ruled that existing banking practices in the country were inconsistent with Shariah principles due to the involvement of Riba, setting a deadline of June 30, 1992, for its removal from the economy. Additionally, this year marked the beginning of the denationalization and privatization of the banking sector.
1992	CIE submitted its first report regarding riddance of Riba from the economy.
1997	CIE invites recommendations from The International Institute of Islamic Economics (IIIE) from The IIUI – International Islamic University Islamabad regarding IBF system. PBC liquidated.
1998	CIE in consultation with IIIE submits the second report regarding the implementation of a truly Islamic financial system in the county.
1999	The Shariah Appellate Bench (SAB) of the Supreme Court of Pakistan heard appeals from the government and other parties challenging the Federal Shariat Court's 1991 ruling on Riba in the economy. On December 23rd, the Supreme Court delivered a landmark judgment upholding the FSC's decision, rejecting all appeals, and set a deadline of June 30, 2001, for the government to restructure the financial system in accordance with Islamic principles

2000	The State Bank of Pakistan (SBP) established the Commission for Transformation of Financial System (CTFS) to accelerate the elimination of Riba from the economy, in line with the Supreme Court's ruling. Additionally, the government formed a task force within the Ministry of Finance to discuss and transition governmental finances to an Islamic financial framework.
2001	Significant changes were made to legal statutes and regulations to advance the Islamic financial system, including amendments to the Banking Companies Ordinance of 1962 and the repeal of the Money Lenders Ordinances. On June 14th, the government submitted a petition to the Supreme Court requesting an extension of the deadline for transforming the economy along Islamic lines. The Court granted a one-year extension, moving the deadline to June 30, 2002.
2002	Pakistan's first fully-fledged Islamic bank, Meezan Bank, was established. On June 24th, the Supreme Court reviewed a petition filed by the government and United Bank Limited (UBL) challenging its previous ruling on Riba. The Court overturned its 1999 decision and declared the 1991 Federal Shariat Court judgment void.
2003	The State Bank of Pakistan established its own IBD – Islamic Banking Department to facilitate and promote the Islamic banking initiative in the country.
2004	Dual Banking system continues in the country with several Islamic banking branches (IBBs) of conventional banks in addition to one full-fledged Islamic bank. HBL gets approval for Islamic banking. Moreover, State Bank received 24 applications for more IBBs.
2007	Six purely Shariah-compliant Islamic banks and several IBBs of interest-based banks signaled for positive Islamic banking prospects in Pakistan.
2010	Pakistan approved four Shariah Standards from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for implementation in the Islamic banking sector
2020	The State Bank of Pakistan actively supported the Islamic banking sector through various awareness campaigns. By this year, the sector had achieved a market share of around 15% within the overall banking industry. Operationally, there were five fully Shariah-compliant Islamic banks and 17 conventional banks with dedicated Islamic Banking Branches (IBBs) across the country
2021	State Bank of Pakistan (SBP) launches a five-year plan to promote Islamic banking in the country. Meezan Bank, Pakistan's first Islamic bank, is awarded "Best Islamic Bank in Pakistan" by The Asian Banker. SBP issues guidelines for the establishment of Shariah-compliant financial technology (fintech) companies.
2022	Pakistan's Islamic banking assets reach PKR 4.7 trillion (USD 26.5 billion), accounting for 22% of the country's total banking assets. The government launches a sovereign sukuk (Islamic bond) worth PKR 50 billion (USD 285 million) to finance its budget deficit. The Securities and Exchange Commission of Pakistan (SECP) introduces new regulations to promote sukuk issuance.
2023	SBP introduces a Shariah-compliant liquidity facility for Islamic banks to manage their liquidity. Meezan Bank launches Pakistan's first-ever Shariah-compliant credit card. The Pakistan Stock Exchange (PSX) introduces an Islamic index to track Shariah-compliant stocks.

2024	The government announces plans to establish an Islamic finance regulatory authority to oversee the sector. SBP issues guidelines for the establishment of Shariah-compliant digital banks. Pakistan's Islamic banking industry reaches a milestone of 28% market share in the country's banking sector.
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Methodology

The development and progress of Islamic banking was based upon secondary sources of data including the already available literature, records, reports, facts and figures. For the discussion regarding the challenges faced by the Islamic banking sector, primary data was fetched by conducting the interviews. Further details regarding methodology being adopted to undertake interviews, is discussed hereunder:

Data Collection

The data was gathered by conducting semi-structured interviews that included the State Bank of Pakistan (SBP) personnel and Shariah supervisors serving in the Islamic banking industry of Pakistan.

Sampling

The study employed the purposive sampling technique because VanRijnsoever (2015) posited that purposive sampling technique in comparison to other random sampling methods is especially much efficient in the domain of qualitative research. The choice of purposive sampling is also chosen based on past similar research studies (Ali & Hassan, 2017; Ayedh & Echchabi, 2015; Echchabi & Aziz, 2014; Echchabi & Olaniyi, 2012).

Data Analysis

The data was fetched from conducting the interviews, in mainly two ways i.e. audio and voice recordings and in the shape of textual content when the researcher was taking notes during the interview sessions. Subsequently, that data collected was meticulously and carefully reviewed before the transcription of data was undertaken. Afterwards, analysis of the data was done by formulating themes in the context of issues as discussed with the interview participants; the analysis entailed a detailed interpretation of collected data so as to have a holistic understanding regarding the responses, opinions and experiences of interview participants (Echchabi & Aziz, 2014; Lester, 1999).

Ethics

The data was collected from the interviewees after taking their written consent. All interviewees were briefed about the research aims and purpose and were ensured about their confidentiality and anonymity and use of the information provided by them was being collected only for academic objectives.

Interview Data Findings and Discussion

The research interviewees provided their valuable feedback about various challenges being faced by Pakistan's Islamic banking industry. The researcher delved deep into the discussion with the interviewees regarding various problems and important issues as experienced by the IB sector of the country. There were many important points highlighted by the interviewees in their responses to the questions asked which are categorized under the following sub-themes.

Understanding and Awareness

The interview respondents were quite unanimous upon the issue of limited Islamic banking awareness among the masses. This is why most of the interviewees perceived that spreading the knowledge and understanding about Islamic banking philosophy, products and processes must be the greatest agenda point for all IB stakeholders in the country in order to ensure a progressive and stable IB market in Pakistan. Across both interviewee segments, including Shariah experts and regulators, majority of the respondents concurred that promotion of IB awareness

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among general public is crucial for a sustainable and successful Islamic banking sector. The interviewees deemed the lack of IB awareness as among the top hurdles in the realization of true IB market potential and suggested an all-out approach to disseminate the true and clear Islamic banking knowledge to the maximum extent among the masses by using all the possible resources to enhance the level of awareness in order to warrant a thriving IB industry. Some of the interviewees even pointed that general people aside, there is lack of understanding of true IB spirit even among the top-tier management of various Islamic banking and financial institutions, hence as the saying goes —charity begins at home; the drive to inculcate concrete knowledge and understanding to raise awareness about Islamic banking products and processes must start from within the Islamic financial institutions to better equip their management and staff with necessary knowledge to pursue the cause of Islamic banking which will eventually facilitate the greater dissemination of IB awareness to a larger number of people including customers and general public. The matter of IB awareness must be considered at priority-basis, according to the interviewees as it would not only enhance IB products acceptability but would also help to dispel the negative viewpoints regarding the products and operations of Islamic banking sector in Pakistan. The interviewees asserted that all possible mediums and channels of communication must be utilized to spread Islamic banking awareness among the people to make them better understand the Islamic banking offerings and operations, so they accept and adopt Islamic banking products and services instead of going for the inter-based conventional banking products. The views of some of the interviewees with reference to the important aspect of IB understanding and awareness are mentioned as under: -

1. Interviewee 4: The issue of awareness tops all others because it is indeed the most crucial aspect in terms of acquiring new customers and attaining the confidence of existing customers in order to retain them, the fundamental distinction of Shariah- conformity of transactions by avoiding riba-based dealings must be conveyed in a clear manner to the general public to lift the IB market share in Pakistan.
2. Interviewee 5: This is amongst the major challenges faced by the IB sector of the country that there is absence of conviction regarding IB philosophy even among the management of IBFIs [...] and public at large comes later, firstly the IB knowledge and understanding must be diffused effectively within the Islamic banks' leaderships, staff and personnel to eventually spread the message of Islamic banking in a clear fashion to other stakeholders like customers, competitors and general masses.
3. Interviewee 9: —[...] and I think the most pertinent variable to IB growth is the IB awareness, simply put, the greater the awareness of IB paradigm, the more the market share will be [...]; therefore, every possible effort must be made to maximize IB understanding among the people using all available channels of communication including electronic media, social media, press and others.
4. Interviewee 12: The IB knowledge shall be the central focus of the Islamic banks and they should ensure that the issue of IB awareness is pursued at grassroots level involving branch-level staff, in order to maximize the impact of IB understanding to the general public.
5. Interviewee 13: [...] and Islamic banks must strive at all levels to spread the knowledge of Islamic banking to their staff and customers as well as they must conduct awareness events, learning sessions and seminars, etc sorts of activities to draw the interest of general public towards the IB paradigm, this must be the focal agenda of all their marketing endeavors to effectively convey the message of Islamic banking model to the stakeholders.
6. Interviewee 20: All stakeholders must play their role to get the message (of Islamic banking) across including academia, mosques, and media in particular. Islamic banks must strive at all levels to spread the knowledge of Islamic banking to their staff and customers as well as they must conduct events and seminars etc. sorts of activities to draw the interest of general public towards Islamic banking services

The interviewees discussed various points in connection to the IB understanding and awareness which largely emphasized the significance of expanding the understanding of general public towards Islamic banking services and offerings. This aspect regarding the knowledge and understanding of IB products and offerings has also been elucidated in past literature including the studies by Haron et al. 1994; Metawa and Almosawi, 1998; Ahmad and Haron, 2002; Aziz, 2005; Khattak and Rehman, 2010; Soud and Sayılır, 2017; Riaz et al., 2017; Lujja and Hassan, 2018; and Latif, 2019.

Conventional Banking System

Among other issues, the interviewees underlined the challenge of countering conventional banking setup in the country. The majority of Shariah experts were of the opinion that the authorities including the governmental and regulatory bodies must intervene to support the cause of Islamic banking by putting some sorts of constraints upon the conventional banking sector. The fact that the country operates on dual banking basis apparently provides an open field for both interest-based as well as Islamic banks to compete but the level-playing field is not truly available to Islamic banks because they have a largely disproportional competition with conventional banks who are clearly winners in the race because of their already established organizational and industrial superiority over the Islamic banking institutions. The interviewees from both groups of respondents i.e. regulators as well as Shariah scholars emphasized some sort of measures to curtail and restrict further conventional banking growth to facilitate and support the IB initiative. The fact that the competition with conventional banks is an extremely uphill task is ratified by the Islamic banks' fractional share in the overall market share of Pakistan's banking industry which currently stands at approximately 28%. The cut-throat competition from conventional interest-based banks is perceived as one of the key obstacles and one of the biggest threats to the overall growth and progression of Islamic banking sector by the interviewees. Some of the opinions of the respondents are noted as under:

1. Interviewee 8: —There had been supportive arrangements already done in the past to favor Islamic banks and to discourage conventional banking system somewhat by encouraging them to operate their Islamic banking divisions/windows [...] but more needs to be done to put some type of limits to the exponential growth of conventional banking system to impact the Islamic banking sector in a favorable way.
2. Interviewee 11: —[...] people at the helm must have to take some tough decisions in order to constrict the conventional banking setup in one way or another to assist the Islamic banking sector because current scenario warrants not much IB success provided there is nothing done to put some reigns on the conventional banking setup.
3. Interviewee 21: —[...] as this, in my opinion, is not an option but a necessary move to facilitate the slack IB sector and steps to tighten control over conventional banking system would not only serve as a booster to full-fledged Islamic banks but would also send a strong signal to the conventional banks to divert more energies to expand their Islamic banking operations through their Islamic windows and IBDs (Islamic banking divisions).

The interviewees also talked about developing Islamic banking sector by addressing key challenges including capacity limitations which are discussed in the next section. The capacity expansion is also contingent upon Islamic banks' survival from the fierce competition posed by the powerful conventional banking entities, so this was aptly highlighted by the research participants, and therefore they generally suggested supportive measures by constricting the rampant conventional banking system is quite essential.

Capacity Constraints

The challenges of capacity building and capacity enhancement are among the key challenges faced by the Islamic banks, operating in Pakistan's IB sector. The capacity issues are multi-faceted and varied in nature and magnitude,

posing a threat and being cause of disadvantaged position of Islamic banks in comparison to the interest-based banks. The interview respondents noted several relevant issues including dearth of qualified and trained staff, lack of competence of Shariah and managerial personnel, limited financial resources and weak infrastructure among top factors which hinder a stable and sustainable IB set up in Pakistan. The points indicated by the interview participants were also highlighted in some of the previous studies like the ones by Mehmood, 2002; Ahmed et al., 2013; Aqib and Hussain, 2016; Ayub, 2019; Latif, 2019; and Shaikh and Shah, 2019. The viewpoints of the interviewees are given in the following statements as quoted:

1. Interviewee 2: —One of the obvious issues faced by the industry is the lack of human capital; it includes various aspects including overall competence of Islamic banking branch staff, managers, and executives who have lack of clear understanding about philosophy and processes of Shariah-compliant banking because mostly they come from the conventional banking entities [...] as well as the Shariah board members having a limited knowledge of modern banking and financial issues essentially make them unable to perform their roles in an effective manner.
2. Interviewee 7: —Poorly trained staff and underqualified Shariah personnel are major problems whereas, on the other end, limited financial resources render the Islamic banks to lag far behind in the competition with their conventional counterparts [...].
3. Interviewee 10: —[...] and weak financials and limited physical resources of Islamic banks in comparison to conventional banks presents major challenges also causing setbacks in terms of stiff competition with the conventional banking sector.
4. Interviewee 18: —[...] and conventional banks naturally being already established and in operation since a long period undoubtedly puts them at a frontal position whereas Islamic banks are lagging far behind owing to less-developed infrastructure, for instance in terms of several branches, inadequate and less-trained staff [...] all largely because of underdeveloped IB market and restricted financial capability.

Stakeholders Engagement

The interview participants offered their insights regarding the promotion of the IB sector by suggesting various points regarding how to achieve IB sector growth and expand in terms of market share. The interviewees opined that the IB industry must engage in various forms of direct level communication with stakeholders from various walks of life and convey to them the understanding of Islamic banking and its significance in terms of religion and otherwise. The respondents suggested that in addition to addressing issues relating to product designing and development, and delivery of customer-oriented IB services; the Islamic banking stakeholders must adopt a holistic and comprehensive approach to take on board the general masses; this would certainly lead towards favourable interaction with prospective customers who may ultimately become IB customers and would be patronizing the Islamic banks in some way either by becoming clients or by otherwise spreading the message of Islamic banking by word-of-mouth advertising, which is the greatest mean to disseminate the Islamic banking awareness in society. The interviewees especially emphasized that awareness regarding Islamic banking requires an integrated approach and made various recommendations to enhance Islamic banking acceptability by involving general people from different fields of life. The proposals included stakeholders' engagement through the involvement of academia (colleges and universities), madaris (Islamic seminaries), business and corporate entities, as well as members of the society from all walks of life including organizations from the public and private sectors. The community involvement initiatives may also be materialized by involving various institutions of social interaction including mosques, recreational and social clubs, market-places, shopping malls, etc. Apart from business and financial benefits, the interviewees suggested that the religious element is an essential and integral component of the Islamic banking model, and therefore, the same must be stressed while engaging the communities and general people to persuade them to patronize Islamic banking products and services. Some of

the pertinent statements of interviewees are noted hereunder:

1. Interviewee 5: —[...] and a small market share of Islamic banks proves the point that the IB market potential remains largely untapped in Pakistan to a greater extent and thus the situation calls for a coordinated effort to take all the concerned stakeholders on board by community engagement activities at various levels including diverse means like by conducting events and activities at banks, business places, and other public and private sector organizations to spread awareness and offer IB services at the doorstep of the people to win over new customers and maximizing the prospective clients [...].
2. Interviewee 8: —[...] and people must be urged to realize that the Islamic banking alternative should be considered as a mandatory choice instead of being an optional one, particularly from a religious perspective because Riba is one of the most serious sins in the Islamic faith, this fact may be reiterated by involving communities and individuals at different social and institutional scales.
3. Interviewee 9: —No doubt an integrated and well-organized marketing and awareness campaign to involve general people, to enable them to understand and adopt Islamic banking services, is the need of the hour [...] and various social setups and institutions including mosques, madaris, educational institutions, public places like marketplaces, transport centers, shopping areas and corporate and business establishments, etc may be approached for the purpose.
4. Interviewee 15: —A systematic and carefully planned strategy is much required to ensure engagement of the common people to patronize and participate in the Islamic banking initiative of the country, there have been some efforts in this regard from various stakeholder groups including the central bank and other governmental and regulatory organizations [...], rather a comprehensive and well-coordinated effort from all concerned stakeholders including Islamic banks, state-owned governmental and regulatory agencies, academia and business entities is needed to lift the status of IB sector and to ensure a thriving and sustainable Islamic banking industry in the country.

Operational Obstacles

The interviewees discussed several operational hurdles and challenges faced by the IB sector. These issues as highlighted by the interview participants included the use of KIBOR as a benchmark rate; operational transparency of Islamic banking transactions; issues about Shariah compliance and Shariah spirit of IB transactions; and lack of a comprehensive, standardized, and uniform IB legal and regulatory framework. The issues as described by the interviewees act as irritants and stumbling blocks in the smooth functioning and execution of IB dealings and operations and hence must be addressed aptly by the concerned quarters including the regulatory and banking entities to ensure a progressive IB setup in the country. The opinions of various interviewees are mentioned below to elucidate their views regarding the operational issues faced by the IB sector:

1. Interviewee 4: —[...] and one of the most pinching matters is one of the benchmark rates, this is high time for all stakeholders including especially the regulators and Shariah experts to devise some sort of alternative which may substitute the benchmark rate to price the IB offerings.
2. Interviewee 6: —[...] and this is obvious that customers' expectations from Islamic banks in terms of operational transparency and accountability concerning the execution of transactions are high, and so this is one of the areas the Islamic banks must look into to enhance the confidence of customers [...].
3. Interviewee 11: —There are certain misconceptions and misunderstandings about the Shariah spirit of IB products, but these are not unfounded, there needs to be done a lot to dispel the idea that Shariah is not the top goal of Islamic banks, which requires dedication and honest efforts from all concerned including Shariah board members, the management being decision-makers as well as the IB staff who are responsible to execute transactions as per Shariah parameters.

4. Interviewee 12: —Benchmark rate is a chief irritant and a major cause of criticism faced by the Islamic banks, therefore something must be done at a priority basis to look for some alternatives in terms of an index, rate or percentage that may be utilized to replace the KIBOR benchmark [...] and it would not be possible without the interest and involvement of regulators and decision-makers at the top from the government sector to approve and implement the same.
5. Interviewee 14: —[...] and from Shariah perspective, both forms, as well as the substance of transactions, must be considered to ascertain whether a transaction conforms to the Shariah guidelines in true letter and spirit.
6. Interviewee 17: —There are issues concerning the Shariah and regulatory framework, for instance, partial adoption of AAOIFI standards resulting in a mixed-up legal schema and absence of a uniform code to resolve Islamic jurisprudential differences among others there is still much progress needed towards the development of a standardized framework to serve as of basis for a stable IB sector [...].
7. Interviewee 19: —[...] and Shariah violations in transactions, as well as grey areas in product designing and structuring from Shariah conformity standpoint, are critical issues [...] and these may only be effectively addressed by introducing a standardized system of product development at the central bank level to ensure uniformity and a greater degree of Shariah compliance to avoid the phenomenon of fatwa shopping.

The issues and irritants regarding the Islamic banking operations and processes, as discussed in the context of responses of the interviewees comprising members of the central bank's staff and members from SSBs of various banks, were also shed some light by being part of the past literature as contained in the previous studies including the ones by Mansoori, 2011; Ahmed et al, 2013; Butt and Aftab, 2013; Oseni, 2017; Majeed and Zainab, 2017; Shakir et al., 2018; Ayub, 2019; Shaikh and Shah, 2019; and Tlemsani, 2020.

Regulatory and Government Support

The interview participants were concerned about the lack of adequate facilitation and support from the concerned state-owned authorities including the governmental and regulatory institutions; especially the Shariah experts segment raised their concerns regarding the lack of governmental support towards the IB initiative and urged greater support from the governmental and regulatory bodies to strengthen and promote the IB sector in the country.

The interviewees opined that the government's lack of an honest will and slack regulatory support hinders a fast-paced IB growth and the interview participants also discussed issues of the weak legal and regulatory framework, slack policy formulation and implementation, as well as lack of political will to warrant a prosperous Islamic banking regime in Pakistan against an extremely dominant interest-based banking system at both national and international levels. The interviewees suggested that there must a committed and result- oriented policy shift from the government to lift the IB sector by incorporating modifications in legal statutes as well as by introducing a potent and progressive regulatory schema to enable smooth functioning and regulation of the IB industry in Pakistan. The views of some of the interviewees are discussed as follows:

1. Interviewee 1: —The governmental support is not where it should have been in terms of legislation and legal framework [...] and therefore it is up to the central bank and governmental machinery to back the IB sector in a true sense to strengthen the IB industry against a mighty conventional banking sector.
2. Interviewee 4: —SBP has done very well in facilitating the IB sector and its contribution has been commendable yet the policy-related and legal issues from the government's end require greater interest and consideration to support the IB industry [...].
3. Interviewee 10: —[...] and there are several proposals in the pipeline such as modifications to the BCO (Banking Companies Ordinance) and amendments in other statutes to expedite and facilitate

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the functioning of IB sector and to ensure effective regulation.

4. Interviewee 15: —The SBP as the regulator has played a very positive role to strengthen and promote the IB system of the country and further efforts are underway to contribute even more towards the development of the sector.
5. Interviewee 16: —There have been measures taken by the regulatory institutions, especially SBP but there is always a margin for the better [...] and facilitation from the government's end and other regulatory and policy-formulating agencies may surely be enhanced to lift the IB sector in order to support it to achieve greater potential in order to better compete with the conventional banking system. The discussion regarding the regulatory and governmental support that Pakistan's central bank has certainly played a much favorable role in assisting the IB industry of the country (Siddiqui, 2021), yet the interviewees stressed that a lot can be achieved if the regulator along with the backing of governmental support. There must be improvement in terms of policy formulation and in terms of designing and implementation of effective legal framework to facilitate IB governance and ensure a greater degree of reliability of IB operations in the context of Shariah compliance which is the cornerstone of the Islamic banking paradigm. The endeavour must be to develop a superior system of regulation and control based on focused legislation to promote and strengthen the IB initiative in the country. The need is to involve the corridors of power in the governmental institutions to expedite the necessary statutory amendments in relevant laws specifically the Banking Companies Ordinance as well as the enactment of fresh legal and statutory regulations that must be focused on refinement of the Shariah governance framework and are aimed at assuring a greater degree of operational transparency. The interviewees proposed that there must be separate IB exclusive modus operandi to be implemented by the authorities in terms of policy and regulation to enhance the confidence of the general public at one end and ensure superior regulation of the IB sector on the other.

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Summary of Key Findings from interview Data Analysis

The following table provides the major findings based on the data analysis from conducting the interviews for the study from the two key stakeholder segments including regulators and Shariah scholars involved in the IB sector. The table is followed by the conclusion.

Table 2: Summary of Key Findings from Interview Data Analysis
Challenges Faced by Islamic Banking Sector in Pakistan

Subject/Theme	Findings
Understanding Awareness	<ul style="list-style-type: none"> • Almost all interviewees asserted that there is a great need to enhance understanding and awareness of the Islamic banking paradigm in the country. • There must be an all-out approach to disseminate Islamic banking knowledge and understanding among the general public by using all possible communication channels and media.
Conventional Banking System	<ul style="list-style-type: none"> • The conventional banking sector is perceived as the greatest challenge to the Islamic banking set up by a majority of the Shariah supervisors. • The size and share of interest-based conventional banks in the overall banking sector pose a major setback for Islamic banks and put Islamic banking entities in a survival race that eventually acts as a barrier toward a progressive and stable Islamic banking setup. • There is surely a need to somehow restrict and curtail the conventional banking sector to support the Islamic banking initiative in the long run.
Capacity Constraints	<ul style="list-style-type: none"> • The capacity issues at Islamic banks are multi-faceted and varied in nature and magnitude putting Islamic banks in a compromising position, especially in comparison to the conventional interest-based banks. • Major capacity limitations and issues include a dearth of qualified and trained staff, lack of competence of Shariah and managerial personnel, limited financial resources, and weak infrastructure.
Stakeholders' Engagement	<ul style="list-style-type: none"> • There is a certain necessity to engage stakeholders at all levels of society to ensure the uplift of the Islamic banking sector. • The approach must be to involve various segments of society including religious, business, public, and private sectors. • The efforts to improve Islamic banking awareness must be well coordinated and integrated targeting all levels of society by engaging various stakeholders from diverse walks of life including banking and non-banking business organizations, religious institutions, academia, social structures/setups, and the government sector.
Operational Obstacles	<ul style="list-style-type: none"> • Among other difficulties and predicaments, the interviewees also described some key obstacles faced by Islamic banks. • The points highlighted by the interview participants included the use of KIBOR as the benchmark rate; operational transparency of Islamic banking transactions; issues about Shariah compliance and Shariah spirit of IB transactions; and lack of a comprehensive, standardized, and uniform IB framework.
Regulatory and Governmental Support	<ul style="list-style-type: none"> • Regulatory institutions particularly SBP have played a positive role to further the cause of Islamic banking in the country. • There have been favorable progress and good steps taken by the SBP in promoting and strengthening the Islamic banking sector. • There is a need to enhance the level of regulatory and governmental support for the IB industry. • The government must step forward by enacting and introducing new laws as well as amend the existing ones to facilitate better regulation and to ensure the smooth functioning of the IB sector.

Conclusion

The analysis of Pakistan's IB initiative from its beginning to its current state of affairs shows that the Islamic banking setup in Pakistan had a long and difficult journey which had its share of constraints and achievements but as time passed, the IB sector progressed steadily. A breakthrough for the IB sector came in 2002 when the premier and very first fully-fledged Islamic bank was set up in the country which later paved way for stable industry growth. Furthermore, based on the responses of interview participants i.e. Shariah supervisors and SBP staff members, this may be concluded that sustainable success of the IB paradigm is only possible with the coordinated efforts involving all stakeholders including IB regulators, Shariah experts, customers, and bankers.

Moreover, the interviewees emphasized that to cope with the challenges and issues faced by the Islamic banking sector, there must be greater support from the government to facilitate the IB industry in comparison to the mighty conventional banking system and there must be dedicated efforts to raise understanding and awareness regarding Islamic banking products, offerings, and operations, to truly lift up and enable the IB sector to blossom and achieve its true potential. From the assessment of Pakistan's Islamic banking in the past two decades, as well as keeping in context, the recently launched supportive measures from the SBP, in shape of five-year Islamic banking plans, the prospects for the sector look promising.

The SBP plans to ensure a one-third market share for Islamic banking by the year 2025, but a well-integrated and coordinated approach from the concerned stakeholders would be needed to achieve the desired growth objectives.

Limitations and Future Research Directions

While this study provides valuable insights into the development and challenges of Islamic banking in Pakistan, it has some limitations. The study's scope is limited to Pakistan, and the findings may not be generalizable to other countries. Additionally, the study relies on interviews with Shariah supervisors and SBP staff, and future research could benefit from a more diverse range of perspectives, including customers and bankers.

Future research directions include:

- **Comparative studies:** Conducting comparative studies on Islamic banking in other countries to identify best practices and areas for improvement.
- **Customer perspectives:** Examining customer perceptions and experiences with Islamic banking products and services to better understand their needs and preferences.
- **Product development:** Investigating the development of new Islamic banking products and services that cater to the evolving needs of customers.
- **Regulatory framework:** Analyzing the regulatory framework for Islamic banking in Pakistan and identifying areas for improvement to enhance the sector's growth and stability.

By acknowledging the limitations and identifying areas for future research, this study contributes to the ongoing dialogue and development of Islamic banking in Pakistan and beyond.

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